AUDIT COMMITTEE INSTITUTE

Audit Committee Insights
2007 Annual Digest

KPMG INTERNATIONAL

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***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.

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As a result, it is essential for the audit committee to maintain a cooperative relationship with the CEO.

"It is always easy for a dominating CEO to make the rest of the organization fall into line," Medora says. "This can make the whole organization defensive about cooperation. With the help of the external auditor, and by maintaining good communications, the audit committee can avoid having this happen."

The board, on the other hand, should have its role in oversight clearly defined. In fact, all of the roles for all of the players—the board, audit committee and external auditor—should be precisely set out, so there is never confusion and conflict between the various players.

Medora believes that the relationship with the external auditor should also be carefully delineated.

"The independent auditor has to be thorough, but he should not attempt to exceed the boundaries of his role as it is determined by the organization's charter," Medora says. "The entire process of working with the external auditor should be clearly defined."

Article written by Andrew Rosenbaum, Contributing Editor, Audit Committee Insights*.*

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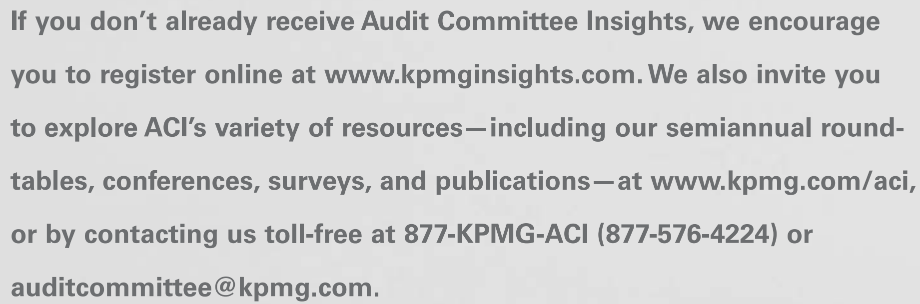

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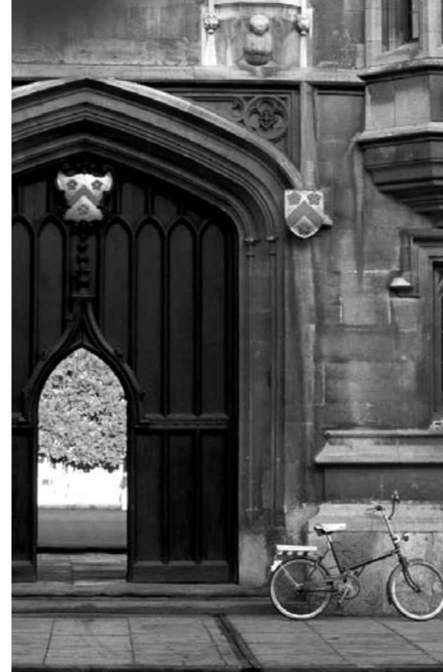

We've all seen it happen: Someone in the meeting asks a seemingly innocuous question that ends up turning the discussion—and sometimes a critical decision—180 degrees. The quality of the insights that audit committee members, directors, and senior management bring to boardroom discussions—however subtle those insights may be—can have a tremendous effect on the quality of the oversight process.

In our third year of publishing the electronic biweekly journal Audit Committee Insights—and our first year of Audit Committee Insights International—we continue to explore the critical factors underlying audit committee effectiveness. Our 2007 Audit Committee Insights Annual Digest offers a collection of Insights articles focused on issues and practices shaping audit committee agendas—from communication and coordination of oversight activities and responsibilities, to the consideration of financial reporting through an emerging "risk lens," to CFO-succession planning and audit committee orientation and ongoing education.

It is evident from readers' feedback—and by our growing readership of nearly 18,000—that Insights has come to play an important role in supporting the audit committee process. We consider our commentaries to be part of a continuous interactive dialogue among audit committee members, directors, management, auditors, and others with a role in financial reporting and "audit governance."

We hope you find this annual digest helpful in your efforts to support the audit committee and strengthen the financial reporting process. If these and other Insights articles trigger new thinking, prompt pivotal questions, or otherwise elevate the quality of the dialogue, then we're accomplishing our objective.

To learn more about Audit Committee Institute's variety of resources go to www.kpmg.com/aci, call 877-KPMG-ACI (877-576-4224), or e-mail auditcommittee@kpmg.com.

Edward F. Smith
Executive Director
KPMG's Audit Committee Institute

Audit Committee Insights articles are informed by insights and research from KPMG's Audit Committee Institute, and include analysis by KPMG professionals as well as commentary on leading practices from prominent audit committee chairs, directors, executives, and corporate governance observers.

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INFORMATION TECHNOLOGY

As Technology Committees Grow, Audit Committees Lend a Hand

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

As more companies use technology to operate their business and monitor their internal controls over financial reporting, boards and audit committees are realizing they need a clear oversight process for IT governance and risks.

A clear allocation and alignment of information technology (IT) oversight responsibilities is fast becoming everyone's worry as companies try to avoid the "train wreck waiting to happen," also known as bad IT governance, according to Richard L. Nolan, chair of the information technology committee and member of the compensation committee of software provider Novell.

As for IT risks that directly affect financial reporting, there are quite a few. In addition to those risks associated with automated internal controls over financial reporting, there is the consolidation of accounting systems following a merger or acquisition and business continuity and disaster plans that rely on computer and software backup for data centers.

"Audit committees have the responsibility for oversight of IT risks associated with financial reporting, including compliance and internal controls risks," says Kenneth Daly, executive director of KPMG's Audit Committee Institute.

"This oversight responsibility includes asking questions about how investment decisions are made, how IT strategy supports business strategy as well as the role of internal and external resources."

The end game is that boards and management want to avoid the inefficiencies that can cost a company millions of dollars or noncompliance with new corporate governance regulations. Boards should ensure against IT-based surprises, such as project overruns, the "ticking time bomb" computer legacy systems or lax IT internal controls, Nolan says.

An October 2006 Compliance Week analysis of 400 companies disclosing material weaknesses in internal control over financial reporting showed that 52 blamed their IT systems on the weakness.

According to the global market intelligence firm IDC of Framingham, Mass., U.S. companies invested $314 billion in technology in 2005. Another study by AMR Research, a Boston-based advisory firm, found that companies spent $9 billion on IT compliance costs alone in 2006. That same survey estimates total compliance spending to reach $28 billion this year.

"What has taken place in the last 20 years is that IT expenses have moved from 1 percent to 10 percent of the budget," says Nolan, who also is an emeritus business professor at Harvard Business School and a professor of management and organization at the University of Washington Business School.

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This focus has brought about the creation of board-level technology committees at some public companies and the expansion of those that have existed already at technology firms, Nolan says. He believes the implementation of the Sarbanes-Oxley Act of 2002 has put more of a focus on the technology committee.

The 2006 National Association of Corporate Directors Public Company Governance Survey reports that the number of companies with technology committees grew to 8.4 percent from 5 percent in 2005.

The growing focus on IT oversight does beg the question of just what constitutes IT governance.

According to the Information Systems Audit and Control Association (ISACA), "IT governance is a framework that supports the effective and efficient management of information resources, which can be people, funding and information."

ISACA states that the focus is on measuring and managing IT performance to ensure the risks and costs associated are appropriately controlled.

"When you look at IT risk, you should be looking at all business risks," says Norman Marks, vice president of internal audit for San Jose, Calif.-based software company Business Objects.

"I believe they [the audit committee] should be doing a lot of listening," says Marks. "Very few audit committees meet with the CIO. They usually talk to the CFO."

"On a periodic basis, the audit committee should be talking about IT with the CIO, talking about marketing issues with the marketing officer or talking to the general counsel about other risks," he says.

George Spafford, a principal consultant with Pepperweed Consulting, a Indianapolis-based IT management process improvement firm, believes there is one important question audit committees should ask management.

"I would like to see audit committees asking management why [they are using IT]," Spafford says. "Audit committees have to shift to asking the question, 'What are the controls?'"

As a follow-up, audit committees should be more concerned with asking management, internal audit and the CIO if the company is getting what was promised by the technology, he says.

"A clear allocation and alignment of information technology (IT) oversight responsibilities is fast becoming everyone's worry as companies try to avoid the 'train wreck waiting to happen,' also known as bad IT governance," Richard L. Nolan, chair of the information technology committee and member of the compensation committee of Novell.

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"IT governance is a framework that supports the effective and efficient management of information resources," according to ISACA.

"What's amazing is how very few organizations require business cases to show they are getting the benefits of what was promised," Spafford says.

One way audit committees can try to get the answer to that question is by collaborating with the technology committee or in some cases an IT governance committee. Nolan has first-hand knowledge of how the audit committee and the technology committee work together to provide clear oversight of IT governance and risks.

"There's a hand in glove relationship," he says about the relationship. "What you need on the audit committee is someone who understands all the different IT audit processes."

