2006*

Current developments for audit committees

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To Our Clients and Friends

Audit committees have had a busy few years, and some still struggle to strike the right balance between monitoring management and providing advice and counsel. This is especially important in light of landmark settlements that obligated directors to pay damages from their own pockets following major corporate failures. Although they have largely addressed their new responsibilities, audit committees and boards continue to face new challenges. These include dealing with investors who may have conflicting objectives, and ensuring that their companies have the resilience to weather storms of all kinds, from actual hurricanes to the increasingly common corporate storms occasioned by restatements, CEO departures, and unsolicited tender offers.

Fortunately, audit committees are getting a break in other areas. The 404 compliance effort is leveling off, as both companies and auditors transition from a compliance project to a sustainable and cost-effective process. Audit committees appreciate the accommodations in revised accelerated filer deadlines and the regulatory reforms that ease large companies' access to the capital markets. And directors of smaller companies are monitoring developments as the special needs of their companies get attention. The agenda in that market segment is a broad one—from reconsidering the appropriate level of regulation to easing filing deadlines, postponing 404 compliance dates, and even recommendations to remove altogether the 404 reporting obligation for the smallest companies.

Transparency remains a watchword. Developments in the coming year will bring about increased disclosure of executive compensation—an issue at the forefront of investor and employee discontent. The SEC is requiring companies to include disclosures about risk factors in their annual reports, and continues to urge clearer and more expansive disclosures in a number of key areas. There is greater transparency in the accounting realm as well, with the continuing trend toward moving information from footnotes to the financial statements, the new requirement to expense stock options, and imminent standards around accounting for postretirement benefits, which would put related obligations on the balance sheet.

Directors of U.S. companies are recognizing the impact of international regulation and standards as their European peers adopt international accounting standards. U.S. companies listing on European exchanges likely will need to provide additional disclosures to address differences between U.S. GAAP and IFRS. The need for greater awareness of international standards is now evident. Joint projects between the FASB and the international accounting standard-setting body mean that U.S. companies interested in influencing U.S. standard setting need to get involved in the international standard-setting discussion sooner rather than later.

PricewaterhouseCoopers is committed to helping you enhance audit committee performance, the financial and business reporting process, and, ultimately, the quality of corporate reporting. In keeping with that commitment, in mid-2005 we issued the third edition of *Audit Committee Effectiveness—What Works Best,* a publication designed to help audit committees understand how leading practices have evolved in the post-Sarbanes world. We would be pleased to discuss the contents of that report or this publication with you. Our goal is to bring you the full benefit of PricewaterhouseCoopers' knowledge and resources.

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Corporate governance information available

Website	Description
www.pwc.com/uscorporategovernance	Focuses on U.S. corporate governance developments, with links to relevant PwC and other select publications, most of which are in downloadable format. Also allows ordering of hard copies of most publications.
www.cfodirect.com	PwC's online resource for senior financial executives, providing news, PwC analysis, and financial and business tools.
www.pwc.com/corporatereporting	Provides a global perspective on corporate reporting, including corporate governance and audit issues. Includes downloadable publications and information on financial reporting, corporate governance, and audit developments around the world.
www.pwc.com/view	PwC's U.S. Thought Leadership magazine, providing perspectives on challenging issues of interest to directors, CEOs, CFOs, and other high-level executives.

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Corporate governance—current issues

The governance year in review

While 2005 didn't see any major changes in governance rules—and so was relatively calm in comparison to recent years—there were still some important highlights.

Landmark court decisions

The WorldCom and Enron settlements announced in early 2005 required directors of those companies to pay substantial sums from their own pockets, potentially setting a troubling precedent. Fortunately, that worry abated somewhat when the Delaware Chancery Court announced its decision in The Walt Disney Company derivative litigation in August. The Court determined the Disney directors had not breached their fiduciary duties—in particular, their duty to act in good faith—and thus were not liable. The Court did, however, criticize certain of the 1995–1996 board's processes and practices. And although the decision made it clear that applying contemporary views on best governance practices to a situation that happened over a decade ago is inappropriate, the Court encouraged directors in their work now to apply best practices as currently understood. While a reading of the entire decision is instructive, its key lessons are that directors continue to need to understand and fulfill their fiduciary duties, be independent in fact and appearance, ensure robust processes are followed—and be sure their conformance with those principles is adequately reflected in the documentation of their boardroom and committee activities.

Majority vote

Various methods to provide shareholders with greater power to nominate, elect, or remove directors have been hotly debated in recent years. At the heart of the issue is that, under the current system of uncontested director elections, even a single vote for a director will elect that person to a board. Withholding votes doesn't count and can't be used as a mechanism to prevent a nominee's election. Understandably, shareholders have a certain level of frustration with this system.

A concept attracting growing attention is "majority voting," and institutional investors and shareholder rights advocates are urging public company boards to adopt it. In its simplest version, a majority voting rule would require that a director who received a majority of "against" or "withhold" votes would have to resign. While simple on the surface, there are many legal concerns and complications. An American Bar Association task force is studying it, as is a working group of corporations and labor pension funds.

Meanwhile, a modified version of this concept—"majority vote lite"—has surfaced. Under it, any director who receives a majority of "against" or "withhold" votes must offer his or her resignation to the board, which would determine whether to accept the resignation. If the board accepted the resignation, it would be free to appoint its own candidate. Several major companies have adopted this approach, and many others are considering it. While some think majority vote lite doesn't go far enough, others see it as a good first step in empowering shareholders.

Hedge funds flexing their muscles

Hedge funds have been all over the news in 2005. While many hedge funds take the long view, others have a short-term focus, sometimes using leverage and short selling to hedge their portfolios' exposure to market movements. A key concern many observers have is that the investment objectives of these highly speculative, short-term hedge funds differ greatly from the objectives of long-term shareholders. Although there's no comprehensive data on the sector, in 2005 Federal Reserve Bank Chairman Alan Greenspan estimated there are total assets of $1 trillion under management in hedge funds. While historically most hedge fund managers have not been required to register with the SEC—and thus have not been subject to SEC oversight—certain hedge fund managers must register with the SEC as investment advisers by February 2006.

So why are hedge funds important in the governance landscape? A few grabbed headlines as they began pressuring boards in companies in which they held significant stakes to break up the companies, spin off businesses, accept a higher-value tender offer over another offer with features that might be more attractive, or take other steps to produce an immediate increase in shareholder value. They also have an impact when short selling—because they have to borrow shares, generally owned by long-term investors and available in lending programs, to cover their short sales. By holding borrowed shares, hedge funds get the right to vote on corporate decisions. And the concern is they're voting in only their own interests, which may not always be the same as the company's or as long-term shareholders' interests. Accordingly, some companies in securities lending programs are recalling their shares before key votes. Directors should understand the influence of hedge funds on their companies and consider the implications when making key corporate decisions.

CEO turnover and succession

According to Challenger, Gray & Christmas, an executive outplacement firm, total CEO departures for 2005, through the end of November, were 1,228, compared with 663 for all of 2004. That adds up to a lot of turmoil at companies. While some turnover was the result of planned retirement, many departures undoubtedly were unexpected, the result of nonaligned strategic vision or failure to meet performance targets. And the sheer number points to just how vital it is for boards to insist on robust succession plans. Our PricewaterhouseCoopers–Corporate Board Member magazine 2005 *What Directors Think* survey showed many directors (44% of the over 1,000 respondents) want to spend more time on the topic and 47% were dissatisfied with their companies' current succession plans. Of those who indicated dissatisfaction, 26% pointed out that CEO discomfort with the topic was at issue, and 41% admitted their board operated only in reactive mode—addressing succession only when the need arose. That stance clearly is not adequate, especially if the trend toward higher CEO turnover continues.

Restatements

In the past few years, we've seen the level of financial restatements rise significantly—both in absolute numbers and on a percentage basis (i.e., for every 100 U.S. public companies). The increased restatement level may stem from a number of factors. A different approach to evaluating errors (discussed more fully under *SEC Areas of Focus*) may be driving lower tolerance to unadjusted errors that may have been accepted in the past. Perhaps the intense scrutiny companies have subjected their accounting processes to in the 404 effort has led to a "clean up" of messy accounting. But whatever the underlying causes, this trend is worrisome. Even leaving aside the inevitable lawsuits, public trust in capital markets cannot be restored fully if financial statements are perceived as unreliable. All directors need to focus on the fairness and completeness of financial reporting, as part of their support for quality reporting.

So what are the lessons for directors? First, understand your responsibilities and the current state of best practices, and be thoughtful in discharging your duties and memorializing your actions in minutes. Second, listen to your shareholders, and consider proactive means to address shareholder dissatisfaction with board composition. Third, understand who your shareholders are, and the extent to which their differing perspectives impact your decisions. Fourth, if your board doesn't have a plan for CEO succession, develop one. Finally, provide

quality oversight to help your company avoid being caught up in the restatement cycle. And of course, ensure and maintain your independence at all costs.

Looking forward: Key themes for 2006

Investor confidence in the capital markets continues to be a pressing concern for companies, management, directors, investors, bankers, regulators, lawyers, and accountants. The real question is what will drive investor confidence upwards? Although no one is certain, it's clear that boards' independent oversight of companies and management is critical in representing and protecting shareholders. We continue to encourage directors, as they discharge their duties, to reflect on their role in restoring investor confidence and supporting strong capital markets. And, while directors are exercising their independent business judgment, they need to ensure that they're providing the advice and counsel management needs. And do that while remaining alert to these issues, which could take on an even greater visibility next year.

Executive compensation

Concerns around the level of executive compensation persist. And many are looking to directors to address the issue. Of the roughly 1,100 directors who responded to the PricewaterhouseCoopers–Corporate Board Member magazine 2005 *What Directors Think* survey, 70% indicated U.S. company boards are having trouble controlling the size of CEO compensation. That said, 84% thought their individual boards were either effective or very effective in overseeing CEO compensation. In other words, there's little recognition that their individual boards may themselves not be addressing this issue well.

Many have warned that if boards don't start addressing the perceived problem of excessive CEO compensation, lawmakers will do it for them. And in late 2005, a bill was introduced in the House of Representatives that would require expanded disclosure of executive compensation and shareholder approval of golden parachute compensation to top executives when a company is being acquired, merged, or sold. For its part, the SEC is considering rules to drive transparency by requiring companies to disclose more information about executives' compensation, and to explain the objectives behind compensation decisions. It's vital boards understand the concerns of shareholders, employees, and the public; accept responsibility for addressing those concerns; and work diligently to ensure compensation packages align pay with performance, in the shareholders' interests.

Postretirement benefits, including pensions

Many defined benefit pension plans were put into place over 40 years ago. At that time, companies didn't envision the economic impact of making good on the promises in those plans—including the cost of providing healthcare under plans, some of which included unlimited retiree medical benefits. Accordingly, some companies have amended, frozen, or eliminated their plans. And some that are in financial distress have shifted their pension obligations to the Pension Benefit Guarantee Corporation (PBGC), the federal corporation charged with protecting workers' pensions, which is now under some financial pressure itself. Momentum for pension reform is growing, with both Houses of Congress passing their own pension reform bills in late 2005. Essentially, these bills would require companies to close funding shortfalls in their pension plans within a seven-year period. The bills also require increased premiums to the PBGC for plan termination insurance, as well as increased disclosure to both participants and the government about a plan's funded status.

What are the implications? Directors should recognize that fully funding pension obligations will divert companies' operating capital earmarked for other purposes—like acquisitions, capital projects, and dividend payments. Further, employers will pay higher PBGC premiums—some substantially higher because of the new risk-based premium element. That in turn may prompt more companies to reduce employees' retirement benefits, and freeze or terminate their defined benefit plans. Directors need to understand the implications of any current pension reform and of management's planned changes. And they'll want to be aware

of accounting changes coming, as discussed in *Developments Affecting Corporate Reporting*.

