



Audit Committee Issues and Expectations



MIS Super Strategies Conference

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KPMG's Audit Committee Institute



KPMG's Audit Committee Institute (ACI)

Celebrating its 5th year Anniversary

1999-2004

Reaffirming KPMG's commitment to:

- Communicating with Audit Committee members and other participants in the financial reporting process
- Resulting in enhanced Audit Committee processes

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KPMG's International Audit Committee Institutes





Audit Committee Roundtable Series

<i>Event</i>	<i># Loc</i>	<i>Registrants</i>	<i>Topic</i>
<i>Fall 1999</i>	<i>11</i>	<i>370</i>	<i>New Rules—Blue Ribbon</i>
<i>Spring 2000</i>	<i>14</i>	<i>700</i>	<i>Earnings Management</i>
<i>Fall 2000</i>	<i>15</i>	<i>900</i>	<i>Audit Committee Leading Practices</i>
<i>Spring 2001</i>	<i>18</i>	<i>1,000</i>	<i>Effective Utilization of Internal Audit Resources</i>
<i>Fall 2001</i>	<i>22</i>	<i>1,550</i>	<i>Information Security—Issues for Boards and Audit Committees</i>
<i>Spring 2002</i>	<i>27</i>	<i>2,150</i>	<i>Current Issues Dominating the Audit Committee Agenda</i>
<i>Fall 2002</i>	<i>30</i>	<i>2,650</i>	<i>Corporate Accountability Reforms – Challenges Facing Your Audit Committee</i>
<i>Spring 2003</i>	<i>30</i>	<i>2,700</i>	<i>Building a Framework for Effective Audit Committee Oversight</i>
<i>Fall 2003</i>	<i>31</i>	<i>2,550</i>	<i>A Legal Issues Update & Audit Committee Oversight of Income Taxes</i>

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A Perspective for Today

Would I be willing to serve on the audit committee?

If I served on the audit committee ...

- Would I be satisfied with the depth and timeliness of information and analysis currently being provided?
- What changes would I want to make to the processes and information flows currently in place?
- What factors would I consider in assessing the overall control consciousness and “tone at the top” of the company?

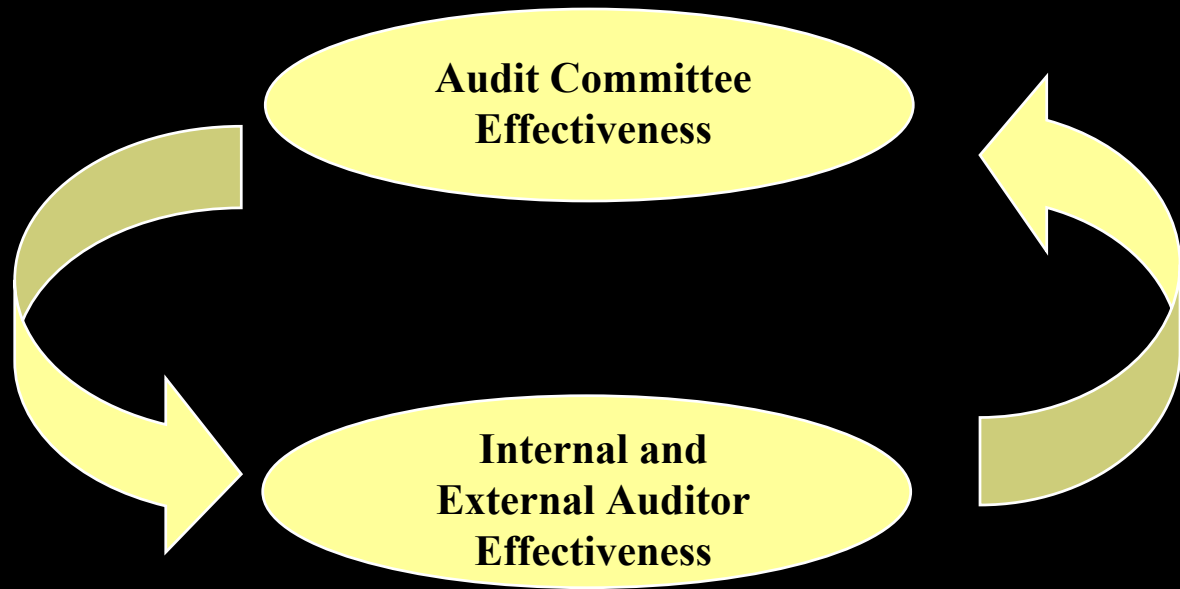
Issues and Expectations

Do you understand your Audit Committee's issues and are you meeting their expectations of you?