And a technology committee should have a person versed in IT audit as well, preferably a member of the audit committee, says Nolan.

In two cases where Nolan has been a director, he has seen audit committees that had knowledge of the IT audit process. "One was a CEO for an IT company and another was a CIO for a purchase management company," he says.

Nolan goes as far as to say that any IT oversight committee's relationship with the audit committee be very close "because IT issues can affect economic and regulatory matters such as S-O compliance." He even says the committee's charter should spell out its relationship to the audit group.

Borrowing a page out of the audit committee's play book, Nolan says a technology committee should have an IT expert similar to the aforementioned committee's financial expert.

"The IT expert must have not only a solid grounding in the firm's overall business needs but also a holistic view of the organization and its systems architecture," Nolan and Warren McFarlan, a Harvard Business School professor emeritus, wrote in a recent HBS article. "The expert must also thoroughly understand the underlying dynamics governing changes in technology and their potential to alter the business' economic outlook."

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INFORMATION TECHNOLOGY

IT Governance Is a Matter of Information Over Technology

IT risk has become one of audit committees' top oversight priorities, yet most audit committee members say they don't spend adequate time on the issue, a problem compounded by a tech "language barrier" between audit committee members and technology officers.

Results from KPMG's Audit Committee Institute (ACI) surveys released in February and March show that while most audit committee members say oversight of IT risk and IT governance is one of their top priorities for 2007, only 9 percent of them said they are "very satisfied" their committee devotes sufficient agenda time to it.

Why the dichotomy? Information technology is highly complex, and many audit committees lack IT expertise. Making the problem worse is that management tends to talk about technology rather than information.

"You need a good translator," said Alvaro Garcia-Tunon, senior vice president, CFO and secretary of Wilmerding, Pa.-based Wabtec, of the relationship between IT and audit committees. "Whether it's the CFO or CIO, you need someone to bridge the gap."

Garcia-Tunon spoke about audit committee oversight of IT at the ACI spring roundtable in Pittsburgh on May 22.

There's a lot at stake for companies in managing their information and technology. Companies are making huge IT investments—Boston-based advisory firm AMR Research estimates that U.S. companies spent $9 billion on IT in 2006 and will spend up to $28 billion in 2007—and information and IT are essential to virtually every aspect of business.

"[IT oversight] has nothing to do with the bits and bytes," Garcia-Tunon said. Instead, IT oversight is about where management is taking IT, how management is using technology to meet corporate goals, and how it is handling the company's information and related technology risks.

Information technology is highly complex, and many audit committees lack IT expertise.

Despite the complexity of information technology, IT oversight doesn't necessarily call for a lot of tech expertise on the part of the audit committee, Kevin Shearan, executive vice president and CIO of Pittsburgh-based Mellon Financial, said at the roundtable.

"The language question falls squarely on the back of the executives," he said. "They need to speak in business terms."

Jeremy Garvey, an attorney who is in charge of Pittsburgh law firm Buchanan Ingersoll & Rooney's securities/SEC practice, said at the roundtable that the IT translation and education responsibility starts with the CIO.

"The CIO should have someone who can [translate]," Garvey said. "Those experts are in high demand. As the environment changes, you need those people."

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"It is important that audit committees and boards consider how to best align their oversight responsibilities for IT governance," Scott Reed, KPMG partner in the New York office.

To address the language barrier issue, audit committees can focus management discussions on information, not only for financial reporting purposes, but information involved in managing every aspect of the enterprise, according to Scott Reed, a partner in KPMG's New York office, who moderated the Pittsburgh roundtable.

"There is a need to manage and oversee the risks to information reliability and security," Reed says. "A question for the audit committee is what is management doing to manage these risks, which are many. They include poor information quality, privacy and security, outsourcing and business continuity."

Shearan said one of his major tasks is simply to make committees aware of how his department mitigates IT risks.

"From a major investment perspective, [IT risk mitigation] is blurred by the jargon of technology," Shearan said. "My job is to frame that investment in terms of how important it is to the board. Very rarely do I have to get into the granular details when speaking to the board."

According to the ACI, audit committees' and boards' oversight of IT risks raises three questions:

- How is management ensuring the information is high quality?
- What is management doing to ensure the information is available around the clock, especially if there is a disruption?
- What is being done to protect against unauthorized access?

Generally, IT governance is the framework and processes through which a business measures and manages IT performance to ensure appropriate control of risks and costs.

So what is the role of the audit committee in IT governance?

"In the current oversight model, audit committees may be responsible for IT governance by default," Reed says. "Yet some audit committees may believe they lack the time and/or expertise to oversee all IT governance. It is important that audit committees and boards consider how to best align their oversight responsibilities for IT governance."

While the audit committee is responsible for financial reporting-related IT risk, Reed says that it is critical for the audit committee and the board to clarify who should be responsible for overseeing the non-financial reporting IT risks.

Some audit committee members believe audit committees can serve as a catalyst for doing that.

"My experience is that most boards have not stepped back and looked at who is responsible for IT oversight," John D. Collins, an audit committee member for several companies, including Surburban Propane Partners, said at the June 7 ACI roundtable in New York.

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FINANCIAL REPORTING

Will FIN 48 Bring Audit Committees and Tax Directors Together?

Tax risk management oversight has suddenly become an audit committee priority, thanks to a new accounting rule that establishes a threshold that must be met to recognize tax benefits of uncertain tax positions for financial reporting purposes.

Industry observers say that there needs to be a strong relationship between the tax director and the audit committee. And the new interpretation of the accounting for income taxes standard—Financial Accounting Standard Board (FASB) Interpretation No. 48, Accounting for Uncertain Tax Positions (FIN 48)—will test the effectiveness of the tax director-audit committee relationship.

"Tax is a little like a black box," says Sampriti Ganguli, practice manager of Tax Director Roundtable. "Outside the tax department, no one else knows the details of what's going on."

Financial Executive International (FEI) lists FIN 48 as the second-greatest challenge to finance departments and their boards for 2007, behind internal controls. In addition, the 2006 KPMG Global Tax Transformation Services Tax Department Survey found that 40 percent of respondents said tax risk assessment has increased as a priority, due to a highly compliance-oriented environment.

FIN 48 went into effect for companies with fiscal years starting after Dec. 15, 2006 and Jan. 1, 2007 for calendar-year companies. It establishes a threshold of "more likely than not" that must be met to recognize tax benefits of uncertain tax positions for financial reporting purposes.

FIN 48 also specifies new disclosure requirements with regard to unrecognized tax benefits. Additionally, it requires companies to identify and evaluate all tax positions, not just those arising after the effective date.

"Companies will have to identify the [tax] exposure, then determine whether it's more likely than not that they have to pay something, and then determine the proper amount," says Dennis R. Beresford, former FASB chairman and currently audit committee chair for Kimberly-Clark Corp. and Legg Mason.

These changes to the FASB standard will force audit committees to think differently about tax positions and reserves, Ganguli says.

"The audit committee should have some awareness of all the uncertain tax positions," she says. "They should ask what they are setting as reserves [to pay those future taxes] and how the tax director came to those tax positions."

According to Beresford, the reason FASB looked at its original standard on accounting of uncertain tax positions was that the Securities and Exchange Commission discovered that several companies had been "too safe" in their tax positions and were building up reserves they may need to pay future taxes.

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"With FASB's new approach, you have to assume [the income tax return] will be audited," says Beresford, who is also an accounting professor at Terry College of Business at the University of Georgia.

The American Institute of Certified Public Accountants (AICPA) calls for financial statement preparers to consult outside auditors and tax advisers to coordinate the FIN 48 analysis with the company's tax department.

Companies that have started the FIN 48 process say that it has increased the work burden on both the tax and finance groups.

"The big problem some companies are facing is that they have to do an inventory of all tax returns that are auditable," Beresford says, adding that could include going back as far as 10 years, depending on the taxing jurisdiction.

FEI lists FIN 48 as the second-greatest challenge to finance departments and their boards for 2007, behind internal controls.

In addition to taking an inventory, Beresford believes companies need a plan for disclosing uncertain tax positions in financial statements.

"They have to determine if the company has appropriate disclosure for the end of 2006 [financial statements] and proper accounting for the first quarter of 2007," he says. "They should ask, 'Will it be a huge hit on earnings or a pickup in earnings?'"

FIN 48 can be an opportunity for audit committees and tax directors to collaborate more on the oversight of tax risk management strategies.

"FIN 48 is causing many audit committees to have conversations with their tax directors and focus on tax risks more generally," says Steven K. Rainey, a tax partner with KPMG.

"Going forward as a result of FIN 48, we will see more interaction between tax directors and audit committees on tax risk management issues affecting their companies," Rainey says.

For audit committees, the upshot to FIN 48 enforcement is that they will have to change how they coordinate with tax departments. Tax Director Roundtable's Ganguli says one key is that the two entities must get to know each other.