Making corporate deals

Merger and acquisition activity was up in 2005, and shows no sign of abating. Many companies are sitting on substantial quantities of cash, and are looking to spend it. Directors on those companies' boards will want to be vigilant that management's proposed acquisitions make sense in light of the corporate strategy. And they'll want to ensure they agree with management on both a target price and a maximum price, setting clear limits on how high they'll go before the deal economics cease to pay off. On the other side of the equation, directors of companies that are potential targets will want to think through their plans to deal with disruptive events. What would happen if the company got a tender offer tomorrow? Are there features that make the company particularly attractive? What deal terms would be acceptable to shareholders? Having a clear sense of the answers to these questions would help companies and boards prepare—moving beyond reactive mode.

Balancing roles

Directors may not be getting the balance right between their advisory and fiduciary roles. While they need to advance beyond the recent focus on compliance, they still need to ensure they're closely scrutinizing the messages they're getting about management's performance and the reliability of financial reporting. Is the company dealing with restatements? Are there troublesome matters arising from the whistleblower process? Are there mixed messages from management? Any of these should be raising a red flag for directors. So while directors are beginning, in the post-404 landscape, to turn their attention back to the often more enjoyable task of advising management and helping the company create value, they shouldn't lose track of their fiduciary duty to oversee.

Dealing with disaster

Hurricanes, earthquakes, severe floods, and other natural disasters struck many areas around the world during 2005, devastating people and businesses, and affecting customers and suppliers. While the direct consequences of physical destruction are easy to see, the indirect effects can be just as devastating, and not only to companies in the affected areas. Critical inputs—such as fuel or construction materials—may skyrocket in price, or simply be unavailable. The results of a disaster may put pressure on debt covenants and other contractual obligations. And a chaotic environment also may increase the risk of misappropriation of financial and physical assets.

The natural disasters of the past year are a stark reminder of the need for sound disaster recovery plans in every company. While clearly people's safety and security are the top priority, the company also has to consider the implications of disasters on operations. Contingency plans should be in place to protect vital electronic and other information from loss, destruction, theft, and other risks. Plans should cover temporary work sites and systems for communicating with employees, customers, and others. Communication, both internal and external, is critical as compliance with legal reporting requirements may be significantly hampered while the company reestablishes itself. Finally, companies need to perform a robust risk assessment to identify potential risks and ensure mitigating controls are in place and appropriately managed.

The board of directors or the audit committee should oversee the company's disaster recovery plans, ensuring the appropriate focus and processes are in place. They should challenge management to identify not only obvious exposures, but also less apparent ones; not only risks of physical damage to property, operations, and information, but also indirect or intangible effects. The more thoughtful the crisis management process, the better prepared the company will be if a crisis occurs.

In addition to disaster recovery plans, companies need to realize the importance of their embedded culture and values. If everything breaks down and the company's survival depends on the initiative and behavior of individ-

ual employees, embedded values will govern their decisions and conduct. No disaster plan, however detailed and effective on paper, can replace the values instilled in employees. Thus, it's vital management establishes a culture that reinforces those values.

Some specific considerations:

- **Company operations.** Disasters impact companies' operations in myriad ways—damage to or destruction of facilities; destruction of transportation and communication infrastructure (e.g., train tracks, bridges, telephone lines); damage to and destruction of customers' assets, substantially decreasing sales opportunities; inability to operate because necessary records and information are not available (e.g., destruction of debt information or credit card transactions); and inability to interact and communicate with customers and suppliers. The increased importance of the service sector in today's economy further exacerbates the impact of a disaster—it's likely easier to replace a damaged machine or warehouse than it is to rebuild a service offering that depends on direct interaction with customers, especially in situations like Hurricane Katrina, where the customer base has been so widely dispersed since the disaster.

- **Dependence on technology.** The widespread electrical blackout in the northeast United States in 2003 and the hurricanes in 2005 removed any doubt about our dependence on technology. Even many manufacturing and primary-sector operations are unimaginable without sophisticated IT systems. Loss of electricity generally results in an absolute standstill in our modern economy—knocking out banks, ATMs, insurance response, transportation, and other communications—and requires massive efforts to recover lost data, restart affected operations, and repair damage. Hurricane Katrina also highlighted the vulnerability to long-term loss of power. Once backup generators ran out of fuel and battery charges ran out, everything they operated—hospitals, hotels, and communications devices—either ground to a halt or had significantly reduced functionality.

- **Safety of people.** Disasters and the accompanying chaotic environment often present a huge challenge to locate and ensure the safety of employees and other stakeholders. Established communication processes often don't work as expected, particularly if the electrical grid is down for an extended period, and companies have to depend on ad hoc solutions. Hurricane Katrina demonstrated the immense power of the Internet and other noncentralized communication options. Certain industries—such as healthcare and tourism—are responsible for their customers and have to consider their safety and basic requirements.

- **Addressing accounting challenges.** Disasters raise complex accounting and reporting problems. Companies need to identify and determine the extent of asset impairments, assess insurance recoveries, determine the appropriate periods of recognition for various resulting expenses, and determine whether financial statement disclosures are adequate. These are challenging judgments even when facilities and records are intact.

- **Complying with statutory requirements.** Even with a sound disaster recovery plan in place, many companies lose records when disaster strikes. This in turn generally endangers companies' compliance with regulatory reporting requirements—everything from providing timely and complete reports to the SEC, to filing adequate tax returns. Companies that miss important compliance milestones could see crucial operating or professional licenses withdrawn or face monetary penalties. A geographically widespread disaster like Hurricane Katrina also poses challenges for many industries that are required by law to maintain communications with customers, such as distribution of statements by broker/dealers or periodic reports by mutual funds.

- **Impact on audit requirements.** Loss of records, unavailability of IT systems, and dispersion of company personnel also affect auditors' ability to fulfill their responsibilities around periodic financial reporting. Those factors could impact the quality of the company's available information, which in turn limits its ability to make complex accounting judgments, or the evidence for transactions may be missing—either of which could impact the scope of audit procedures and possibly lead to audit implications. And even if a company's records survive, there's also the possibility the auditor's records or premises could be lost or destroyed in a disaster.

- **Impact on reporting requirements under Section 404.** Management's assessment of internal controls and the auditor's related reporting rely substantially on the documentation of control procedures. A lack of documentation at a significant location due to a disaster may result in the conclusion that there are significant deficiencies and potentially a material weakness in the company's financial reporting process, even without an actual shortcoming in the design or operation of controls. At a minimum, management and the auditor might have to expend substantial effort to recreate the internal control documentation and testing.

Nonprofit sector—new governance recommendations

In our 2004 publication,[1] we discussed how the greater focus on public company governance was having an impact in nonprofit boardrooms. In June 2005, a panel of nonprofit-sector executives issued a final report to the U.S. Congress entitled *Strengthening Transparency, Governance, and Accountability of Charitable Organizations.* Recognizing that charitable organizations can fulfill their missions only by maintaining public trust, the report recommends a number of improvements.

Governance recommendations

Some of the Panel's recommendations have direct bearing on corporate governance and are similar to reforms adopted for public companies.

Size and composition of governing boards—A nonprofit organization should be required to have a minimum of three members on its board in order to qualify for tax-exempt status. Further, at least one third of the board members should be independent, and charities should be required to disclose on Form 990—the annual information form filed with the IRS to report on financial and program operations—which of its directors are independent. The box shows the suggested independence definition.

Defining independence for board members of charitable organizations

- Individuals who have not received compensation or material benefits directly or indirectly from the organization in the past 12 months
- Individuals whose compensation is not determined by other board or staff members
- Individuals who are not related to someone who received such compensation from the organization

While the Panel doesn't suggest limiting the number of members on a governing board, it does recommend charitable organizations periodically review their board size to determine the most appropriate size. Further, all boards should establish strong and effective mechanisms to ensure they can carry out their oversight functions and that members are aware of their legal and ethical responsibilities for governance.

Who shouldn't be allowed to serve on charitable boards? In the Panel's view, any individuals barred from serving on corporate boards or convicted of crimes related to breaches of fiduciary duty.

Audit committees—The governing boards of charitable organizations should include individuals with some financial literacy. And those charitable organizations that have their financial statements independently audited—whether legally required to or not—should consider establishing a separate audit committee.

Board compensation—The Panel discourages paying compensation to directors of charitable organizations. Any charities that do, should be required to disclose the amount of and rationale for the compensation, as well as the method used to determine its reasonableness. The Panel recommends that Congress prohibit public charities from making loans to directors—such loans are already illegal for private foundations. Congress also should increase penalties for directors of charitable organizations who receive or approve excessive board compensation.

[1] See *Current Developments for Audit Committees 2004*, available at www.pwc.com/uscorporategovernance.

Executive compensation—Charitable organizations should be required to disclose more clearly compensation paid to their chief executive officer, other "disqualified persons"—that is, anyone who within the prior five years could exercise substantial influence over the organization—and the five highest-paid employees. And Congress should place the burden on officers and other disqualified persons who receive compensation that the IRS alleges is excessive, to demonstrate that it is reasonable. Similar to board compensation, the Panel recommends increased penalties for individuals who receive and managers who approve excessive compensation. The Panel would exempt board members from penalties, even if the executive compensation was found later to be excessive, if they followed due process in relying on market data and documenting the basis for compensation decisions. Finally, the full board of a charitable organization should approve, in advance, any change in the CEO's annual compensation and periodically review the organization's staff compensation.

Transparency recommendations

Another focus is the nature and extent of information organizations provide.[2]

Financial audits and reviews—Congress should require charitable organizations with at least $1 million in annual revenues to attach audited financial statements to their Form 990 returns, and those with annual revenues between $250,000 and $1 million to have their financial statements reviewed by independent public accountants.

IRS reporting—Form 990 should be revised to provide more accurate, complete, and timely information, and charitable organizations should be required to file electronically. Further:

- Congress should impose penalties on preparers that willfully omit or misrepresent information on the returns.
- Congress should direct the IRS to require an organization's highest-ranking officer to sign and certify Form 990.
- The board or an appropriate board committee should review the Form 990 return before it is filed.
- Congress should require organizations with less than $25,000 in annual revenues (currently excused from filing Form 990) to file basic contact and financial information annually.
- The IRS should suspend the tax-exempt status of any charitable organization that fails to correct incomplete or inaccurate returns for two consecutive years.

Disclosure of performance data—The Panel recommends charitable organizations provide to the public more detailed information about their operations and how they evaluate program results.

Recommendations on ethical conduct

Ethical misconduct potentially damages the reputations of all charities. The Panel suggested ways of promoting ethical behavior.

Conflict of interest and misconduct—The Panel recommends charitable organizations adopt and enforce a conflict of interest policy. The IRS should require organizations to disclose on Form 990 whether they have such a policy. Further, charities should adopt policies and procedures that encourage individuals to report illegal practices or violations of organizational policies, and protect those who do so.

Travel expenses—Charitable organizations should establish and enforce clear policies on travel, including the types of expenses that can be reimbursed and the required documentation. Further, charities shouldn't pay or reimburse travel expenditures for spouses, dependents, or others who accompany individuals conducting organization business. Charities also should be required to disclose on Form 990 whether they have a travel policy.

Selected other recommendations

- Congress should increase the resources allocated to the IRS for overall tax enforcement and oversight of charitable organizations.
- Boards of directors are encouraged to review their organizations' governing documents

[2] For additional information on transparency in nonprofit financial reporting, see *Enhancing the Transparency of Financial Reporting* available at www.pwc.com/education.

and policies thoroughly at least once every five years.

- Laws and regulations governing donor-advised funds should be strengthened to ensure donors or related parties do not benefit inappropriately from those funds.