Does your Audit Committee understand your issues and are they meeting your expectations of them?

Do we have a "symbiotic" relationship?

Symbiosis



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Does Your Audit Committee Know That...?

“Internal auditors are rock stars now. This is their day in the sun.”

Pitney Bowes Inc. CFO Bruce Nolop,
CFO.com article “New Terrain” (2004)

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Issues and Expectations

A “Quick Look Back”

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What They Were Saying in 1926

“ ... There can be no hope for the independent audit unless and until it be tied in with the positive creation of some body **independent of management** to which the auditor shall be accountable.”

– William Ripley, “Main Street and Wall Street” - **1926**

More Recent History...

- Treadway Commission Report – 1987
- 1994—Strengthening the Professionalism of the Independent Auditor (report of SECPS of AICPA)
- Blue Ribbon Report on Audit Committees - 1999
- New Audit Committee Regulations - 1999
- Earnings Management Issues - 1999 and 2000
- POB Panel (O'Malley) on Audit Effectiveness - August 2000
- Revisions to SEC Auditor Independence Rules - November 2000
- Levitt Letter to 5,000 Audit Committees - December 2000

Acceleration...

- “Diastrophism” (the “big bang”) – *beginning November 2001 and continuing*
 - Enron et al
- “Corporate Accountability Reforms” – *Summer 2002*
 - Legislation, regulation, rule making and ultimately, judicial interpretation
 - Re-definitions and refinements of roles, responsibilities, and accountabilities— of all participants
- **Increased Expectations and Demands**



ISSUES AND EXPECTATIONS

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“THE” Threshold ISSUE

Making sure that the motive is
“effectiveness”, not “compliance”

“...a ‘check in the box’ approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting ‘politically correct’ dictates.”

*SEC Chairman William H. Donaldson
March 24, 2003,
Remarks at the National Association for Business Ethics*

The Challenge

“Balancing common sense and good judgment [**“effectiveness”**] against an ever-expanding rule book that will always be inadequate to cover every situation” [**“compliance”**]

Source: ACI’s Spring 2003 Audit Committee Roundtables -Anonymous Participant

Audit Committee Definition

A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing

- the accounting and financial reporting processes of the issuer and
- **audits** of the financial statements [*“financial reporting process”*] of the issuer

*“Under the PCAOB’s proposed standard, the audit of a public company is now an **audit of the company’s financial reporting process.**”*

Douglas R. Carmichael, Chief Auditor PCAOB
Speech to the American Accounting Association
January 2004

NYSE Requires Internal Audit

NYSE listing standards require

- Each listed company to maintain an internal audit function to **provide management and the audit committee with ongoing assessments of the company's**
 - **Risk management processes**
 - **System of internal control**

As an audit committee member, how do I satisfy myself that internal audit has

- The focus and capacity to assess the company's risk management processes and system of internal control
- The independence to bring forward controversial financial reporting issues

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Audit Committee Issues

- What is “oversight”?
- “Balancing practicality and priorities with the new governance environment”
- “Ensuring that we not only focus on the form but also the substance”
- “Too many pronouncements leading to too much checking off requirements and not enough thinking”
- “Getting the auditors to understand who they work for”

A key audit committee responsibility –

“the unique ability and responsibility of the audit committee to insulate the auditor from the pressures that may be exerted by management”

SEC Final Rule on *Strengthening the Commissions Requirements Regarding Auditors Independence* January 28, 2003

Direct Reporting and Responsibility

Audit committee

“...Must be directly responsible for the appointment, compensation, retention, and oversight of the work of [the Company’s independent auditor]”

Independent auditors

“...Must report directly to the audit committee”

“...The audit committee should be the external auditor’s biggest fan and harshest taskmaster.”

SEC Chief Accountant Donald T. Nicolaisen

December 11, 2003

What Roundtable Participants Are Saying ...