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"There is a failure to communicate," Ganguli says about the audit committee-tax director relationship. "What we see is a reluctance to give information to the audit committee."

In part, that reluctance may explain why 70 percent of respondents in the KPMG Tax Director Survey said their companies did not have a formal tax risk management policy, compared to 72 percent in 2005.

"If nothing else, [audit committees] want to know what their companies' tax risk management strategies are," Beresford says. "The number-one issue for audit committees is how aggressive a company is [tax-wise] and what tax positions they are taking."

According to a Tax Director Roundtable survey, 51 percent of corporate tax chiefs said they rarely or never report to the audit committee, while 36 percent said they did so on an annual basis.

"We had some focus groups recently with audit committee members," KPMG's Rainey says. "Many of them thought they had a handle on their companies' risk management profile. But they told us that when they talked to management, it was only the CFO they were talking to. And they found many of them only talked in general terms."

Rainey suggests that audit committees may want to hear from the tax director for particulars on tax risk management so they can see management's perspective of the risk profile.

It seems that one of the most effective ways for tax directors to communicate those strategies is to meet more frequently with the audit committee, according to Ganguli, whose organization includes members from 450 global corporations.

"From our perspective, the gold standard would be to meet quarterly," she says. "Our observation is that due to the nature of the issues, quarterly meetings are desired."

She also believes the meetings should be more interactive. "Now they are just progress reports," Ganguli says. "I feel that decisions are made by the head of tax, which is why you hire that person. However, given the overall climate to risk [awareness], it behooves the audit committee to understand their company's tax risks and have a more engaging conversation."

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

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Companies that have started the FIN 48 process say that it has increased the work burden on both the tax and finance groups.

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FINANCIAL REPORTING

Audit Committees Called Upon to Facilitate Internal Control Assessment Changes

As the SEC fine-tunes guidance for management and the PCAOB proposes a new standard for external audit of internal controls, audit committees may want to fine-tune their "facilitating" skills as well.

Realizing the intended benefits of these proposals—a more efficient and cost-effective evaluation of internal controls—may come down to how well management and auditors coordinate their work. [The SEC posted its management guidance regarding Section 404 of Sarbanes-Oxley on June 20. The SEC approved the PCAOB's new Audit Standard No. 5 on July 25.]

Before they begin planning for the 2007 year-end audit, audit committees will be called upon to ensure that management and external auditors understand regulators' expectations. In an open meeting on April 4, Securities and Exchange Commission (SEC) Chairman Christopher Cox told Commission staff members he wants the rules in place by June.

For management, there is proposed SEC guidance on management's report on internal control over financial reporting under Sarbanes-Oxley's (S-O) Section 404. For independent auditors, there are the proposed Public Company Accounting Oversight Board (PCAOB) standards on audits of internal control over financial reporting integrated with a financial statement audit, as well as auditors' considering and using the work of others in an audit.

"I don't see the process and the relationship changing," says Barbara H. Franklin, audit committee chair of Dow Chemical and biotech firms MedImmune and GenVec. "I don't see audit committees wholesale doing anything different. [However], I see some re-thinking going on.

"What the audit committees are doing is being cognizant of the changes being considered. They are going to go to the auditor and to management and ask them, 'What are you doing about this?'"

Justin Klimko, an attorney in the Detroit office of law firm Butzel Long, believes audit committees should be taking action now, and not waiting until the SEC and PCAOB issue final rulings.

"Audit committees should be worried about what management is doing and whether or not it harmonizes with the auditor," Klimko says. The concern has been that management relied almost exclusively on an auditing standard to determine the nature, timing and amount of work they would do in making their assessment of their system of internal control, he says.

In a recent Audit Committee Alert briefing, KPMG's Audit Committee Institute (ACI) points out issues audit committees should consider focusing on when they are speaking to management and external auditors about the SEC and PCAOB proposals.

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Audit committees and boards should begin to consider management's plan for scaling its internal control assessments and its potential impact on the level of the external audit effort, according to ACI. Directors should also consider how management and the external auditor plan to communicate and coordinate their activities in light of the proposed changes. Another key consideration: how management and the external auditor anticipate exercising judgment in making risk assessments and the extent to which management's work might be leveraged to support the auditor's work.

The SEC proposed guidance to management, which was released in December 2006, encourages management to use a "top-down, risk-based" approach in evaluating the effectiveness of internal control over financial reporting. The guidance also calls for management to design an evaluation of internal controls that is tailored to its company's "individual circumstances."

Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, says that while he is not quite clear what the SEC means by a "top-down, risk-based approach," he is confident that risk awareness is important to the process.

"You have to create a culture where everyone takes risks seriously," says Elson, who is also a director with AutoZone, Alderwoods Group and HealthSouth.

If companies don't create such a culture, the guidance will just be a lot of jargon. "The point is you have to emphasize a culture of risk awareness and transparency," Elson says.

The SEC guidance also encourages "frequent and frank dialogue among management, auditors, and audit committees."

The PCAOB, meanwhile, is proposing a standard to replace the existing one for an audit of internal control over financial reporting when done in conjunction with a financial statement audit. It is also considering a new standard for auditors using the work of others in an audit.

In its proposed standard, known as "AS-5," the PCAOB directs auditors to focus on the matters most important in determining whether the system of internal controls over financial reporting can detect and prevent a material misstatement to the financial statements.

Like the proposed SEC guidance, the proposed PCAOB standard specifies the auditor use a top-down approach to identify which controls to test. In such a process, auditors would start with financial statements and company-level controls, and link them to "significant accounts, relevant assertions, and, finally, to the significant processes where other important controls reside."

"I don't see audit committees wholesale doing anything different. [However], I see some re-thinking going on," Barbara H. Franklin, audit committee chair of Dow Chemical, MedImmune and GenVec.

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The proposed PCAOB standard specifies the auditor use a top-down approach to identify which controls to test.

In its comment letter to the PCAOB, KPMG stated it supports enhancements to its auditing standards that increase the use of professional judgment, the ability to use knowledge obtained during prior audits, the elimination of the requirement to evaluate management's assessment process and the increased use of the work of others, assuming certain conditions are met.

As for the proposed standard on the use of the work of others—management, internal audit, or third parties—the extent of their work, objectivity and competency is an issue, according to comment letter-writers. KPMG, in its comment letter on the proposed PCAOB standards, suggests that the proposed standard should not supersede the existing American Institute of Certified Public Accountants (AICPA) standard on the consideration of internal audit in the financial statement audit.

"We believe that [the existing standard for using the work of others], combined with the changes outlined in the Board's [PCAOB] proposed standard on an audit of internal control over financial reporting, introduces the flexibility necessary to expand use of the work of others by auditors in an appropriate and responsible manner," the KPMG letter states.

KPMG also pointed out the importance of documentation in the internal control assessment process.

"Clearly, the auditors' ability to use the work of management improves as the quality of documentation of internal control design and management's assessment and evaluation increases," the firm stated.

In an April 4 meeting, the SEC instructed its staffers to work closely with the PCAOB to finalize the guidance and proposed standards so that they are better aligned with S-O Section 404. It also charged the staff with making the proposed PCAOB standard less prescriptive and more principles-based.

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FINANCIAL REPORTING

Audit Committees Good Partner for CD&A Oversight

Compensation committees this proxy season are tapping audit committees to help oversee management's compliance with the Securities and Exchange Commission's new executive compensation disclosure rules.

The SEC's new rules, effective for fiscal years ending on or after Dec. 15, 2006, completely revamp executive compensation disclosure requirements. The rules are intended to provide a clearer and more complete picture of the total compensation paid to the company's principal executive officer, principal financial officer, and the three other highest-paid executive officers and company directors.

The centerpiece of the SEC's rules is the new Compensation Discussion and Analysis (CD&A), which is designed to be a "plain English" discussion of the data in the expanded compensation tables. The CD&A is required to discuss the material factors underlying the company's executive compensation policies and decisions, and to provide context for the compensation information in the tables.

Many compensation committee members now realize just how valuable the audit committee can be in overseeing compliance with these new disclosure requirements.

"Right now, we're in the middle of the CD&A," says David Merritt, who serves on power producer Calpine's audit committee and is the chairman of cable provider Charter Communications' audit committee as well as a member of its compensation committee. "We're at the front of the process and management has met with counsel."

Terry Christenberry, who serves on the audit and compensation committees for the publicly traded flatbed trucking carrier Smithway Motor Xpress and the private Wilbert Funeral Services, doesn't view the new disclosures as a significant problem.

"In the public company, I do not believe we will be concerned about the filing nor will the differences be substantial or worrisome," Christenberry says about the difference between the old compensation committee report and the new CD&A. "Our compensation policy there is pretty simple and transparent."

For other companies, CD&A preparation is a significant undertaking, requiring input from such departments as human resources, accounting, tax and legal. Compensation committees are required by the SEC to write a report disclosing whether they have reviewed and discussed the CD&A with management, and whether they have recommended its inclusion in the company's annual report.