- All tax-exempt organizations, even those not required to file tax returns, should be required to report participation in potentially abusive "listed" and other "reportable" tax shelter transactions—in the same manner required of taxable entities.[3]

The Panel issued some additional recommendations in September, with more expected in 2006. And in November, the Senate passed a tax reconciliation package (S 2020) that included some of the Panel's recommendations.

Audit Committee Effectiveness—What Works Best

Audit committees are trying to find an appropriate balance between overseeing and advising management, while avoiding micromanaging. And, they are coping with the many new responsibilities that have been added to their plates as part of governance reform over the past few years.

In light of this challenging environment, PricewaterhouseCoopers has updated *Audit Committee Effectiveness—What Works Best*, first published in 1993 and revised in 2000. The 3rd edition, published in 2005, captures how practice has developed and provides numerous examples of how leading audit committees are not just coping, but succeeding. The publication covers responsibilities, relationships, and processes, and the individual chapters address the following topics.

- **Financial statements**—The focus here is on how audit committees can bring the discipline to ensure companies provide information to the investor world that is digestible and reliable. Also highlighted are the different types of information and various perspectives committees need to draw on in order to oversee the integrity of the financial statements, as well as tips on how committees can be confident they understand the financial statements.

- **Risk management and internal control**—Increasingly, audit committee oversight is extending beyond financial reporting risks, to the effectiveness of management's responses to risks that might prevent a company from achieving its strategic objectives. Once there's consensus on the scope of its oversight of risk, the audit committee needs to understand those risks within its purview and to be confident that management's practices—both identifying and assessing risk and responding to it through the internal controls it has established and operates—are satisfactory. And audit committees also should ensure management's reporting on the effectiveness of internal control over financial reporting is complete and understandable. Ways to perform these responsibilities effectively are described.

- **Compliance and ethics**—Directors now clearly understand how quickly corporate and personal reputations can be destroyed by unethical actions. And audit committees are playing an increasingly central role in ensuring ethics, codes of conduct, and tone at the top meet appropriate standards. Descriptions of how they are doing it are provided.

- **Oversight of management and internal audit**—The strength and candor of the audit committee's working relationships with management and the internal audit function are key to determining the committee's success. Audit committees always have needed to balance their fiduciary role with their role as advisors to management. However, as audit committee responsibilities have increased and the external pressure to emphasize their fiduciary role mounts, tensions have increased. And committees increasingly are looking to the internal audit function for objective assessments of risk and control in operational, compliance, and reporting areas, and many are taking steps to support internal audit's stature and effectiveness. Also addressed is how to improve communications and the role of management at meetings, as well as tips on evaluating management's performance.

- **Relationship with external auditors**—Audit committees now must own the relationship with the external auditors. How? By having

[3] See American Jobs Creation Act section in *Current Developments for Audit Committees 2005*, available at www.pwc.com/uscorporategovernance.

direct reporting by external auditors, ongoing communication, frequent meetings, and robust discussions about audit scope and results. Also, by paying more attention to greater levels of detail, such as evaluating potential services to determine whether the committee will grant its preapproval, ensuring the auditors' independence, and considering how well the auditors perform.

- **Resources and special investigations**—Audit committees' authority and willingness to access needed resources further support their self-sufficiency and autonomy. Given that crises may develop suddenly, committees need to understand the basics of conducting special investigations.

- **Committee composition**—Requirements for independence and financial literacy, limitations on the number of audit committees a director can serve on, and concerns around liability have made it more challenging to recruit qualified members to an audit committee. The various characteristics needed in audit committee members and other elements of a committee's composition that help it succeed are addressed.

- **Training**—In light of the intricate nature of companies' business activities, the complexity of accounting transactions and policies, and frequent changes to financial accounting standards, even the most experienced audit committee members can benefit from training. New audit committee members also need robust orientation, allowing them to understand their role and the company's financial reporting process, so they can add value sooner. While the level and type of training needed by audit committee members is a personal decision, possible sources, avenues, and topics for training are discussed.

- **Meetings**—Audit committees have to steer their agendas. Audit committee chairs often provide the foundation for effective meetings—by driving the agenda, facilitating the discussion, holding premeetings to explore issues, and ensuring the right people are present. Audit committee members also are on the hook to prepare thoroughly for meetings. And the meetings need to have active meaningful participation, not presentation.

- **Charter and evaluation**—Charters—the clearest articulation of the audit committee's purpose, composition, roles and responsibilities, and authority—are public documents. That makes it even more important for committees to evaluate regularly whether their charters are appropriate and whether they are discharging all their responsibilities. Committee evaluations are useful in identifying areas for improvement and training needs.

We believe you will find this report extremely useful as you grapple with the demands of today's environment. Copies may be obtained from your PricewaterhouseCoopers contact or ordered from www.pwc.com/uscorporategovernance.

Impact on audit committees

Institutional investors and shareholder advocates continue to voice their views on how companies should be governed, demanding an increasing say. Directors also are noting pressure from hedge funds, and find themselves needing to balance competing interests. And they're following key court decisions involving their fiduciary duties. They're also observing some worrisome trends—including rising levels of CEO turnover and increased numbers of restatements—and reflecting on how to insulate their companies from being unprepared to address such issues. And they're preparing to deal with the challenges ahead, such as addressing CEO compensation and economic sustainability issues relating to pensions.

Hurricane Katrina and other natural disasters have driven home yet again the importance of disaster recovery planning. Audit committees will want to ensure management is prepared if a crisis strikes the company. Preparedness includes ensuring the company maintains a culture that instills the appropriate values in employees—those values will guide employees' actions in a crisis, even if key support systems are unavailable.

Nonprofit organizations have seen new recommendations for improving their governance, ethical conduct, and transparency. Governing boards of these organizations, realizing they must maintain the public trust if they are to fulfill their missions, will want to understand these

recommendations and consider implementing them.

Finally, the 3rd edition of *Audit Committee Effectiveness—What Works Best*, authored by PricewaterhouseCoopers, provides audit committees with valuable insight into how leading practices have evolved in the wake of governance changes over the past five years.

404 redux

Report card on year-one 404 compliance

The bottom line: Most companies[4]—85% of the nearly 3,400 accelerated filers that filed 404 reports through November 15, 2005—filed reports free of any material weaknesses. The box shows the common areas resulting in material weaknesses for the 15% of companies that received adverse opinions. It wasn't uncommon for a company to report multiple material weaknesses. And 44% of the companies reporting material weaknesses saw them stem from a restatement.

The costs

For larger companies, the average total implementation costs of first-year 404, based on a sample of 79 Fortune 1000 companies, was $7.3 million, or 0.09% of revenues.[5] And 101 smaller companies—with market capitalization between $75 and $700 million—had total implementation costs of $1.5 million on average in year one, or 0.46% of their revenues. Costs included time spent by company personnel, fees paid to service providers other than external auditors, and out-of-pocket expenses for travel, recruiting, hiring staff, training, and software purchases, in addition to audit fees. For the larger companies, audit fees represented roughly one-quarter of those total implementation costs, while for smaller companies, they were just over one-third of those costs.

Of companies reporting material weaknesses, most of the identified problems were . . .

. . . in the following categories of internal control issues:

- Material year-end adjustments proposed by the external auditors and required to correct misstatements, including required changes to footnotes
- Personnel issues, including sufficiency of accounting personnel resources and related competence
- Segregation of duties
- IT processing, access issues

. . . in the following accounting areas:

- Income taxes
- Revenue recognition
- Inventory, cost of sales
- Leases or commitments
- Fixed or intangible assets
- Depreciation and amortization
- Consolidation issues

[4] These findings are from a report from Audit Analytics™ that analyzed filings as of November 15, 2005.

[5] Cost information from a CRA International report, *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update*, issued in December 2005 and sponsored by the four largest accounting firms.

In part, the costs for year-one implementation were driven by the challenges companies faced:

- Need to document controls; PricewaterhouseCoopers estimates companies devoted 25% of their total 404 resource time to this documentation effort

- Need to address numerous control deficiencies; 225 PricewaterhouseCoopers clients identified approximately 275 control deficiencies per company, and we estimate over 40% of these companies remediated or implemented more than 25% of their key controls in year one

- Learning curve for a first-year initiative, including need to train staff, interpret new guidance, and reach new judgments—for example, on what constitutes a "key control"

The benefits

First and foremost, companies strengthened their internal control over financial reporting and remediated the deficiencies they found. This alone should improve the reliability of financial reporting. Internal control ownership also has expanded beyond the finance and accounting functions to executive, business unit, and operating management. Companies gained insight into their operations, often identifying inefficiencies they could eliminate. And in a few cases, savvy management used the 404 exercise as a strategic opportunity to streamline operations. Still, given the 404 deadline, many companies' remediation activities included stopgap measures. With a focus on enhancing both business and 404 compliance processes, described below in the *Achieving 404 Sustainability* section, companies should be able to achieve further benefits and reduce costs.

For their part, directors are substantially more engaged in overseeing financial reporting processes and control environments, as witnessed by increased discussion of internal control at board and audit committee meetings. And, at the end of the day, an enhanced control environment and tone at the top help reduce risk—for the market as well as for directors.

What about other benefits to the capital market? Investors and other market participants now have increased transparency into how management designs and implements internal control over financial reporting. Further, they will benefit from the increased reliability of financial reports, aiding in more efficient allocation of capital. Yet the debate continues as to whether the benefits ultimately will outweigh the costs—a notion that some find difficult to imagine given the magnitude of year-one compliance costs. Accordingly, it will be several years before a robust cost–benefit analysis can be considered.

Year two

The good news is that year-two compliance isn't as expensive. According to the CRA International survey, year-two 404 costs for larger companies, once they've been tallied, are expected to decrease by approximately 42%, to an average of $4.3 million. The expected decline at smaller companies is 39%, to about $900,000.

How are companies achieving these reductions? By:

- Identifying fewer controls as key controls that need to be tested by the company and the auditor. Large companies are identifying on average 13% fewer key controls to test. Smaller companies are seeing a decrease of approximately 17%, on average. The declines in auditor testing are even larger for both groups of companies.

- Relying on most of the documentation prepared in year one and updating it as required

- Avoiding the need for expensive and extensive remediation, since controls are generally in much better shape after the first year's compliance push

- Leveraging learning curve effects

For their part, auditors are relying more on the work of others, such as management, internal audit, and third party consultants. And they've adjusted the nature, timing, and extent of audit procedures in year two, reflecting their learning from year one and improved internal control at companies. This allows auditors to achieve the right balance when performing an effective and efficient audit. See further discussion in *Auditors and First-Year 404.*

Achieving 404 sustainability

Companies recognize that, even with the reductions seen in year two, they can't continue to expend so much effort on 404 year after year.

Aligning quarterly and annual reporting

Companies are trying to integrate their responsibilities under Sections 302 and 404. Section 302 requires management to certify quarterly that it has evaluated disclosure controls and procedures and identified material changes in internal control over financial reporting. Although controls testing is not required as part of the evaluation, many companies are conducting some level of quarterly testing to support the 302 certification and to accomplish other important objectives. Two alternatives are being used:

- Testing controls throughout the year, thus allowing for timely detection of problems, remediation, and any retesting needed

- Testing higher-risk controls quarterly, and using other assessment methods—such as periodic self-assessments—for controls and processes with lower risk

Whatever approach management takes, it must support both the quarterly certifications and the year-end assessment of controls over financial reporting.

Staying on top of change

Change is an inevitable fact of business operations. Ongoing 302 and 404 compliance requires companies to identify and consider the impact of significant changes in their processes and controls. That means amending their documentation and testing to reflect those changes. If changes are not identified early, then time and effort will be wasted, if the wrong controls are tested. Further, if a change is made and its control impact isn't properly considered, by the time the eventual 404 controls testing reveals the failure, it may be too late to remediate. It is vital to ensure that control documentation and testing plans address major changes—new IT systems, acquisitions, or new accounting standards—as an integral part of the business project.