Challenges

- “How much detail should the audit committee get into in setting scope and other details of the audit?”
- “Maintaining oversight role versus managing”
- “Making management understand and accept the new roles”
- “Making sure the independent auditor views the audit committee as its employer”
- “Management acceptance of audit committee responsibility”

Approaches

- “Having an audit committee that is composed of truly independent members”
- “Leadership of the auditor selection process”
- “Clear statements to auditors and management regarding committee’s relationship with each”
- “Changing a couple of audit firms who were not paying attention to us”
- “Stating this direct relationship with the auditors and having them at every audit committee meeting”

Audit Committee Issues

- “What's most important to focus on?”
- “Knowing what level and type of information to present to the audit committee ...”
- “Coordination between the audit committee, management and the auditors”
- “Making the audit committee process time-effective and efficient”
- “Incorporating all requirements, while still maintaining an effective process”

What are the elements of an effective audit committee process?

Audit Committee Oversight



Audit Committee Process

The audit committee process must support the audit committee's efforts to:

- Establish with management, internal audit and independent auditors their responsibilities and accountabilities
- Focus the nature and timing of its activities on the company's key financial reporting risks (not driven by “check the box mentality”)
- Ensure audit committee receives the right information, from the right party, at the right time, and in the right context
- Influence and continuously monitor “tone at the top”

Identified Risks Must Drive the Audit Committee Agenda

Risk Oversight...

“...making sure that management has instituted processes to identify, and bring to the board’s attention, the major risks the enterprise faces.

Report of the NACD Blue Ribbon Commission
Risk Oversight—Board Lessons for Turbulent Times

- Audit Committee effectiveness comes from prioritizing activities based on risk



Institute of Internal Auditors “Quick Poll”—June 10-19, 2003

Do the risk managers in your organization have assessment processes, effective in design and application, that inform senior managers and directors of significant risk exposures facing your organization?

- | | |
|--------|-----|
| 1. Yes | 29% |
| 2. No | 71% |

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Oversight of Internal Control Over Financial Reporting

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Internal Control Reporting and Auditing Requirement (Sarbanes-Oxley Section 404)

Final SEC Rules – Annual report must contain a report on internal control from management that:

- States management’s responsibility for establishing and maintaining adequate internal control over financial reporting...
- ...Contains management’s assessment, as of year-end, of the effectiveness of internal control over financial reporting, including whether it is effective
- States that the external auditor has issued a report on its audit of internal control over financial reporting

In March 2004, the PCAOB adopted Auditing Standard No. 2, “An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements”

Internal Control Reporting

- Is it worth the effort?
- Can we get it done in time?
- Is the cost too high?
- Will it matter to our shareholders (and others)?
- Will it make management (and the audit committee) more effective?
- What is required to sustain it?
- What involvement should the audit committee have in this process?

“404” Issues for the Audit Committee

- Do the company’s activities related to “404” reinforce (or detract from) an appropriate control environment and tone at the top?
- What are the key judgments inherent in management’s *assessment, documentation, evaluation and testing* of internal control over financial reporting?
- Is there a process for reporting and resolving differences of opinion regarding these judgments?

“404” Issues for the Audit Committee

- What is the role of Internal Audit in the company’s “404” activities?
 - Initial implementation?
 - Ongoing?
- Does the Chief Audit Executive agree that this is the most appropriate role for internal audit?
 - If not, why was the audit committee not notified of this difference?
 - Who made the final determination of the internal audit role?
- If internal audit resources have been redirected to “404” activities, does the audit committee understand the implications (risks) of not completing other internal audit activities?

A Question to Consider

Based on my observations, management's approach to Section 404 has had the following impact on the overall culture and "Tone at the Top"

1. Very positive impact
2. Positive impact
3. No impact
4. Negative impact

'Tone at the Top' and Accountability...

“Simply complying with the rules is not enough.”

SEC Chairman William H. Donaldson – July 30, 2003

“Today, oversight is facilitated because of better defined responsibility and accountability for internal control.”

*Risk: From the CEO and Board Perspective
by KPMG senior professionals
Mary Pat McCarthy and Timothy Flynn*

***Don't lose sight of the impact upon “Tone at the Top”
of how management embraces, communicates, and
implements these new requirements.***

Other Current and Future Issues

- “In Board Room” education for directors
- Expectations of “audit committee financial experts”
- Board and committee “evaluation processes”
- Future PCAOB actions/rulings
- Pressure from Governance “ratings” organizations
- Does “compliance” represent “effectiveness”?

And Finally...

“One size does not fit all” ...

- > Avoid the temptation to adopt someone else’s “best practices”
- > Rather, establish your own based on an understanding of and commitment to the role of the audit committee in overseeing the financial reporting process



***Thank you for the opportunity to meet
with you today***

***I hope to see you (and a member of
your audit committee) at the Spring
2004 Audit Committee Roundtable!***

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