The CD&A is required to discuss the material factors underlying the company's executive compensation policies and decisions.

An important difference between the CD&A and the compensation committee report is that the CD&A is "filed" with the SEC and therefore covered by the CEO and CFO certifications of the Form 10-K. The compensation committee report is "furnished," and not covered by the officer certifications.

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While the audit committee does not review or set executive compensation policy, it can play an important oversight role in the CD&A process. Its communication with the compensation committee is key, especially since audit committees have already been through a similar process in connection with the MD&A, says Catherine Dixon, a partner with the New York City-based law firm Weil Gotshal and Manges.

The MD&A, which provides a narrative disclosure of the company's financial position and results, focusing on risks, trends and key events, can serve as a model. And the process for preparing the MD&A, including the involvement of management's disclosure committee, can serve as a platform for the CD&A process.

While the audit committee does not review or set executive compensation policy, it can play an important oversight role in the CD&A process.

"The audit committee has already invented that wheel," says Dixon, who was a former chief counsel of the SEC's Division of Corporate Finance.

According to Caryn Bocchino, senior manager of KPMG's Audit Committee Institute (ACI), "Audit committees can confirm with management's disclosure committee that the company's disclosure controls and procedures have been revised to address the new executive compensation disclosure requirements, and that internal processes are in place to identify and collect complete information regarding executive compensation."

The audit committee can also discuss with auditors their review of the CD&A disclosures and related controls and procedures, she says.

Dixon expects the CD&A rules to take the same path as the MD&A disclosure requirements that were established in 1980. There, the SEC issued interpretive guidance over the years to refine MD&A disclosure rules, and Dixon expects a similar scenario to play out based on comments by SEC Chairman Christopher Cox and SEC Corporate Finance Director John White, as well as others.

One of the key issues being debated is the meaning of "plain English."

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"We'll probably see [developments] in the late fall," Dixon says. "We just don't know what they mean by plain English."

In a February speech to an attorney group, White said the SEC staff will review a "critical mass" of the new disclosures, and issue a report on its observations about the adequacy of the disclosures. According to White, these targeted reviews could result in further "rulemaking refinements for the next proxy season."

Chairman Cox and the debt rating agency Moody's Investors Service are also concerned about the lack of plain English in the early CD&As that have been filed.

Moody's, which on April 17 issued its own guide to the SEC's new executive pay rules, is "concerned that the additional legal burden attributed to the CD&A will encourage companies to veer towards legalese and boilerplate disclosures."

"It's clear that many companies are letting lawyers have the final say on the CD&A," according to Moody's.

Cox, in a March 23 speech, said he was "disappointed with the lack of clarity in much of the narrative disclosure that's been filed with the SEC so far." And he warned the SEC may be soon looking to various models "to judge the level of compliance with plain English rules." The chairman noted that the median length for CD&As was 5,472 words, or 1,000 words more than the U.S. Constitution.

With the continuing focus on "plain English" in the CD&A, audit committees have an opportunity to apply some of the "lessons learned" from the MD&A process.

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

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Moody's is "concerned that the additional legal burden attributed to the CD&A will encourage companies to veer towards legalese and boilerplate disclosures."

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RISK MANAGEMENT

Audit Committee Risk Reports Take Center Stage in Risk Management Oversight

Risk management tools such as “heat maps” and dashboards as well as risk reports and matrices can give the audit committee a clear picture of the company’s risks—which, in turn, can help audit committees members in their oversight over risk management.

At present, some risk management reporting is “wimpy,” said Kenneth Daly, executive director of KPMG’s Audit Committee Institute (ACI), at the recent Corporate Board Member magazine’s Boardroom Summit in New York City. “There’s a lot [of tools] that can be [used] to make those reports robust.”

Heat maps and dashboards are computer desktop applications (or printed reports) that give directors a quick view of financial and competitive information. Management and audit committees use this information in developing risk reports and risk matrices.

Daly says what’s important is how audit committees use such information, especially when considering the adequacy of the company’s internal controls, and the audit plans of both the internal and external auditors. The risk matrix is an essential part of that process.

Mary K. Bush, audit committee chair at MGIC Investment Corp., said at the Boardroom Summit, that the risk matrix has become an important tool for the audit committee. At one of the companies where she is an audit committee member, the chief of internal audit has taken charge of the process.

“He’s putting together a risk matrix of who is responsible for what,” she said, “and we [on] the audit committee use [it] as a tool.”

A matrix is a grid that identifies a company’s significant risks and the status of management’s mitigation efforts. It allows audit committees, management and the external and internal auditors to view risk across an entire organization. Companies often come up with their own approaches, sometimes using outside consultants to help facilitate and vet the process.

Several people at the Boardroom Summit pointed out that the risk matrix can be a starting point for management and audit committees to ensure risk management efforts are properly coordinated.

Microsoft Corp.’s audit committee Chair Charles H. Noski, who was also at the Boardroom Summit, said that risk matrices give shape to the risk assessment process.

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"You need to listen to the outside auditor's risk assessment and listen to what the risk scope is," Noski said. "You should ask your companies to map their [anticipated] risks vs. what they actually are.

"You should see if the internal auditor and the external auditor are looking at the same thing. I [personally] have seen a disconnect here."

"[The chief of internal audit] is putting together a risk matrix of who is responsible for what, and we [on] the audit committee use [it] as a tool," Mary K. Bush, audit committee chair of MGIC Investment Corp.

Noski added that to ensure the risk management report results in effective oversight, there needs to be a means for the audit committee to evaluate management's progress in risk management, and communicate that progress to the board.

According to the ACI's Daly, an important part of the vetting process is that the audit committee help ensure that internal and external audit plans properly focus on internal controls associated with the potentially significant financial reporting risks and those business risks that could become financial reporting risks.

"The audit committee should review the audit plan and see what risk areas are addressed," he said. "They [audit committee members] should compare the plan with the significant risks identified by management."

Daly suggests the overall audit plan (developed by both internal and external auditors), which spells out the nature, timing and extent of a company's audit, map out how audit responsibilities are divided between the external and internal auditors. Daly also says the audit committee should ensure proper coordination of the audit plans of the external and internal auditors.

He recommends a list of questions for audit committees that can be used for assessment. They include:

Have management and internal and external auditors communicated their process for identifying and ranking the financial and non-financial reporting risks they believe may have a financial impact?

Have they identified the same risks that management identified, and explained differences?

Have they focused their audit plans on key risks, and shown the audit procedures are appropriate to address these risks?

Have they communicated the design and performance of audit procedures (including their nature, timing and extent)?

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RISK MANAGEMENT

Audit Committee's Focus on Risk Management Changing Internal Audit Function

With Section 404 compliance no longer consuming such a large portion of internal audit's resources, some audit committees are asking their internal audit departments to expand their responsibilities beyond financial audits and 404 to include risk management as well.

"As audit committees are focusing more on risk management, many are calling on their internal audit departments to provide periodic assessments of the company's risk management processes and the adequacy of the company's controls for its risks," says Caryn Bocchino, a senior manager of KPMG's Audit Committee Institute (ACI).

However, some audit committees believe their internal audit departments should not take on significant additional responsibilities for risk management. Instead, they say internal audit should remain focused on financial audits and internal controls.

Internal auditors have a number of tools at their disposal, including financial and forensic audits, risk assessments and operational audits that can help audit committees most in their oversight of risk management.

"Management should be telling the audit committee, 'Here are our controls for our top three risks,'" David Richards, president of the Institute of Internal Auditors (IIA), said at the ACI's Audit Committee Issues Conference in January.

Typically, management is asked to describe how effectively risks are being mitigated, Richards said. Then, the audit committee turns to the internal auditor to ask if those controls are working.

In a survey conducted by ACI at its annual Issues Conference in Miami and Phoenix, nearly 160 audit committee members identified risk management oversight as their highest priority for 2007. At last year's conference, they identified it as their second-highest priority.

In addition, 72 percent of people surveyed said their audit committee relied on internal audit to support committees' oversight of risk management.

During a Webcast held by the IIA and The Value Alliance and Corporate Governance Alliance, Richards described how operational audits—an evaluation of the effectiveness and efficiency of a particular business unit in relation to the overall company policies and budgets—can assist an organization in understanding core strengths and weaknesses.

This understanding is critical in determining corporate strategies and the risks associated with them. "It's a process review," Richards said. "It adds a real value to the organization because it helps that organization figure out how things get done vs. the stated goals and objectives of that process."

A survey of participants in the Webcast found that 55 percent used operational audits to "inform strategic conversations about the core competencies or strengths and weaknesses" of the company.

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Operational audits can help audit committees obtain a bigger and clearer picture of their companies' risk portfolio.