Sometimes it's difficult to identify change. One overlooked area is the impact of changes in personnel. Different people may not apply procedures in the same way, perhaps because training lags behind reassignments of personnel. Or positions may be eliminated, leading to a single person assuming incompatible tasks or controls being dropped altogether.

How can companies ensure they recognize the impact of changes in a timely manner? By building into their everyday operations a specific process for identifying changes, including minor ones, that affect internal control over financial reporting. Other ways to catch changes that otherwise might go unnoticed are by using periodic walkthroughs of business processes to look for deviations from documented procedures, or by conducting 404 testing throughout the year. Self-assessments and annual risk assessments are still other effective ways of identifying changes.

Blueprint for sustainability

So what can companies do to cut their efforts down to a manageable size? The first critical step toward sustainable compliance is in mindset—redefining the effort as a process rather than a project. What does that mean? It means building the documenting and testing of controls into day-to-day operations. A structure for cost-effective compliance involves three factors: accountability, operations, and technology.

Accountability

The first key is to drive ownership of controls beyond the finance and accounting functions.

- *Business unit leaders* need to take responsibility for the continued effectiveness of controls affecting financial reporting. *Process owners* within business units will support them by identifying changes in their processes and documenting and testing key controls. *Risk and control specialists* may participate in the documentation and testing as well.

- *Internal audit* played a major hands-on role in initial 404 compliance—often at the expense

of its traditional monitoring of operational and other compliance processes and procedures. If companies continue to dedicate internal audit's role to 404, management needs to consider how internal audit's traditional monitoring role will be discharged.

There are compelling reasons why internal audit should not be involved in day-to-day testing and change management activities. Requiring business units to handle 404 themselves impresses more strongly on them that they are responsible for their business processes and related controls. Their ownership might not be as concrete if internal audit remains responsible for control documentation and testing.

- Some companies have a *chief internal control officer (CICO),* who oversees controls testing, evaluates deficiencies, and monitors remediation efforts. The CICO role is the focal point for identifying and assessing process changes and for monitoring risk assessments and test results for indications that changes in controls are needed in response to business changes. In many companies, the CICO reports directly to the CFO, with indirect reporting to the CEO and audit committee.

- *Employees who perform operational and financial processes* also play an important role in maintaining the effectiveness of internal control over financial reporting. These individuals need appropriate training and supervision.

All individuals involved need to understand their responsibilities—and that requires training and reinforcement. One of the best ways to reinforce individuals' accountability for control is to incorporate monitoring of compliance activities into their performance measurements. Measurements may include timeliness of activities such as documenting and testing controls and remediating problems.

Operationalizing compliance

Some approaches to compliance seem to work better than others. For example, standardized documentation protocols, including guidance on the level of detail to provide, can improve efficiency and effectiveness. Templates for controls testing and centralized approval of testing programs also help.

Who should perform the tests? Although there are different approaches, one practical way is to train groups of process-level employees to perform testing. This has several advantages:

- It's less costly than outsourcing

- It expresses management's confidence in employees

- Employees gain a better understanding of the business and exposure to senior business unit leaders

- It builds periodic testing into job responsibilities

Whoever does the testing should come to the table with the requisite level of competence and objectivity. Objectivity means that the testers' normal reporting lines should not influence their testing, conclusions, or reporting.

Quarterly testing reinforces expectations that employees are following prescribed policies and procedures throughout the year. It allows companies to spread the costs over the year and to even out workloads. It allows management to keep abreast of changes in controls for 302 certification purposes. And, with evidence that controls are operating effectively throughout the year, external auditors may reduce the amount of substantive testing and perform a more efficient integrated audit.

The CICO (or equivalent) should review testing results, resolve exceptions, and evaluate the implications for potential financial statement misstatements, then manage any remediation process and oversee the retesting.

Technology support structure

First-year 404 underlined the tremendous but largely untapped potential of technology.

To the extent they haven't yet, companies should look at how to automate manual controls and any "quick fixes" they put in place to remediate deficiencies in the short term.

In terms of the 404 process itself, a compliance management tool can facilitate information flows, both now and as compliance processes evolve over time. This tool assists with workflows, communications, reporting dashboards, version control, storage, archiving, and so on. Companies could use databases to store: process documentation, including objectives, risks, and key controls; templates for assessing the design effectiveness of controls; and

test programs and results. The IT architecture could support communication of testing requirements, summaries of results, and a sorting process to distinguish satisfactory results from exceptions. Some tools also provide a means of extracting and analyzing business information and metrics, thus serving as an early warning system for control problems.

Technology also can facilitate surveys, self-assessments, and training efforts. And it can enhance efficiency by providing both internal audit and external auditors access to documentation, testing programs, and results.

404 and smaller companies

Since 404 was enacted, questions have been raised about how best to implement its requirements for smaller companies, and concerns have been voiced that the costs may heavily outweigh the benefits for those companies. After much deliberation, the SEC in September 2005 deferred the compliance date for filing internal control reports by smaller companies for an additional year, to fiscal years ending on or after July 15, 2007.

The SEC is assessing public comments concerning smaller companies' compliance with 404 and will evaluate whether additional guidance would assist those companies in complying in a way that would be practical, in light of their internal control structures. This is part of a larger review of the impact of regulation on smaller companies. The work of the Advisory Committee on Smaller Public Companies is described in *Spotlight on Regulation*.

In October 2005, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued an exposure draft of its report, *Guidance for Smaller Public Companies Reporting on Internal Controls over Financial Reporting*. The objective of this report, which builds on the first COSO report, *Internal Control – Integrated Framework* (the *Framework*), published in 1992, is to provide guidance for smaller companies and their auditors in applying the *Framework* in connection with 404 assessments. It illustrates ways smaller organizations can efficiently design and implement effective internal control. Comments on the exposure draft are being analyzed and incorporated, with release of the final report expected toward the end of first quarter 2006.

Stay tuned.

Auditing standard on previously reported material weaknesses

In July 2005, the PCAOB adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AS 4), which allows auditors, at a company's request, to report on whether a specific material weakness continues to exist.

The auditor's report would be based on an evaluation of management's assertion that the material weakness no longer exists. There are several conditions: management must accept responsibility for internal control over financial reporting, evaluate the effectiveness of the specified controls that address the material weakness, assert that those controls are effective in addressing the material weakness, and support its assertion with sufficient evidence, including documentation. The auditor's testing is limited to the controls identified by management as addressing the material weakness.

AS 4 also specifies what's in the auditor's report, including the choice of two possible opinions—"the material weakness exists" or "the material weakness no longer exists." An auditor who is engaged to perform this work and finds that a material weakness continues to exist, must communicate that conclusion in writing to the company's audit committee if no report is issued. The auditor also must communicate to the audit committee, in writing, any new material weaknesses identified during the engagement.

The fact that such a report is available gives companies an option in providing the public with assurance that a previously reported material weakness no longer exists. But time will tell whether many companies will elect to have their auditors report under AS 4, particularly

if management concludes its 302 quarterly certifications provide sufficient communication about any material changes in internal control. Other factors in that decision are how the market views the material weakness and the time to year end, when the regular 404 report will be issued.

The SEC is considering public comments on the standard and will have to approve it before it becomes final.

Impact on audit committees

With two years of 404 now substantially behind many of them, audit committees will be looking at the costs and benefits—and at management's efforts to establish cost-effective sustainability. Committees will be monitoring progress, ensuring that 404 is integrated into routine business operations, and continuing to play their own significant role in overseeing 404. They'll also continue to monitor the status of significant deficiencies and material weaknesses, ensuring management's remediation plans are sound.

And where companies reported material weaknesses, audit committees will want to consider whether the situation merits having external auditors report on whether a material weakness continues to exist, as provided for in AS 4.

Although smaller companies have a reprieve through the postponement of their 404 reporting deadline, audit committees of those companies will want to keep an eye out for guidance from COSO, and possibly from the SEC as well, on how smaller companies can comply with 404 efficiently.

Spotlight on regulation

New faces at the SEC … and many more to come

Reflecting on 2005, the extent of change in both the SEC and its senior staff is striking.

The Commission

In August, Christopher Cox was sworn in as the SEC's 28th Chairman, succeeding William Donaldson, who had served in that post for just over two years. Mr. Cox brings an impressive resume to the SEC, including more than 16 years in the U.S. House of Representatives, where he served in a leadership capacity on the committees that oversee investor protection and the U.S. capital markets. His legislative legacy includes the Private Securities Litigation Reform Act and the Internet Tax Freedom Act. From his first day, Chairman Cox has emphasized that the SEC is the advocate of investors. And he has made vigorous enforcement of the federal securities laws the SEC's top priority.

In terms of Commissioners, Roel Campos was reappointed for another term and Annette Nazareth—previously Director of the SEC's Division of Market Regulation—was appointed to fill the seat of Commissioner Harvey Goldschmid.

Commission staff

In 2005, Linda Chatman Thomsen succeeded Stephen Cutler as Director of the SEC's Enforcement Division. As of the end of the year, a number of senior staff positions in key divisions and offices needed to be filled: Chief Accountant, General Counsel, and directors of the Division of Market Regulation and the Division of Investment Management. Although this publication covers developments to December 31, 2005, we'd be remiss not to mention that in early 2006, Alan Beller—architect of arguably the most sweeping period of regulatory modernization and change at the SEC since the creation of the federal securities laws—announced his intention to leave his position as Director of the Division of Corporation Finance.

Only time will tell how the new leadership at the SEC will shape the future of the regulatory landscape.

SEC areas of focus

Two areas have become focal points for the SEC.

Quantifying unadjusted errors

It is not uncommon for a company's management or its auditors to identify financial statement errors, some spanning multiple accounting periods. To the extent the errors are material, the underlying financial statements are, of course, corrected. But, if management and the audit committee determine—and the auditors concur—that the errors are immaterial to the financial statements taken as a whole, they could remain unadjusted.

Sounds simple. But the entire process of evaluating errors has become increasingly complex over the past few years.

First, identified errors must be quantified. Many view the quantification and tracking of unadjusted errors as the auditor's responsibility. However, that line of thinking is not accurate—management is responsible for presenting financial statements that are free of material misstatement, and audit committees are responsible for overseeing that process.

Two primary models are used for quantifying the impact of unadjusted errors:

- The "iron curtain" method. The impact of unadjusted errors is quantified based on the *cumulative adjustment* that would be needed to correct the *balance sheet* for the current period, without regard to the period in which the errors arose.

- The "rollover" method. The magnitude of unadjusted errors is quantified based on the amount by which the affected period's *income statement* is misstated, with little or no consideration of the cumulative unadjusted errors in the balance sheet.

When applied on a consistent basis, each method has been viewed as generally accepted. But the SEC thinks there shouldn't be multiple ways to approach something as fundamental as quantifying unadjusted errors. Determining which method to mandate is difficult—each has its own merits and shortcomings. For instance, the rollover method—with its income statement bias—can lead to a gradual buildup of erroneous assets and liabilities in the balance sheet. The iron curtain method—with its balance sheet bias—can lead to a complete disregard for material misstatements in the current-period income statement. How? Assume an immaterial cutoff error in a prior year is corrected in the current year. If revenues have declined substantially in the current year, that correction could represent a material amount, but the iron curtain method wouldn't take that into account, as it looks only at balance sheet misstatements.

It is not entirely clear if or when the SEC ultimately will provide guidance on which method should be used. However, it has expressed a view that the "dual approach," under which unadjusted errors are analyzed under both methods and the method yielding the greater error is used, may be preferable.

How can you prepare? Management and the audit committee should ensure they understand and are comfortable with the company's policy for evaluating unadjusted errors and that it has been applied consistently from period to period. Additionally, management should maintain a complete inventory of all unadjusted differences by year. By preparing in advance, management can minimize the time needed if and when any final SEC guidance is issued.