James C. Key, an audit committee member of Coastal Banking in South Carolina and principal of consulting firm Shenandoah Group in Beaufort, S.C., believes through operational audits, internal audit departments can focus on assurance responsibilities as well as compliance duties.

"Internal audit should be looking at the near-misses in the newspapers," Key says. "Those are the risks that others are looking at."

James T. Brady, who chairs the audit committees for Constellation Energy Group, McCormick & Co., T. Rowe Price and NexCen Brands, says the collaborative nature of the relationship between the audit committee and the internal audit department makes it a natural to help initiate the risk management oversight process.

"The audit committee can be a catalyst to see that a full risk management inventory is done," Brady said. "Some risks would go to the compensation committee or the risk committee."

Shenandoah Group's Key notes that a major part of the audit committee's role as catalyst is its relationship with the internal auditor, especially in regards to risk management oversight.

"The chief audit executive should use his position and power to have a [risk management] discussion at least annually with the audit committee," Key says. "This way the audit committee can say, 'we have it covered,' or 'we didn't know about that.'"

Eleanor Bloxham, CEO of The Value Alliance and Corporate Governance Alliance, stressed that the internal audit department needs to understand what risk management information the audit committee wants.

"One of the starting places for the audit committee is to be clear about what information they want," Bloxham said during the IIA Webcast. "By clarifying that, it moves the audit committee into a position where they can bridge the internal control disclosure gap."

As internal audit focuses more on operational audits and risk management, audit committees need to review the internal audit's mission and responsibilities and ensure that they are consistent with the charter, Bocchino said.

"As audit committees rely more and more on internal audit to support the committee's oversight activities in areas such as risk and compliance," she said, "it's also important they take a close look at internal audit's resources and ensure that the department's resources are properly aligned with its responsibilities."

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INTERNAL AUDIT

Audit Committee's Key to Internal Audit's Heart Is Independence, Objectivity

A dramatic change shifting internal audit's reporting relationship directly to the audit committee instead of company management is making many chief audit executives tense about maintaining the independence and objectivity of the internal auditor.

Since 2002, when the Sarbanes-Oxley Act (S-O) assigned direct responsibility for oversight of external auditors to audit committees, many industry observers have suggested a similar reporting relationship for internal auditors. They call for the chief audit executive to report functionally to the audit committee and administratively to either the CEO or the CFO.

"We think the audit committee should feel that it is in control of the internal audit function," says Mark Watson, senior vice president of corporate governance analysis at Moody's Investors Service. "As internal audit puts its audit plan together, its first line of reporting should be to the audit committee chair."

Watson, who was the author of Moody's recent report "Best Practices in Audit Committee Oversight of Internal Audit," stresses how important it is that the audit committee make sure an internal audit team is independent, empowered and sufficiently staffed to deal with all matters, including the S-O Section 404 internal control reporting.

The report is part of a series the rating agency is writing to describe how it evaluates the quality of corporate governance within rated corporate debt issuers.

Ensuring internal auditor independence is one of five best practices Moody's advocates audit committees employ in their oversight of internal audit. The rating agency also says audit committees should ensure an audit plan is sufficiently broad in scope and executed in a timely manner, ensure audit reports are actionable and implemented, promote effective committee functioning and sufficient expert staffing as well as promote an open relationship with audit professionals.

The Institute of Internal Auditors (IIA) in its Standards for the Professional Practice of Internal Auditing recommends the chief audit executive "report to a level within the organization that allows the internal audit activity to fulfill its responsibilities." However, the practice advisory for that same standard recommends the CAE "report functionally to the audit committee… For administrative purposes, in most circumstances, the chief audit executive should report to the CEO of the organization."

In its audit committee toolkit, the American Institute of Certified Public Accountants (AICPA) calls for a solid-line reporting relationship between the chief audit executive and the audit committee with a dotted-line relationship to a senior executive. Also, the AICPA emphasizes the audit committee should be consulted before the internal auditor can be hired, fired or reassigned.

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The 2005–2006 KPMG Audit Committee Institute Public Company Audit Committee Member Survey reports 74 percent of those audit committee members surveyed said the audit committee or the full board had the ultimate authority to hire or fire the chief audit executive.

Many observers suggest the internal auditor should report to both the audit committee and the CFO, or in some cases to the CEO. But they aren't sure about what the proper roles are for the audit committee and the CFO. For example, who is responsible for the review and approval of the internal auditor's audit plan, budget and resources? And who should be responsible for the significant decisions regarding the internal audit function?

Kenneth Daly, executive director of KPMG's Audit Committee Institute, says the answer may be both the audit committee and the CFO, or CEO. It's actually more of a situation where the CFO seeks the advise and consent of the audit committee when he or she is making decisions about the internal auditor.

"The CFO is generally in a good position to review the internal auditor's audit plans, budget and resources, to consider appropriate compensation and to make recommendations about hiring and terminating the internal auditor," Daly says. "However, in all those decisions the CFO should make recommendations and consult with the audit committee."

Daly does point out there is an exception to the advise and consent model. "Neither the CFO nor any other manager should filter internal audit's findings and reports before they are presented to the audit committee," he says.

Watson says Moody's is only satisfied with the advise and consent model so long as it gives audit committees more direct control over internal audit.

"The hands-off approach didn't work three years ago," he says referring to a spate of accounting scandals. "Personally, I'm going for having internal audit speak to a director every time."

For instance, he points out that the audit committee should feel that if it wants to look at a company's travel and expense budget it should be able to ask the internal auditor for that information whenever it wants.

Diane Murray, the internal audit director for Bridgehampton National Bank in Bridgehampton, N.Y., says her company subscribes to the advise and consent model on everything from her performance review to compliance issues.

"The CFO will handle the formal [performance review] process, which includes getting input from the audit committee or whomever I'm in contact with," Murray says.

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In her case, the small size of her bank and its audit committee allows her to call an impromptu meeting at a minute's notice on issues that come up because two of the members live only five minutes from the main branch. She then gets the other member on the phone and holds the meeting in her office.

Such an intimate relationship may not be possible at much bigger companies where it isn't logistically possible. But the idea behind including audit committee members on sensitive matters goes a long way toward protecting internal audit's independence and empowerment, Moody's says.

"We believe audit professionals feel more accountable to the audit committee and, as a result, more independent within the organization," Watson wrote in the Moody's report.

Many observers suggest the internal auditor should report to both the audit committee and the CFO, or in some cases to the CEO.

Moody's suggests audit committees do the following to ensure independence of internal audit:

- Have a significant role in setting and approving the audit function's staffing and budget.
- Have periodic benchmarking of the audit function with peers by using both external auditors and other outside resources.
- Make sure internal audit is clear about its role in operational risk and pre-implementation control development matters.

Internal audit's independence and objectivity plays a big part in the freedom that person has in reporting sensitive matters to the audit committee.

"The internal auditor should report directly to the audit committee any concerns regarding sensitive matters, including issues involving senior management," Daly says.

As an accountant for 14 years, Bridgehampton Bank's Murray believes upholding the ethics and values associated with a CPA license gives her an incentive to be independent and objective as an internal auditor.

"You need to ensure there's a verbal and written dialogue between the internal auditor and the audit committee," she says. "At all times, remembering how important it is to be independent."

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INTERNAL AUDIT

Greater Reliance on Internal Audit Means More Oversight for Audit Committee

The increasing stature of internal audit—and the audit committee's growing reliance on it—has placed greater focus on the audit committee's oversight responsibility for the internal audit function.

There is some evidence that relationship between audit committees and internal audit could improve. According to the KPMG's Audit Committee Institute (ACI)/National Association of Corporate Directors survey, although 46 percent of audit committee members say they are "very satisfied" with the effectiveness of the internal audit function, most are only "somewhat satisfied" or see opportunities for improvement.

So what are audit committees doing to enhance internal audit's value and effectiveness?

"With so many demands on internal audit, including responsibilities in connection with Sarbanes-Oxley Section 404, compliance and risk management, many audit committees are taking a close look at internal audit's workload and considering whether it has adequate resources," says Caryn Bocchino, a senior manager with ACI.

"They're also considering whether some of the responsibilities recently assumed by internal audit are appropriate for the longer term," Bocchino says.

According to an ACI survey conducted at its annual Audit Committee Issues Conference this year, audit committee members indicated they are concerned with the issue. When asked, "How satisfied are you that your company's internal audit function has adequate resources (budget and people with the training, skills, education, and knowledge of the company) to carry out its responsibilities," only 28 percent of audit members said they were "very satisfied."

For some audit committee chairs, internal audit planning is an important time to assess the adequacy of internal audit's resources, as well as its overall effectiveness and efficiency.

And the planning process is also an opportunity for the audit committee to set expectations for the internal auditor, according to C.H. Moore, audit committee chair for Perot Systems and an audit committee member for NL Industries.

On the boards Moore serves, one company has a stand-alone internal audit department, while two companies outsource the internal audit function.