Leveraging technology

Chairman Cox's agenda envisions greater use of technology in the corporate disclosure and financial reporting system. Toward that end, he has assumed leadership of the global effort to expand the use of interactive data, through venues such as XBRL.[6] The SEC launched an XBRL Voluntary Program in 2005 as a tentative first step. The program is designed to encourage participants to help assess the potential for using interactive data both within and outside the SEC.

Chairman Cox also is championing the notion that in today's day and age, the Internet availability of important disclosure documents—such as proxy statements—coupled with appropriate investor notification, may be a sufficient delivery mechanism in lieu of the costly printing and mailing of those documents. And in December, the SEC proposed a so-called "notice and access" model that would permit a company to satisfy its proxy statement delivery obligations by posting its proxy materials to an unrestricted Internet website (other than the SEC's EDGAR website) and notifying shareholders that the materials are available, with an explanation of how to access them. Similarly, in connection with Securities Offering Reform, discussed below, the SEC adopted a conditional "access equals delivery" model for final prospectus delivery. Taken together, these two initiatives highlight a trend in SEC reporting and disclosure toward promoting use of the Internet as a reliable and cost-effective means of delivering information to investors and markets.

Revised filing deadlines

In December 2005, the SEC revised annual and quarterly report filing deadlines for many companies. It also designated a new class of companies as *large accelerated filers*—essentially, companies that, as of the end of their fiscal year, have had to file reports with the SEC for at least 12 months and had a worldwide common equity public float[7] of at least $700 million on the last business day of their latest second fiscal quarter. Such companies represent roughly 95% of the U.S. equity market capitalization.

[6] See the appendix on XBRL in *Current Developments for Audit Committees 2004*, available at www.pwc.com/uscorporategovernance.

[7] Worldwide common equity public float is the aggregate market value of the company's outstanding voting and nonvoting common equity held by nonaffiliates.

Generally, the rules postpone the final stage of accelerated filing[8] for both quarterly and annual reports. Many companies would have had to file their 10-Qs 35 days after quarter end, and their annual 10-K filings 60 days after year end.

The SEC also made it easier for companies to exit accelerated filer status. Under the new rules, a company would exit accelerated filer status at the end of its fiscal year if its worldwide common equity public float was less than $50 million on the last business day of its latest second fiscal quarter. For a company that is a large accelerated filer, the exit threshold is $500 million.

The new rules are summarized in the box.

Why is this important? If a company is on the verge of entering a higher category, it needs to monitor its second quarter-end public float closely, to see whether it will have to report in a shorter time period. For companies with growth plans that would see them entering higher categories in future years, establishing processes now to allow for a faster, high-quality close is advisable. A company's changing status also drives its 404 compliance timetable.

Securities Offering Reform

On December 1, 2005, new SEC rules became effective that will have a dramatic impact on the public offering of securities. The rules allow enhanced and more timely communication with investors prior to an offering, expedite shelf registrations, and, as discussed in *SEC Areas of Focus*, eliminate most requirements for physically delivering prospectuses. The SEC also addressed a number of important liability-related issues in connection with its new rules.

Communications

The SEC believes investors benefit from increased communications, as long as there are appropriate provisions to protect them. Accordingly, the new rules interpret the so-called gun-jumping provisions—designed to ensure the prospectus, with its specific line item disclosures, is the primary source of information regarding a securities offering.

Thus, companies generally are allowed to publish regularly released factual information at any time, and, up to 30 days before filing a registration statement, to make any statement provided it does not reference the securities offering. In addition, companies other than nonreporters—that is, those companies that file with the SEC under the terms of, say, indenture contracts, but that otherwise wouldn't have to file—may publish regularly released forward-looking information at any time.

The rules also establish a new category of issuer, *well-known seasoned issuers* (basically, companies with more than $700 million of public equity, although other criteria apply), whose information investors, the financial press, and analysts track and evaluate on a regular basis. These companies have more or less free rein over communications.

Shelf registrations

The shelf registration process was designed to allow companies to go to market quickly. The new rules liberalize many aspects of the shelf registration process by allowing a company to

Filing deadlines and criteria to categorize companies

	Public float		Filing deadlines			
			Years ending before 12/15/06		Years ending on or after 12/15/06	
	Entry	Exit	10-K	10-Q	10-K	10-Q
Large accelerated filers	$700 million	$500 million	75 days	40 days	60 days	40 days
Accelerated filers	75 million	50 million	75 days	40 days	75 days	40 days
Nonaccelerated filers	N/A	N/A	90 days	45 days	90 days	45 days

[8] See Accelerated SEC Filings in *Current Developments for Audit Committees 2003*, available at www.pwc.com/uscorporategovernance.

omit information from the base prospectus for certain primary offerings if it doesn't know the information or if the information is not reasonably available to the company at the time the registration statement becomes effective. The new rules also provide flexibility in how companies can provide the omitted information at the time of an offering, referred to as a takedown. They can file a post-effective amendment to the registration statement, incorporate the information by reference from an Exchange Act report, or provide a prospectus supplement.

The new rules allow well-known seasoned issuers even more flexibility. Those companies can file *automatic shelf registration statements* that become effective immediately upon filing, without SEC review. Under the automatic shelf registration process, companies may register unspecified amounts of different classes of securities.

And, they can omit even more information from their base prospectus. With the increased latitude to determine, on a real-time basis, what types and amounts of securities to offer, well-known seasoned issuers will be able to take advantage of market windows and respond quickly to investor demand and changing market conditions.

To facilitate the shelf registration process, companies must disclose risk factors, where appropriate, in Form 10 and Form 10-K (with updates in Form 10-Q), and accelerated filers, large accelerated filers, and well-known seasoned issuers must disclose certain unresolved SEC staff comments in Form 10-K and Form 20-F.

Addressing smaller companies' needs

The specific concerns of smaller companies have been in the foreground this past year—from the SEC's deferring 404 compliance deadlines, to its modifying accelerated filing deadlines for smaller companies, as discussed earlier in this section.

The Advisory Committee on Smaller Public Companies was created to assist the SEC in examining the impact of the Sarbanes-Oxley Act and other aspects of federal securities laws on smaller companies. The Committee has 21 representatives from various professions and industries—financial and operating executives from smaller companies, public and private accountants, venture capitalists, and lawyers—as well as three official observers from the PCAOB, FASB, and North American Securities Administrators Association, the organization of state securities regulators.

Specifically, the Advisory Committee is focusing on how best to ensure that the costs of regulation for smaller companies are commensurate with the benefits. Four subcommittees tackled separate issues and presented their preliminary recommendations at a December 2005 meeting. The full Advisory Committee accepted all recommendations. Now the subcommittees are developing exposure drafts—expected in February 2006—for public comment. After incorporating the comments, the Advisory Committee is targeted to present its final recommendations to the SEC in April 2006.

Among the recommendations:

Corporate governance

- Amend SEC rules to increase the thresholds that would trigger required registration under the 1934 Act, and modify the definition of security holder. This would decrease the likelihood of companies inadvertently triggering the public registration requirements when their intent is to remain private.
- Require smaller public companies to provide two years of audited balance sheets and statements of income, cash flows, and changes in stockholders' equity. While this would increase from one to two the number of audited balance sheets required of S-B smaller companies—those filing under Regulation S-B—it would decrease from three years to two the number of statements of income, cash flows, and changes in stockholders' equity for non-S-B smaller public companies.

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- Exempt microcap companies[9] from Section 404.

[9] Companies with market capitalization of less than $100-125 million and annual revenue of less than $125 million.

- Exempt small companies[10] from the auditor attestation requirement.

- If the SEC believes some level of auditor involvement is required for small public companies, develop a new auditing standard requiring an opinion on the design and implementation of internal controls, but no opinion on operating effectiveness.

Accounting standards

- Permit microcap companies to apply the same effective dates in implementing new accounting standards as the FASB provides for private companies, which are sometimes a year later than the effective date for public companies.

- Establish a de minimis provision for applying aspects of auditor independence rules.

Capital formation

- Adopt a new private offering exemption for general solicitation and advertising, to apply to transactions with certain "eligible purchasers," as defined.

- Allow certain small public companies to go private more easily.

Listing on European exchanges

Starting January 1, 2007, non-European Union (EU) companies with debt securities with a value per unit of less than 50,000 euros and equity securities trading on an EU-regulated market, or that make a public offering of these securities in Europe, will be required to prepare and present financial information in accordance with International Financial Reporting Standards (IFRS) or equivalent standards.

Accordingly, the European Commission (EC) mandated the Committee of European Securities Regulators (CESR) to study and publish technical advice regarding the equivalence of Canadian, Japanese, and U.S. GAAP to IFRS. The approach to determining equivalence with IFRS was whether, using financial statements prepared under the national framework, an investor would make a similar investment decision.

The final technical advice, which has not yet been adopted by the EC, was published in July 2005. It details CESR's conclusion that, subject to a number of remedies—primarily qualitative and/or quantitative disclosures—Canadian, Japanese, and U.S. GAAP are equivalent to IFRS. Thus, companies reporting under one of those national frameworks would not be expected to prepare complete reconciliations of their financial statements to IFRS.

A number of unresolved issues remain—including a final decision in this area by the EC, clarity on the extent of information that needs to be disclosed, and the auditor's association with such information. U.S. companies listing on EU exchanges will want to follow developments and prepare for the new requirements ahead.

Impact on audit committees

The past year has seen many changes at the SEC—in personnel, securities offering regulations, and filing deadlines. Audit committees will want to understand how all of these affect the company, and the implications if the company meets the new definitions of large accelerated filer and/or well-known seasoned issuer, or if it may be moving between accelerated filer categories. And, as the SEC looks into how companies quantify unadjusted errors, audit committees will want to ensure management is monitoring developments and tracking the level of unadjusted errors to understand potential restatements under different scenarios. Audit committees of companies that list in Europe will want to discuss with management any supplemental disclosures needed to address the differences between U.S. GAAP and IFRS, and be comfortable they're providing proper oversight of those disclosures. Finally, audit committees will want to explore with management whether the company is using technology to the appropriate extent, given the SEC's increased focus on leveraging technology in financial reporting.

[10] Companies with market capitalization of less than $700-750 million and annual revenue of less than $250 million.

Focus on auditing

PCAOB developments

The Public Company Accounting Oversight Board (PCAOB), in existence since 2003, has largely established its core functions to regulate accounting firms that audit public companies—registering firms, inspecting them, establishing auditing and related standards, and conducting investigations. As it emerges from infancy, the PCAOB is undergoing its first changing of the guard. In late 2005, William McDonough resigned his position as the PCAOB's first Chairman. Board member Bill Gradison is Acting Chairman at the time of this writing.

By the end of 2005, staff levels exceeded 400 and are expected to increase by another 25% in 2006. Almost half of the PCAOB's staff is in the inspection area. The first Chief Auditor, Douglas Carmichael, resigned in late 2005 and was succeeded by Thomas Ray, previously Deputy Chief Auditor.

The Standing Advisory Group (SAG) also will have a number of new members in 2006. The SAG, with approximately 30 members—auditors, issuers, and investors—advises the PCAOB on priorities and other issues relevant to its standard setting.

Most of the emphasis in standard setting during 2005 centered, not unexpectedly, on providing ongoing guidance for auditors' initial implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AS 2). And, to respond to a perceived need to add credibility to companies' statements that they have fixed material weaknesses, the PCAOB provided AS 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist,* as described in *404 Redux*.

Areas of emphasis for 2006 are expected to include engagement quality reviews, fraud, risk assessment, and accounting firms' systems of quality control (including independence quality controls). Also expected is a report on auditors' overall implementation of SAS No. 99, the PCAOB's interim standard on fraud. This will encompass the collective knowledge and feedback obtained by the PCAOB, including results of its inspection process, and be similar to its report on the initial implementation of AS 2, issued in late 2005 and discussed next.