"If it appears that the train is going off the track, revisit the plan, understand why expectations are not being met and make the necessary changes," Moore says.

"Should internal audit become involved in too many special projects, either for management or the audit committee, then more of the compulsory work must be outsourced to third-party firms," he says.

Michael Nolan, KPMG's partner in charge of internal audit services, is seeing more companies use third-party providers to support internal audit.

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"For some companies, it is an efficient and effective solution to help internal audit departments deal with the enhanced focus on regulatory compliance, risk management, operational controls and improved internal controls over financial reporting," he says.

In addition to the adequacy of resources, a key to internal audit effectiveness is the auditor's independence. According to the ACI/NACD survey, 22 percent of audit committee members were only "somewhat confident" that the company's chief audit executive would report controversial issues involving senior management to the audit committee.

"The challenge for audit committees is to establish a relationship with the internal auditor that encourages open and candid communications, and helps ensure the auditor's independence," Bocchino says. "The direct reporting relationship between the audit committee and the internal auditor is important, but the communications between the two is critical."

Audit committees find that communication doesn't just take place during formal meetings.

"I have found it helpful to speak to the internal audit group, review their qualifications and get to know them outside of regularly scheduled meetings," says Perot Systems' Moore.

Regular, informal communications between the audit committee chair and the internal auditor not only help build trust, but are important in clarifying audit committee expectations. For instance, what role should the internal auditor play in helping to establish the audit committee's agenda and, more generally, serving as a resource for the audit committee?

Stephen M. Sawyer, a senior vice president and chief audit executive for Columbus, Ga.-based financial services holding company Synovus, thinks of his department as more of a "coordinator of information" than a resource.

"From a resource perspective, I'm not the only resource the audit committee chair has," Sawyer says. "There are [also] the chief accounting officer and the chief financial officer.

For some audit committee chairs, internal audit planning is an important time to assess the adequacy of internal audit's resources.

"If there are questions regarding the 10-Q, [the CAO and CFO] are along for that dialogue with the audit committee chair, as is the general counsel. I am just [copied] on those discussions."

However, Sawyer says it is not uncommon to follow up on issues that arise in dialogue between management and the audit committee.

"If questions arise, we will get the right people to talk to them," he says. "Like with FIN 48 [FASB Interpretation 48 on accounting for uncertain tax positions], which was a very big issue earlier this year. So the tax people were brought in."

Many internal auditors work directly with the audit committee in performing governance audits and special projects, as well as providing input on the audit committee agenda.

"It is important for internal audit to have some face time with our boards so all directors appreciate the importance of internal audit to our companies," Moore says.

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OTHER RESPONSIBILITIES

Audit Committees Might Want to Check With Company Lawyers About 'E-Discovery' Readiness

An electronic discovery demand from a plaintiff's attorney has proven to be a major cost and headache for many companies—and it may be even more burdensome in the future.

E-discovery has become a significant issue for attorneys and IT departments at many companies —as well as for audit committees, who are often responsible for oversight of the company's compliance activities. And the effectiveness of a company's e-discovery processes, including its document retention policy, is about to be severely tested this year, as discovery rules are set to change.

The U.S. Supreme Court recently approved amendments to the Federal Rules of Civil Procedure, concerning "electronically stored information," which will take effect Dec. 1. Among other changes, the amendments require that, before discovery begins, the parties to a lawsuit discuss electronic discovery requirements and agree on a procedure or protocol to govern the process.

The need for such an early discussion and agreement on the preservation and production of electronically stored information means company attorneys and IT departments must understand beforehand just what their electronic information capabilities are.

"Companies and their lawyers will have to understand where their information and records are," says Lori Ann Wagner, a partner with the law firm Redgrave Daley Ragan & Wagner LLP of Minneapolis, "and what costs and burdens are associated with the production of those information sources that are not readily accessible."

Wagner also stresses the importance of understanding the company's information system processes that drive and control the preservation of electronic files as well as how that information will be presented to the opposing attorneys.

That is an integral part of the discovery of digital documents for court proceedings. It is a four-step process that includes preservation, the paring down of the "discovered" documents and the production of the documents for the attorneys.

"Many companies are re-evaluating both their information and records management programs and their discovery processes to determine whether they will be able to meet the challenges posed by these new rules," Wagner says.

As part of this effort, companies are taking a fresh look at their document retention policies. According to a study done last year by Cohasset Associates, 46 percent of organizations surveyed did not include electronic records in their retention policies and did not have an electronic record storage process in place. The survey also found 62 percent were not confident their document retention policy was legally defensible.

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E-discovery has become a significant issue for attorneys and IT departments at many companies—as well as for audit committees.

Cornell University audit committee Chairman John E. Alexander stresses the importance of making sure a company's document retention policy is regularly followed, and that management understands and appreciates the potential consequences if the policy is not followed.

"A good record retention policy should mirror state and federal requirements for retention," says Alexander, who is also CEO of CBORD Group Inc. He also advises that the policy be reviewed at least annually to ensure compliance with any changes in state and federal requirements.

Laurel Sutcliffe, a director in KPMG's Forensic Technology Services, has seen a wide range of document retention policies, many of which have not been updated in years.

"I've seen document retention policies that make no mention of electronically stored information," Sutcliffe says. On the other hand she recalls one company that had no formal policy, and the IT department simply had a practice of collecting old hard drives and back-up tapes.

In addition to a document retention policy, a company also needs a process to identify and efficiently retrieve electronically stored documents, e-mails and other files that may be responsive to an investigation.

According to San Francisco-based KPMG Forensic℠ partner Les Hand, "If you are performing an electronic discovery, it is important to properly plan the process before starting. An inappropriate search term list can result in a much higher false positive hit rate that can cost lots of money in reviewer time not to mention inordinate delays in completing the investigation."

"You'll want to avoid some pitfalls, such as the heavier the coding matrix [for the data] is for reviewers, the more time it will take. If you have to search a terabyte of data using broad search terms, your keyword search could generate millions of hits. The attorneys, IT personnel and perhaps a forensic specialist need to work together to define the scope and responsiveness of the search."

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If they don't do their job efficiently, the cost and expense of retrieving electronically stored data can increase dramatically. Hand recalls one company having to pay out nearly $30 million for an investigation, where a significant amount of the costs was due to e-discovery and the related review of the search term hits.

One way to avoid these pitfalls, Hand says, is for an appropriate groupto stress-test the search terms used to generate responsive documents.

And some, like Jim Butterworth, manager of professional services in the Southwest for Pasadena, Calif.-based Guidance Software, believe it makes sense to create an in-house forensic team to oversee the process for handling e-discovery demands. The team would include executives, line of business partners, legal counsel, certified computer forensic examiners, technicians and testers.

"The process for preserving, collecting, processing and producing both electronic and paper files should be reliable, repeatable and defensible in order to reduce costs and prevent risk," says Wagner of Redgrave Daley Ragan & Wagner.

"Case law tells us that the responsibility for information and records management and systems that ensure the relevant materials are preserved and produced falls on the shoulders of senior management and the company's lawyers," she says.

Given the volume of litigation that many companies are involved in today, and the sanctions that can be imposed for failing to respond properly to an e-discovery demand, many audit committees are checking with their attorneys and IT departments about their readiness.

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"The attorneys, IT personnel and perhaps a forensic specialist need to work together to define the scope and responsiveness of the search," Les Hand, KPMG Forensic partner.

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OTHER RESPONSIBILITIES

Inter-Committee Communications and Coordination Key to Effective Oversight

As an important part of risk oversight, and as the financial reporting watchdog, audit committees must communicate with their board counterparts that the risks other committees oversee can have a profound effect on financial reporting.

"The audit committee's communications and coordination with the full board and other board committees is one of the critical foundations for effective oversight," says Kenneth Daly, executive director of KPMG's Audit Committee Institute (ACI).

Daly says communication and information sharing is necessary for effective risk oversight; in addition, it helps the board identify emerging issues and opportunities that may affect financial reporting.

Perhaps most importantly, good communication enables all directors to understand why the emerging issues and opportunities affect financial statements, and give them confidence in signing-off on the 10-K and other SEC filings.

"There are many areas in which the oversight responsibilities of various board committees may overlap with the audit committee—the oversight of risk, M&A, product development, IT and other areas," says Daly, who recently moderated a panel on audit committees at the recent Directorship Boardroom Forum in Manhattan.

In light of these challenges, at a number of boards, committee chairs are identifying areas in which oversight responsibilities may overlap, and developing a regular communications process to discuss their oversight in these areas.

"When there are overlapping or shared oversight responsibilities, communications are particularly important," he says.

Panel members said that such communications should include formal or informal discussions between the audit committee chair and the heads of the other committees.

"You have to have an ongoing dialogue between the heads of all committees [separate] from the reports at the annual meeting," said Charles Elson, the director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, who was on the Boardroom Forum panel.

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"Sometimes you're going to have simultaneous committee meetings," said Elson, who also sits on the boards of AutoZone, Alderwoods Group and HealthSouth. "But that doesn't mean you can't have the chairs meet separately."

Informal meetings between committee chairs are just one way to ensure that all board members are receiving proper information. For instance, delineating different roles can improve communications.

"They are mapping committee oversight responsibilities to make sure the oversight responsibilities of each standing committee is clear," ACI's Daly says. "They are also identifying risks that may have sensitive financial reporting implications and educating directors about these issues."

Audit committees hold special joint sessions to consider how pension plan assumptions, information technology risks and M&A activity affects internal controls processes such as those relevant to the Sarbanes-Oxley Act's Section 404.

"[Audit committees] want to be apprised about what [other committees] are doing," said Lowell Robinson, audit committee chair of Jones Apparel Group and International Wire Group. "You need some kind of a formalized process."

As some boards address information sharing practices and needs, other boards may want to follow suit.

"My experience is that as more people become concerned with what we do, there is going to be more communication [between committees]," Robert MacDonald, an audit committee member at Allianz Life, said at the forum. "On boards that I serve on, I have seen it increasing."

Daly says committee chairs provide copies of the minutes of their meetings and report on their committee's oversight activities at each board meeting; however, on significant issues where oversight responsibilities may overlap, committee chairs increasingly recognize that communications need to be more frequent and timely.

"Audit committees want to ensure that their reports to the full board are comprehensive and understandable, and that they appropriately highlight the committee's significant oversight activities," ACI's Daly says.

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"You have to have an ongoing dialogue between the heads of all committees [separate] from the reports at the annual meeting," Charles Elson, director of the John L. Weinberg Center for Corporate Governance.

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OTHER RESPONSIBILITIES

Audit Committees Get 'Onboard' the Orientation Express

Industry observers say that audit committee orientation is not keeping pace with the growing number of independent audit committee members who are joining boards for the first time.

And with their duties more complicated than ever, audit committees that lack solid orientation programs risk throwing novice board members into the fray unprepared.

"Many audit committees appear to lack a comprehensive 'onboarding' process for new committee members," says Kenneth Daly, executive director of KPMG's Audit Committee Institute.

At a time when audit committees are being given additional responsibilities, industry observers say it's essential for new members to get up to speed quickly on the key issues facing the company and the industry in which it operates. The need is often more pronounced when directors are new to the company.

So-called "onboarding" programs are designed to bridge the gap. Effective programs should give new audit committee members an opportunity to meet key members of the management team, as well as internal and external auditors.

Because onboarding programs are often informal, they can take anywhere from a few days to nearly six months. For most companies, audit committee onboarding includes meetings with the audit committee chair, CEO, CFO, chief audit executive, internal audit, the external auditor and the chief compliance officer, as well as the general counsel.

But general onboarding for new directors may not be adequate, according to a November survey by the National Association of Corporate Directors. Although nearly three-quarters of public company boards have an orientation process for new directors, fewer than half (46.1 percent) felt the process is effective.

Julie Daum, practice leader for Spencer Stuart's North American Board Services Practice, says that onboarding processes are generally unsophisticated. "Most of the onboarding consists of a meeting [of the new board member] with the CFO and the senior management team," she says.

Spencer Stuart, an executive search firm, recently released its 2006 Board Diversity Report that spells out the importance of building an orientation process. It stated that boards with a formal onboarding process can help directors contribute sooner than those without a formal process.

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"It is smart to give the director time to get to know fellow board members, board priorities and the workings of the board," according to the report.

Daum, who hasn't seen a lot of formal onboarding at companies, agrees: "The smarter you can get the board members, the better off you are," she says.

A Huron Consulting Group study indicates the need for onboarding programs could increase going forward. In a November report sampling more than 700 audit committee members at 178 public companies, the percentage of accountants on audit committees increased from 5 percent in 2002 to 11 percent in 2005.

That means the number of directors who don't have prior board experience at the company who are joining audit committees for the first time is increasing. Often, they don't have the institutional knowledge necessary to understand the company they oversee.

"The audit committee is often traveling at 90 miles per hour, but new members have to get up to speed quickly," Daly says.

There are some dissenting views. One audit committee member whose companies haven't had much turnover believes that a formal education program isn't always necessary, since a good number of new directors are audit committee financial experts.

"It's dependent on who the person is," says Claudine Malone, who sits on the Novell, Hasbro and Avaya USA audit committees. "If they are coming from the outside, they are most likely the audit committee financial expert. And they don't need a lot of orientation. They just meet with the internal auditor, the external auditor, the CFO and the comptroller."

For Malone, president and CEO of Financial & Management Consulting in McLean, Va., most of the orientation she sees is done on an ad hoc basis.

"It wouldn't be the 'Audit Committee University,'" she says. "It's more of a company orientation where they would spend time with the business end of the company."

But there is general agreement that it's crucial to bring these new directors up to speed quickly on company and industry-specific issues.

"We build an onboarding program [in which] we look at where the director comes from and tailor it to that particular board," says Linda Reese, managing partner of Leader OnBoarding in Columbus, Ohio.

"Most of the onboarding consists of a meeting [of the new board member] with the CFO and the senior management team," Julie Daum, practice leader for Spencer Stuart.

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"If they are coming from the outside, they are most likely the audit committee financial expert. And they don't need a lot of orientation," Claudine Malone, audit committee member for Novell, Hasbro and Avaya USA.

"We make sure there is an understanding and respect for the culture," she says. "And that [the directors] develop a broad knowledge of the company and develop strong relationships [with management.]"

Reese says understanding a company's culture—how it conducts business—plays a big part in helping a manager or director understand the company.

As for audit committees in particular, an effective onboarding process should include information about an audit committee's charter, the proper chain of command and a description of how the audit oversight process works, according to the ACI's Daly.

"There ought to be an introduction to senior management and the finance group," Daly says. "You want the audit committee member to have a good understanding of the business model and how the company fits into the industry, as well as a recent history of success or problems the company has had with financial reporting."

In addition, Daly emphasizes the need for prepared materials.

"One of the leading practices is a director manual for onboarding," Daly says. "The manual could provide a broad overview of the audit committee's oversight processes as well as the company's critical financial reporting risks. The manual could be then supplemented by discussion with financial staff."

Malone says that auditor-supplied CD-ROMs, with information from management comprising their companies' accounting policies, estimates and judgments, as well as background on the company and its competitors, have proven to be valuable onboarding tools.

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

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OTHER RESPONSIBILITIES

CFO Turnover Leading to Succession Plans for Finance, Audit Group

A record number of CFOs left public companies last year, forcing audit committee chairs to take a hard look at succession plans in their companies' finance and audit groups.

"There should be a [succession] plan that involves the audit committee," says Alice Richter, audit committee chair for corporate uniform provider G&K Services and boating supply retailer West Marine. "At any time, the audit committee should be able to ask management what is their bench strength for the CFO and controller."

Through the regular course of their oversight activities, audit committees can have an opportunity to observe finance and audit group employees and assess who may be viable internal candidates to succeed the chief audit executive, CFO, chief risk officer, chief information officer, chief compliance officer or tax director.

"The entire board of directors should be involved in succession planning, with an annual review of the plan being a standard item on the board's executive session agenda," says C. Warren Neel, Saks audit committee chair. Neel is also director of the Center for Corporate Governance at the University of Tennessee.

"The audit committee should be particularly aware of the strengths of a prospective candidate as they relate to their financial acumen, mindful that the committee may have some adjustments to make," Neel says.

At the same time, audit committees, who are responsible for hiring the outside audit firm, should review succession plans for the firm's lead audit partner, as well as key senior staff.

"Succession planning is emerging as an important issue for audit committees," says Kenneth Daly, executive director of KPMG's Audit Committee Institute (ACI), who believes that in today's environment, succession planning is another important element of the audit committee's oversight of financial reporting.

Succession planning for senior finance and audit group executives has become a major issue as the rate of CFO turnover has increased. Based on a survey of 163 of its consultants in January, executive services firm Tatum predicts even more CFOs will step down in 2007, after a record 2,302 CFOs left public companies in 2006.

According to the Tatum survey, the two biggest reasons for turnover were compliance and governance issues (37 percent) and unreasonable expectations from board members (30 percent). The most effective means to promote stability? More than one-fourth (27 percent) of survey respondents said that providing additional resources, such as specialized staff, would help reduce turnover, as well as additional support from board members (23 percent).

No matter how much support an audit committee might provide, it's imperative for the company to have solid succession plans. In a 2006 study of CEO turnover, the National Association of Corporate Directors (NACD) defined such a plan as a three-to-five-year program to identify, prepare and develop internal candidates.

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The plan should be part of the annual review process for managers who have been identified as succession candidates. As part of the succession plan, candidates should have the opportunity to assume different responsibilities, learn about the business and develop their management skills.