Auditors and first-year 404

On November 30, 2005, the PCAOB issued its report on the initial application of AS 2. The bottom line: The audits often were not as effective or efficient as AS 2 envisioned.

The PCAOB acknowledged auditors faced enormous challenges in performing first-year 404 audits—primarily the limited timeframe that both companies and auditors faced and a shortage of audit staff with prior training and experience in designing, evaluating, and testing controls.

The report identified five ways to improve the efficiency of internal control audits.

- Better integrating audits of internal control with financial statement audits, resulting in greater reliance on controls in the financial statement audit work.

- Using a top-down approach, by first evaluating company-level controls and significant accounts at the financial statement level and then working down to controls at the process, transaction, or application levels. If controls at the higher levels are well designed

and operate effectively, auditors may be able to reduce tests of controls over individual processes, transactions, and applications.

- Applying a risk-based approach, so that the nature, timing, and extent of testing are commensurate with the level of risk in an area.

- Refining walkthroughs to follow a single transaction from its origin through the entire process until it is reflected in the financial records and to ask company personnel sufficiently probing questions to gain a complete understanding of the transaction process, which assists in identifying missing or inadequate controls.

- Using the work of others to the extent permitted by AS 2, particularly in lower-risk areas.

PCAOB rules on ethics, tax services, and independence

In July 2005, the PCAOB adopted new ethics and independence rules entitled *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees.*

After considering whether a number of tax services impair auditor independence, the PCAOB concluded two types of tax services should be prohibited:

- Those involving marketing, planning, or opining in favor of the tax treatment of a confidential transaction or one initially recommended by the auditor and involving an aggressive tax position—one whose purpose is tax avoidance and that is not "more likely than not" to be allowable under applicable tax laws.

- Tax services to individuals who have a financial reporting oversight role with an audit client.

Because of the uniqueness of tax services, and their potential to align the interest of the auditor with that of the client, the new rules require auditors to provide additional information to the audit committee to assist it in making preapproval decisions about permissible tax services. Specifically, auditors must:

- Describe, in writing, the scope of the service, the fee structure, and any side letter or other amendment to the engagement letter, or any other agreement; and any compensation arrangement or other agreement, such as a referral agreement, referral fee, or fee-sharing arrangement, with respect to promoting, marketing, or recommending a transaction covered by the service

- Discuss with the audit committee the potential effects of the services on auditor independence

- Document the substance of these discussions

The rules do not specify the timing or form of these discussions, but the PCAOB indicates it expects the audit committee to review tax services, and suggests this could be done annually during meetings. Depending on a committee's policies and procedures for approving tax services, the auditor might have the discussion at a full committee meeting or with a committee member designated to deal with tax services. Audit committees might want to reflect the key points of these discussions in meeting minutes as evidence of their understanding and approval of the services.

On a related note, the rules prohibit contingent fees determined by the results of judicial proceedings or the findings of governmental agencies.

The new rules also touch on nontax matters:

- Requiring auditors to be independent of audit clients throughout the audit and professional engagement period

- Requiring auditors to conduct themselves in a manner that would not cause them to violate applicable rules, laws, and standards

Impact on audit committees

Regulatory requirements for the auditing profession continue to evolve, as new standards

are rolled out and the implementation of the 404 audit standard is analyzed. Audit committees will want to understand how new guidance issued by the PCAOB will impact the efficiency of the 404 audit in this and future years. Audit committees also will look for any lessons in the PCAOB's expected report on auditors' implementation of SAS No. 99, on fraud.

And scrutiny of tax services and their impact on auditor independence continues to be a focus. New PCAOB rules prohibit certain services and, for those that are permissible, require auditors to provide additional information to the audit committee to assist in preapproval decisions. Audit committees should consider this new guidance when determining whether to use their auditors for tax services.

The international scene

Global GAAP—why IFRS is important to U.S. companies

International Financial Reporting Standards (IFRS) are here. Over 7,000 companies in Europe converted to IFRS as of January 1, 2005, as did Australian companies. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are committed to working with each other and converging U.S. accounting standards and IFRS. Similar IASB partnerships exist with standard setters in Europe, Canada, Australia, and Japan. Their ultimate goal? One set of high-quality global accounting standards, Global GAAP.

How IFRS impacts U.S. companies

So, why is it important that U.S. companies get involved in the Global GAAP effort?

- **IFRS influences the direction of U.S. GAAP.** Convergence is a two-way street. U.S. standards are changing and will continue to change as a result of convergence. So even a U.S.-based company with no international operations will be affected by the move toward convergence. Take business combinations, for example. In June 2005, the FASB and IASB jointly issued exposure drafts of proposed changes to the current business combination model. Joint decisions were made on the proposed changes, and the IASB's thinking undoubtedly influenced the FASB's decision-making process. If adopted, many of the existing IFRS requirements for business combinations will become part of U.S. GAAP. Thus, for U.S. constituents to influence FASB decisions, they also need to be in a position to shape and influence decisions being made by the IASB.

- **IFRS will play a significant role in the U.S. capital markets.** The SEC has laid out a roadmap to eliminate, possibly by 2009, the reconciliation between IFRS and U.S. GAAP for foreign companies accessing the U.S. markets. Key to being able to eliminate this reconciliation is continued progress toward convergence of IFRS and U.S. GAAP, rigorous and consistent implementation of IFRS, and rigorous enforcement of IFRS compliance by national regulators and auditors. Elimination of the reconciliation requirement will mean that IFRS will co-exist with U.S. GAAP as an accounting language in the U.S. capital markets.

- **U.S. companies must provide—soon if not now—some IFRS data in European securities offerings.** The European Prospectus Directive applies to U.S. companies that offer securities to the public in the European Union (EU)—including certain offerings of shares to employees—or have securities admitted to trading on a regulated market in the EU. This Directive requires certain IFRS information to be presented in the offering document: generally, either a narrative description of differences between IFRS and U.S. GAAP (for offerings of debt securities with unit values above 50,000 euros) or, starting in 2007, financial statements presented in accordance with IFRS or equivalent (for offerings of shares and debt securities with unit values below 50,000 euros). See further discussion in *Listing on European Exchanges*.

  An important point to note is that if the EU requires additional IFRS data, companies may have to provide it in the United States as well, which could then make it subject to Section 404 requirements. And once the topic turns to 404, companies likely will need to demonstrate the necessary controls surrounding IFRS reporting—just as they must

show they have the controls to report properly under U.S. GAAP. These IFRS controls may prove hard to demonstrate.

Issues for audit committees

Understanding the shifting IFRS landscape is important. Engaged audit committees are ensuring they gain an understanding of what IFRS and Global GAAP mean for their companies. The box includes some typical questions.

Convergence of U.S. GAAP with IFRS raises more than technical accounting issues. There are significant issues regarding a company's strategy to educate stakeholders on how to interpret financial results under a converged set of standards. For example, as discussed further under *Developments Affecting Corporate Reporting*, a wider use of fair values in financial statements will create more volatility in the income statement.

PricewaterhouseCoopers' perspectives

IFRS represents the biggest accounting change in a generation. A key challenge is that individuals naturally tend to approach new requirements with their home country bias. And, given local adaptations of IASB standards are allowed in certain territories, there is the risk of possible confusion in the marketplace when different versions of IFRS are used. In our view, local adaptations of IFRS create confusion and lack of transparency. Areas of genuine conflict within or between standards should be addressed by the International Financial Reporting Interpretations Committee. We believe that one version of IFRS is better for the market.

That said, IFRS needs to be interpreted and applied in its own right. Where standards lack guidance or clarity, preparers and auditors will need to exercise greater professional judgment. While it may be tempting for some to default to U.S. GAAP in these circumstances, we believe that U.S. GAAP should not be the default; IFRS should be interpreted on its own. This means that more than one interpretation may be acceptable where guidance is unclear. Full disclosure and transparency will be critical.

With respect to convergence of IFRS with U.S. GAAP, our experience shows that many differences continue to exist. In our view, to ensure continued progress is made toward convergence, the application guidance in the standards needs to be converged as well as the principles. Even when the principles are converged, the nature and extent of application guidance can lead to different conclusions.

The reconciliation between IFRS and U.S. GAAP for foreign private issuers increases the transparency around differences between IFRS and U.S. GAAP for U.S. investors. It also provides a basis for comparability with U.S. GAAP. We support elimination of this requirement when it is no longer needed for investors' understanding of the differences between IFRS and U.S. GAAP.

Questions to ask financial and operating management

- Are we keeping abreast of the IASB's standard-setting activities, as well as monitoring the FASB's projects on convergence, to determine the potential impact, if any, they might have on the company? Do we have resources devoted to tracking key developments?
- Do we make our views known to the IASB and FASB? Are we actively participating in the IASB's standard-setting process, particularly identifying practical application concerns and business implications?
- Have we determined the impact of the Prospectus Directive on our EU securities offerings?
- Have we adequately informed our stakeholders, including industry analysts, as to the potential impact of IFRS and ultimately Global GAAP on the company (including potential Section 404 ramifications)?
- Have we considered the existing IFRS knowledge of our staff and managers and whether additional training or resources may be needed?
- What changes would we have to make to our data, systems, and control environment to comply with IFRS?

New EU rules on audit committees and auditing

In September 2005, the European Parliament approved the European Commission's (EC) proposals for the 8th Company Law Directive on statutory audit (8th Directive). It is expected to be transposed into the national laws of EU Member States by the end of 2006.

The 8th Directive requires "public interest entities"—such as listed companies, banks, and insurance companies—to establish an audit committee (or similar body) and sets requirements for membership and responsibilities. At least one committee member has to be both independent and competent in accounting and/or auditing. The audit committee will select the audit firm to be proposed for appointment and will review auditor independence. And, among other tasks, it will be responsible for monitoring the financial reporting process and the effectiveness of the company's internal control and risk management systems.

The 8th Directive further calls for auditors to communicate on a timely basis with the audit committee on matters arising from the audit—for example, significant changes in accounting policies, significant risks and exposures facing the company, material audit adjustments and uncertainties, disagreements with management, going concern issues, expected modifications to the auditor's report, and fraud involving management—and in particular on material weaknesses in internal control over financial reporting.

Another key objective of the 8th Directive is to harmonize the statutory audit function throughout the EU. It clarifies the responsibilities of statutory auditors, including compliance with independence and ethics rules, and requires the application of international standards on auditing. It also sets out principles for public oversight of the audit profession and introduces a requirement for external quality assurance.

And, the 8th Directive provides a basis for cooperation between EU regulators and regulators in non-EU countries, such as the U.S. Public Company Accounting Oversight Board (PCAOB). The EC has established the European Group of Auditors' Oversight Bodies to respond to the requirement for public oversight of auditors. This group is charged with ensuring effective coordination among the various auditor oversight bodies.

International auditing standards gain momentum

The need for a common global benchmark for audit quality continues to drive convergence in auditing standards. In 2005 the trend accelerated toward adoption of international standards on auditing (ISAs) in major capital markets around the world. Even though the PCAOB has not identified convergence as a key goal in the short term, given the large number of U.S. companies seeking capital in European and other foreign capital markets, this trend is important to U.S. companies.

European regulation of auditing

The previous section describes the 8th Directive. One of its significant provisions is its support for auditors to apply ISAs for all statutory audits conducted in the EU. That said, ISA adoption is subject to certain conditions—the quality of the standards and whether they are "conducive to the European public good."

In anticipation of ISAs becoming mandated in Europe, a number of European countries have already begun adopting them as their national auditing standards. Starting with 2006 audits, the United Kingdom will be among the first to adopt the full suite of ISAs, by implementing its International Standards on Auditing (United Kingdom & Ireland)—essentially, the ISAs with a limited number of UK add-ons. Other European countries are expected to be required to adopt some or all of the ISAs by 2008.

In pursuit of clarity

The International Auditing and Assurance Standards Board (IAASB) has embarked on one of its most significant initiatives yet, its Clarity Project, designed to facilitate ISA adoption.

The IAASB hopes to promote international convergence by making the ISAs more understandable and more easily translated—all in support of high-quality audits globally.

But the IAASB also concluded the work needs to go beyond simply language changes. Accordingly, the Clarity Project proposals include setting out an objective for each ISA, separately identifying requirements (i.e., actions or procedures auditors are expected to perform in order to achieve the objective), and eliminating ambiguity regarding the authority of application guidance. ISAs that focus on the objective to be achieved, rather than a detailed list of specific steps, will support audit quality by helping auditors exercise appropriate judgment, thereby allowing them to adapt to the variety of circumstances they face around the world.

Why does this matter to nonauditors? Because ISAs will drive what auditors need to do, including the documentation required. All of the large international firms are committed to basing their global policies and methodologies on the ISAs. Thus, decisions made in finalizing ISAs will affect not only global audit quality but also the cost-effectiveness of audits.

Four ISAs (ISA 300, *Planning*; ISA 240, *Fraud*; ISA 315, *Risk Assessments*; ISA 330, *Responding to Risks*) have been redrafted and exposed for public comment, with responses due by the end of February 2006. The IAASB is going to try to redraft as many other ISAs as possible by the 2008 EU adoption deadline. In addition, the IAASB has a number of major revisions in process, including ISAs on group audits, estimates, and materiality. As a result, a significant number of new and revised ISAs will come into effect in 2008.

PricewaterhouseCoopers strongly supports the Clarity Project. We have found the revised draft ISAs to be a significant improvement—more readable and understandable and better articulating the requirements in conducting an audit.

IAASB's program

In addition to the Clarity Project, the IAASB also approved the following standards in 2005:

- **Documentation.** ISA 230, *Audit Documentation*, substantially consistent with PCAOB Auditing Standard No. 3, is effective for audits of financial periods beginning on or after June 15, 2006.

- **Review of interim financial information.** International Standard on Review Engagement 2410 outlines the general principles of an auditor's review of interim financial information; provides guidance on the inquiries, analytical procedures, and other review procedures to be performed by the auditor; and prescribes the content of the review report.

- **Auditor's report.** Revisions to ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, introduce new wording for the auditor's report, strengthen guidance on matters the auditor considers when forming an audit opinion, and address other practice issues such as the date of the auditor's report and supplementary information. While the new audit report wording will come into effect at the end of 2006, certain requirements—related to engagement acceptance and to audit objectives and general principles—have been deferred further, pending a review of other ISAs relating to reporting.

Other projects under way include standards on auditing related parties, special purpose audit reports, and management representations.

In addition, of particular note to audit committees:

- **Communications with those charged with governance.** The proposed revision to ISA 260 reflects significant developments in regulatory and auditing standards in several jurisdictions. Since the communication process will vary with the engagement circumstances, the proposed ISA would require the auditor to establish with those charged with governance a mutual understanding of the form, timing, and expected content of communications.

  The proposal sets the expectation that auditors would communicate: their responsibilities; the planned audit scope and timing; audit findings, including the auditor's views about qualitative aspects of the company's accounting practices; specific required communications, such as material weaknesses in internal control and uncorrected misstatements; and other matters the auditor

China commits to convergence with ISAs

To illustrate the global impact of ISAs, in December 2005, the Chinese Auditing Standards Board formally agreed with the IAASB that China will pursue a policy of convergence with international auditing standards. In the statement published by both parties, they agreed that "establishing and improving a single set of high quality global auditing standards is a logical response to the trend of economic globalization—which plays a key role in reducing the risk of decision-making by investors for efficient capital allocation, as well as in promoting economic development and maintaining financial stability all over the world." Since China joined the World Trade Organization in 2001, its integration into the world economy has increased rapidly, and adoption of ISAs is another step in that integration, as well as a signal to investors that they can place greater confidence in Chinese audit results.

judges to be serious and relevant to the audit committee's responsibilities.

Auditors of listed companies also will be required to communicate, in writing, confirmation of their compliance with ethical requirements and the fees charged for audit and nonaudit services provided in the previous 12 months.

It is significant that the revisions also provide some dispensation from certain communications for audits of smaller entities in which management and governance are one and the same. Recognizing different needs of smaller entity audits sets an important precedent for the IAASB.

- **Group audits.** The proposed ISA would give the group auditor "sole responsibility" for the group audit, in line with most auditing standards and practice worldwide—the notable exceptions being the United States, Italy, and some South American countries in which auditors are permitted to divide responsibility with other auditors. This means that, while the group auditor can use the work of other auditors as evidence, the group auditor must be satisfied that sufficient appropriate audit evidence has been obtained to support the opinion on the consolidated group financial statements. As a result, group auditors will need to assess whether they have sufficient access to management and those charged with governance throughout the group. In practice today, auditors seldom have that access in situations such as joint ventures or equity accounted investments.

Matters affecting foreign private issuers

SEC and U.S. stock exchange rules make increasingly less distinction between foreign and domestic issuers. Thus, although this section focuses on new rules of particular concern to foreign private issuers, see broader discussions of rules finalized in 2005 elsewhere in this publication.

NASD requires interim financial statements

In August 2005, the SEC approved a rule requiring foreign private issuers traded on NASDAQ to provide semiannually—in a press release, which also would be submitted on Form 6-K—an interim balance sheet and income statement. While most non-U.S. companies listed on NASDAQ already provide such information voluntarily, this rule is intended to ensure that investors have access to recent financial information from all companies. Among the specifics:

- The interim reports must be submitted within six months of the end of the company's second fiscal quarter.
- As with all information submitted on Form 6-K, the interim financial statements must be translated into English.
- The interim financial information does not have to be reviewed by external auditors or reconciled to U.S. GAAP.

The new rule takes effect for interim periods ending after January 1, 2006.

Section 404—internal control over financial reporting

The Section 404 compliance deadlines for foreign private issuers have been extended.

- Foreign companies that are accelerated filers—those with over U.S.$75 million in global market value of common equity held by nonaffiliates—and that file annual reports on Form 20-F or 40-F must begin to comply with Section 404 requirements for fiscal years ending on or after July 15, 2006. This is a one-year extension from the previous deadline.

- Smaller foreign companies that are not accelerated filers must comply for fiscal years ending on or after July 15, 2007.

First-time adoption of IFRS

In April 2005, the SEC adopted a rule to amend Form 20-F, providing a one-time accommodation to eligible foreign private issuers in their first year of reporting under IFRS. It allows foreign companies to file two years—rather than three—of statements of income, changes in stockholders' equity, and cash flows prepared in accordance with IFRS. This rule applies to foreign companies that previously have not published financial statements under IFRS, and that publish IFRS financial statements for the first time for any financial year beginning no later than January 1, 2007.

In addition to the reconciliations required by IFRS 1, the amendment to Form 20-F requires:

- Companies to provide the reconciliation from Previous GAAP to IFRS in a form and level of detail sufficient to explain all material adjustments to the balance sheet and income statement and, if presented under Previous GAAP, the cash flow statement.

- All first-time adopters that rely on any of the exceptions permitted or required under IFRS 1 to identify each exception used, including an indication of the items or class of items to which the exception was applied, and a description of the accounting principle used and how it was applied. Such disclosures can be included in either the footnotes or management's discussion and analysis.

Footnotes to the audited financial statements must continue to include an audited reconciliation between IFRS and U.S. GAAP for all years of financial statements prepared in accordance with IFRS.

To help ensure the quality of IFRS information, companies are strongly encouraged to prepare the reconciliation from IFRS to U.S. GAAP prior to issuing IFRS information.

Convergence and reconciliations

As discussed under *Global GAAP*, the FASB and IASB have undertaken joint projects to work to reduce differences between U.S. GAAP and IFRS. These projects have resulted in both revisions to existing standards and the creation of new standards, and will continue to do so. While the ultimate goal of the two Boards is convergence and the elimination of differences, the actual number of reconciling differences between IFRS and U.S. GAAP for a particular company may not be reduced and could even increase. While both Boards appear to agree on the high-level accounting concepts, new differences arise from the details of new standards. Companies need to understand fully the implications of differences between U.S. GAAP and IFRS so they can properly identify items that need to be disclosed in the reconciliation to U.S. GAAP.

Litigation

The *PricewaterhouseCoopers Securities Litigation Study* indicates that 29 foreign private issuers listed on U.S. exchanges were sued in U.S. private securities class actions in 2004. This represents the greatest number of private securities litigation matters ever filed in one year against foreign private issuers, and represents approximately 14% of the total number of private securities class actions filed in 2004. That number surpasses the 2003 total of 15 cases and the 23 foreign companies sued in 2002. While litigation activity during 2005 appears to be returning to pre-2004 levels, with 19 class action cases filed against foreign private issu-

ers, the likelihood of litigation may continue to be higher than in the past.

Delisting and deregistering

In December 2005, the SEC proposed rule changes to ease a company's ability to deregister. The current rule prevents a company from terminating its registration unless it has fewer than 300 shareholders who are U.S. residents—which makes it difficult to cease its U.S. regulatory reporting obligations, even if it has relatively little investor interest in the United States. Despite the existing hurdle for deregistration, the number of foreign companies registered with the SEC declined from 1,344 on December 31, 2001 to 1,240 on December 31, 2004, the most recent year for which figures are available, representing a 7.7% decline.

The proposed rule introduces an alternative benchmark designed to measure U.S. market interest for a class of equity securities—based on the percentage of shares held by U.S. investors. It also includes a trading volume restriction for certain large companies. Other conditions would apply, for example, that, with certain exceptions, the company had not, directly or indirectly, sold its securities in the United States during the preceding 12 months. And proposed exceptions would allow other ways for foreign companies to terminate registration.

Impact on audit committees

With International Financial Reporting Standards now in use in Europe and elsewhere, audit committees will want to understand the implications for their companies. This means ensuring management is tracking developments in the international and U.S. standard-setting arenas and that the company has the resources to address this new landscape—particularly critical given some of the challenges are not obvious. Convergence of auditing standards is drawing nearer, as well, with some European countries already adopting international standards. Finally, even with a year's extension of the deadline, many foreign private issuers are facing first-year 404 compliance, and those traded on NASDAQ must start providing interim financial statements.

Developments affecting corporate reporting

SEC focus on reporting

As described in last year's publication,[11] the SEC has started to release comment letters, which describe its concerns about company-specific accounting or disclosure. This section summarizes some common issues raised in comment letters that affect companies across the board. Many other issues exist, particularly in industry-specific areas, that are beyond our scope here.

Uncertain tax positions

The SEC has commented that disclosure of uncertain tax positions should:

- Clearly explain the accounting policy for recording income tax reserves, including how and when the company determined the amounts that ultimately would be paid
- Indicate why it was appropriate to record certain income and expense items differently for financial reporting purposes and income tax return purposes
- Clearly indicate each date when reserves for uncertain tax positions were taken, the reasons behind establishing those reserves, and why it was probable that a loss had been incurred
- Clarify whether the IRS and state taxing authorities examined the issues underlying the amounts
- Discuss more fully the company's accounting for income tax liabilities and provide a "rollforward" of the tax reserve for all income statement periods presented in the financial statements included in the SEC filing in question

Also see separate discussion of FASB draft interpretation on financial reporting practice for uncertain tax positions, later in this section.

Pitfalls to avoid in segment reporting

The SEC typically will not accept:

- Believing segment disclosure is sufficient because it's consistent with that of competitors
- Asserting that only one segment exists—the SEC will investigate this assertion thoroughly, and may request copies of the Chief Operating Decision Maker (CODM) package
- Claiming that information provided to the CODM in a typical reporting package is not really "used" by the CODM
- Aggregating segments that fail to meet all criteria for aggregation (i.e., that do not have similar economic characteristics or are not similar in all specified areas)
- Treating reporting decisions inconsistently—for example, by reporting different segments than those used as the basis for goodwill impairment testing

Requests for additional information

In each of the areas below, the SEC has asked for clarification or additional disclosure.