The NACD also advocates an emergency succession plan—and since many CFOs are often successors to the CEO in emergencies, it's important that the finance group in turn ensure a seamless transition for a new CFO, says the University of Tennessee's Neel.

According to audit committee chair Richter, succession plans can serve multiple functions: "At one company where I was on the board, we took the controller and put him in charge of risk management, [though] not quite a chief risk officer," she says. "It was a really nice fit. It was a vote of confidence in his willingness not to just do the numbers."

At the same time, Richter says, the audit committee had other internal candidates to replace the controller.

In ensuring a good finance and audit group succession plan, audit committees should also have a process to vet candidates for the positions, according to the ACI's Daly.

"There is a real need for a process for audit committees to get to know key members of finance and internal audit departments," Daly says. "The audit committee ought to observe the performance of these candidates over a period of time, and play a role in identifying candidates for possible succession."

"At any time, the audit committee should be able to ask management what is their bench strength for the CFO and controller," Alice Richter, audit committee chair for G&K Services and West Marine.

Daly cautions, however, that while the audit committee should be involved in succession planning, the committee should not assume management's responsibilities. The audit committee's role in the process should be one of advise and consent with others in the financial reporting process, Daly says.

Neel, who was involved in implementing a succession plan 18 months ago, understands the importance of having good internal candidates for all the finance group positions especially when a key member, such as the CFO or chief audit executive, leaves the organization.

"As an audit committee chair, when I am looking at a succession plan I have to ask about [candidates'] financial reporting competency," Neel says. "I need to know if they rely more on [the audit committee] or the CFO."

The responsibility for succession planning for the finance and audit group is being addressed in more audit committee charters. At Fiserv, the Brookfield, Wisc.-based technology services provider, evaluating the performance and succession planning process for the corporation's "corporate finance and accounting personnel" is part of the audit committee's responsibilities.

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INTERNATIONAL

Corporate Governance Convergence Is a Global Problem

By Andrew Rosenbaum, Contributing Editor, *Audit Committee Insights International*

The difficulty in converging international accounting standards points to a larger issue for audit committees: nascent efforts to converge corporate governance leading practices from around the globe.

Some observers support the development of uniform corporate governance principles that apply to the culture of an organization rather than standards that prescribe the structure of companies, says Tim Copnell, director of KPMG's UK Audit Committee Institute (ACI).

"It's difficult to see a wholly unified approach in the short- to medium-term, given the cultural and historical differences in the governance world," Copnell says. "One only has to look at the problems encountered in efforts to harmonize accounting standards, between international accounting standards, national standards and U.S. standards."

Global standardization of corporate governance practice has lots of hurdles. "Such a move would not take into account fundamental cultural and legal system differences; one could not impose the creation of a given culture on the entire world in this sensitive area," agrees Patricia Peter, corporate governance expert at the Institute of Directors in London.

"The British system, with its essential 'comply-or-explain' principle, would not tolerate prescriptive legislation like Sarbanes-Oxley. Nor would the British system work well in Germany, for example," Peter says.

In the United Kingdom, "comply or explain" means companies that don't comply with the British Combined Code have the right to explain why they choose not to do so.

"Instead, such a move would be likely to smother innovation, and the adoption of improved practice: today, one culture is free to borrow better practice from another, or to adapt it to fit its own system, but that would not be possible with global prescriptive standards."

Guy Jubb, an investment director and head of corporate governance at Standard Life Investments Ltd. in London, says flexibility has to be built into the process.

"It is important that companies have the flexibility to adjust and tailor their governance to their particular requirements, in a form consistent with entrepreneurial leadership," Jubb says.

Peter believes more than principles need to be taken into account.

"It is so easy for the industry to agree on principles, but the principles take different forms due to the system in which they are applied," Peter says. "Consider that in the U.S., [institutional] investors are treated very differently from retail investors. This makes it very hard for UK companies to make the same offers to all of their shareholders in the U.S."

The European Commission has, in fact, restricted its initial plan to impose EU-wide standards of corporate governance.

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"The commission had originally intended to impose standards via directive, but now the plan is only to legislate on specific areas like that of shareholders rights," explains Christopher Pierce, CEO of the London-based Global Governance Services Ltd., which trains audit committee members in corporate governance leading practices and advises regulators around the world in formulating corporate governance codes.

As KPMG's Copnell points out, "Of the 24 codes in the EU, it does not matter that Germany has two-tier boards, the UK has unitary boards and France has a choice of a unitary or two-tiered board, as long as those boards operate on good principles in a transparent manner, are well informed and have good information."

The biggest fear is that not only will a global corporate governance regime be too limiting, but will be universally applied to all companies. A common issue is that boards respond to the call for "good governance" by box-ticking rather than managing the business in the best interests of the shareholders and providing them with clear, complete and accurate disclosures as to how this is done, Copnell explains.

Jubb says that flexibility with accountability is the ideal. "[It] works provided that there is proper and appropriate accountability to boards, and that everyone plays their part," he says.

In fact, it is the global markets and global commerce that should drive improvements in corporate governance around the world, Pierce says.

"If people operating in capital markets take the lead, it will require all participants to continue to improve and reach what is considered to be [a leading] practice," he says.

Pierce points out that it is difficult to achieve a consensus on corporate governance issues even within the UK.

"There are more than 150 professional organizations here involved with the topic, and considerable differences of opinion between them," he says. "Consider how difficult it would be to achieve any kind of consensus with their homologues in the U.S., or in Europe."

Copnell adds that self-regulation also needs to be matched with enforcement.

"Any code is essentially useless without an enforcement procedure to make companies apply them responsibly," Copnell says.

"In Europe there are new amendments that require all European companies to state the extent of their compliance with a code and to name that code. This mechanism is a step in the right direction, but success ultimately depends on behavioral aspects of companies rather than compliance."

Andrew Rosenbaum is a London-based journalist who writes frequently on business and finance.

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INTERNATIONAL

Process and Channels Are Key to Financial Oversight

Audit committee members are saying that executives in India must emphasize a good working relationship with audit committees to keep financial reporting information flowing smoothly.

“For audit committees, maintaining open channels with management to ensure the flow of information is consistent is an important priority,” says Sammy Medora, chairman of KPMG’s Audit Committee Institute India.

But it also is important that the audit committee confines its perspective to its oversight responsibilities under the charter. The audit committee should not attempt to become involved in management functions. “Such is not its place, nor would the audit committee members necessarily be qualified for such functions,” Medora says.

Several audit committee members who attended a recent KPMG Audit Committee Institute roundtable in Mumbai say that for the audit committee to maintain this balance, the audit committee chair must be available to the board and management to speak about upcoming issues regarding financial statements and the company.

Audit committee members also expressed the belief that the audit committee chair should discuss issues with the CEO before a board meeting, and audit committee meeting minutes should be presented to the board.

In India, audit committees have existed for about five years, and many companies have become accustomed to the way they function (Clause 49 of India’s Listing Agreement Terms of the Securities and Exchange Board make an audit committee obligatory).

The audit committee’s responsibilities are to review the actions and judgments of management in relation to several areas, including financial statements; operating and financial reviews; interim reports; preliminary announcements; and related formal statements before submission to and approval by the board, before auditor approval.

But not all executives are accustomed to working with the audit committee, putting the burden on audit committees that it receives accurate and necessary information.

“It’s important for this process to be governed by the basic charter originally put in place by the organization,” says Dr. Jamshed J. Irani, director of Tata Sons Limited. “The committee should ensure that the charter is a comprehensive one, and that it is regularly reviewed by the board of directors.

“The charter should give a valid representation of the board’s view of how an audit committee should operate,” Irani says. “The flow of information should be governed by the terms of the charter.”

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"The charter should give a valid representation of the board's view of how an audit committee should operate," Dr. Jamshed J. Irani, director of Tata Sons Ltd.

Lila Poonawalla, independent director and audit committee chair of numerous Indian companies, echoes Irani's comments. "Putting the best processes in place for comprehensive scrutiny of the company's activities is essential," Poonawalla says. "But even more critical is to find hidden information that would pose a challenge to the survival of a company, without getting into operational details."

Medora says that audit committees need to pay particular attention to critical accounting policies and practices, and any changes in them.

In addition, Medora says the audit committee should also be concerned with several other aspects of their duties, including:

- decisions requiring a significant element of judgment;
- the extent to which unusual transactions affect the financial statements, and how such transactions are disclosed;
- the clarity of disclosures;
- significant adjustments resulting from the audit; the going concern assumption, compliance with accounting standards; and
- compliance with stock exchange and other legal/regulatory requirements.

Other topics specific to a given company's context should be defined by the board.

"It's not that management is normally trying to hide anything from the committee and the external auditor, but often management is simply not prepared properly to consider what the committee needs, and in what form it should be related," Medora says.

Whether the audit committee and the board of directors functions as intended depends on the CEO's attitude, as well as founding family shareholder directors, according to Medora.

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