[11] See *Current Developments for Audit Committees 2005*, available at www.pwc.com/uscorporategovernance.

Employee benefit plans

- Disclosure of how the assumed discount rate was determined and the supporting source data
- Disclosure of the need for a minimum liability—which is required when the accumulated benefit obligation exceeds the fair value of plan assets
- Expanded disclosure in MD&A:
  - Assumptions (e.g., discount rates, return-on-asset rates, etc.)
  - Impact of changes in assumptions and estimates for the current period or a statement whether such changes are probable in the near future
  - Differences between estimates and actual results
  - Funding requirements

Management's discussion and analysis of financial position and results of operations

- More disclosure concerning estimates or assumptions involved in critical accounting policies
- More insightful disclosure concerning analysis of cash flows—for example, discussion of the *reasons* for changes in cash flow items, not simply the fact that the items changed by a certain amount
- An executive overview discussing the company through the eyes of its senior management

Non-GAAP measures

- Clear disclosure about why the measure is relevant
- Clear distinction as to whether the measure relates to operating performance or to liquidity, and appropriate reconciliation to either net income or operating cash flows

Revenue recognition

- Disclosure of the considerations underlying the decision to present revenue at gross versus net amounts
- Enhanced disclosure of arrangements with distributors (e.g., price protection, rights of return, etc.), which may affect how revenue is required to be recognized

Financial instruments

- The impact of redemption features on classification as a liability or as temporary equity
- Disclosure of whether beneficial conversion features require recording a charge, thereby affecting earnings per share
- Disclosures relating to the determination and evaluation of other-than-temporary impairments

Accounting for the homeland investment incentive

One of the provisions of the October 2004 American Jobs Creation Act (AJCA)[12] allowed U.S. multinationals to repatriate foreign earnings at a beneficial tax rate in either 2004 or 2005. This new tax incentive gave rise to many accounting questions in 2005, which in turn have important audit implications.

Earnings of a U.S. company's foreign subsidiaries are generally subject to U.S. federal and state income taxes upon repatriation to the United States. Because those amounts are not subject to U.S. tax as they are earned, a deferred tax liability for those future taxes exists. However, many companies have taken advantage of an exception available under GAAP (the so-called APB 23 exception) that permits them to avoid recognizing a deferred tax liability in their financial statements if they plan to reinvest foreign earnings indefinitely. But if a company subsequently changes its intentions with respect to indefinite reinvestment, the tax cost associated with the future repatriation of those earnings must be recognized currently.

Because the beneficial repatriation provisions of the AJCA increased the incidence of companies choosing to return earnings to the United States that previously were considered indefinitely reinvested, the FASB issued guidance in

[12] Discussed in *Current Developments for Audit Committees 2005*, available at www.pwc.com/uscorporategovernance.

December 2004 addressing specific accounting and financial reporting considerations. In particular, the guidance permitted companies additional time to evaluate the effect of the Act on their reinvestment plans—otherwise, they would have had to account for the effect in 2004, when the AJCA was enacted. The guidance clarified that recognizing deferred taxes for foreign earnings is based on management's intent. Therefore, companies weren't required to recognize the effect of the law change (either initial recognition of a deferred tax liability or reduction of an existing deferred tax liability) until they had concluded that some amount of earnings was likely to be repatriated.

Accounting for repatriations under the AJCA also highlighted the subjectivity and risks of an "intent-based" accounting standard, such as the APB 23 exception, and the audit implications. Because management's intent drives the accounting, a decision to repatriate earnings during 2005 (or 2004) might cast some doubt on both past and future assertions by management that a company does not intend to repatriate foreign earnings. Thus, we expect to see increased scrutiny of the substance of management's assertions of indefinite reinvestment now and in the future. Because of the significant judgments involved and the potential significance of the unrecognized liabilities, audit committees should understand management's assertions about unremitted foreign earnings and the strength of their positions, including the nature and specificity of foreign reinvestment plans, as well as why such plans are prudent. And, depending on the significance of amounts that have been indefinitely reinvested offshore, audit committees should consider whether disclosures (e.g., in MD&A) of management's plans are adequate.

Accounting for stock options

The FASB issued FAS 123 (Revised 2004), *Share-Based Payment* (FAS 123(R)), in December 2004, effective for annual periods beginning after June 15, 2005. Therefore, calendar year-end companies will adopt FAS 123(R) beginning January 1, 2006, requiring that they expense stock options in the income statement.

The acceptable option pricing models and required key assumptions under FAS 123(R) are described in last year's publication.[13]

Tax effects of stock option activity

The income tax accounting for the granting and settlement of stock options required by FAS 123(R) is complex and requires detailed recordkeeping of option activity. For example, companies will need to track information at the individual employee level in order to:

- Assess the income tax implications of stock options—for example, whether stock options result in a tax deduction, and whether the deferred tax benefits should be recorded over the options' service period—which will be more complex for companies that operate in multiple jurisdictions with differing tax laws.
- Determine whether the tax effects of an employee's option exercise should be recorded in equity or in the income statement.
- Calculate the "windfall" tax benefits that will be presented as cash inflows from financing activities in the cash flow statement.

Companies should assess whether the systems they currently use to track stock option data are adequate to collect the detailed information needed to account for the tax effects of stock option activity under FAS 123(R).

Transition methods

Companies must use one of two transition methods to adopt FAS 123(R). The alternatives are outlined in the box on the following page, assuming a calendar year-end company.

Given these transition alternatives, we expect that comparability of reported stock option expense across companies will be an issue for a number of years.

[13] See *Current Developments for Audit Committees 2005*, available at www.pwc.com/uscorporategovernance.

FAS 123(R) transition methods	
Modified prospective	• The company recognizes stock option expense, beginning with the first quarter of 2006, using FAS 123(R). • This method requires less effort since the company does not restate prior years. But that lack of restatement may raise comparability issues for a number of subsequent years.
Modified retrospective	• The company recognizes stock option expense, beginning with the first quarter of 2006, using FAS 123(R), and restates all periods beginning after December 15, 1994, using amounts from FAS 123 pro forma disclosures. • This method requires more effort, but because it restates prior financial statements, it significantly improves comparability. This method requires restatement of the financial statements in their entirety, including the income statement, balance sheet, statement of cash flows, and certain footnotes (e.g., segment reporting).

Next steps

To prepare to adopt FAS 123(R), companies should:

- Assess the potential impact on their stock option plans and determine what changes, if any, they should consider to their compensation strategies and financial reporting.
- Assess the availability of data for the development of assumptions and select the most appropriate option pricing model.
- Create an implementation team that includes individuals from accounting, tax, and human resources to address the implementation requirements of FAS 123(R).
- Determine whether upgrades to information systems are necessary to capture the data needed to account for option activity and the related tax effects under FAS 123(R).
- Consider the alternative transition methods and develop a strategy to meet the needs of financial statement users.
- Design controls surrounding FAS 123(R) to meet the requirements of Sarbanes-Oxley Section 404.

Fair value measurements

Both the FASB and the International Accounting Standards Board (IASB) are committed to wider use of fair values in financial statements. The FASB's final standard on how to measure fair value, expected in early 2006, represents one step along that path. It will provide companies with a consistent definition of fair value and methods for measuring assets and liabilities currently required to be measured at fair value. While it's not expected to change existing guidance on measuring most assets and liabilities at fair value, it will require expanded disclosures about such assets and liabilities.

The FASB's standard defines fair value for the first time. Fair value is defined as the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.

To assist companies in measuring the fair value of assets and liabilities, including contingent assets and liabilities, the FASB proposes using the following hierarchy, although this could change before the final standard is issued:

- Level 1 – Fair value is estimated using quoted prices for identical assets or liabilities in active markets that are readily available and representative of fair value

- Level 2 – Fair value is estimated using quoted prices for similar assets or liabilities, regardless of the level of activity, adjusted for differences specific to the asset or liability

- Level 3 – Fair value is estimated using market inputs other than quoted prices that are directly observable for the asset or liability—like using interest rate yields to interpolate the rate at a specific date

- Level 4 – Fair value is estimated using market inputs that are not directly observable but that are corroborated by other observable market data

- Level 5 – Fair value is estimated using company-specific inputs

The standard is expected to become effective for financial statements for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years, except for the disclosure requirements, which will be effective for fiscal years ending after December 15, 2006. For the most part, with exceptions for certain financial services firms, the provisions are to be applied prospectively.

Ultimately, the broader move toward fair value in financial statements will create more volatility in the income statement. Companies will need to ensure they properly communicate the impact of fair values on their financial statements, as well as the assumptions used to determine these values and their sensitivities to future changes.

Business combinations—phase II

A number of years ago, the FASB started addressing accounting for business combinations. The first phase of that project produced FAS 141, *Business Combinations*, and FAS 142, *Goodwill and Other Intangible Assets,* in 2001. The second and final phase addresses applying the purchase method of accounting and is intended to improve purchase accounting principles and practices, increase the transparency of financial statements, and increase consistency with the FASB's Conceptual Framework.

In June 2005, the FASB and IASB jointly issued exposure drafts. Based on the comments received and the complexity of various issues, a final standard is not anticipated until early 2007. The FASB and IASB will jointly issue final standards—reflecting growing convergence between U.S. and international accounting standards.

The anticipated changes to current practice are significant and have important implications for companies planning deals. Why? The current exposure draft would result in:

- Greater recognition of assets and liabilities—for example, in-process research and development (IPR&D) and acquired contingencies

- Expensing transaction costs and restructuring charges

- Recording contingent consideration (earnouts) initially at fair value—with changes in fair value in future periods reflected in earnings

- Changes in partial business combination accounting—when a company acquires less than 100% of another company

- A number of challenging valuation issues

Companies negotiating deals—and audit committees and boards being asked to approve them—will want to follow this project as it progresses, and consider the ramifications of these changes when structuring deals and calculating deal economics.

Uncertain tax positions

During 2005, the FASB issued a proposed interpretation to clarify financial reporting for uncertain tax positions. What are uncertain tax positions? They might include questions as to whether an intercompany transfer price is appropriately determined and computed, or whether a particular transaction is assessed as taxable or tax-free. Given the complexity and diversity of tax law around the world, uncertain tax positions are quite common.

The proposed interpretation would require companies to use a two-step model to account for tax uncertainties, which would be viewed as contingent benefits—by either recording a contingent asset or reducing a contingent liability. This is in contrast to the widely applied approach of treating these potential additional tax payments as contingent liabilities.

The proposed interpretation generated significant comments, which the FASB is considering. At the time of this writing, the Board has tentatively decided that benefits from uncertain tax positions should be recognized only when it is "more likely than not" (a probability of greater than 50%) that the positions will be sustained under audit by the taxing authority. In other words, companies should recognize a reserve against the benefit of any uncertain tax position claimed on a tax return that does not meet the "more likely than not" criterion. Even for positions meeting the criterion, companies nevertheless may need to record a reserve for any portion of the benefit that is not expected to be realized—for example, due to negotiations with tax authorities.

The proposed interpretation also addresses balance sheet classification (current or noncurrent) of income tax reserves, and generally is expected to require significant additional disclosures of the nature and amount of uncertain tax positions.

The interpretation is expected to be finalized in the spring of 2006, and to be effective for fiscal years beginning after December 15, 2006.

Reconsidering accounting for postretirement benefits, including pensions

In addition to the economic concerns regarding pensions, discussed in *Corporate Governance—Current Issues*, there have been some important financial accounting developments concerning these major obligations.[14] In November 2005, the FASB began reconsidering its guidance on pension and other postretirement benefit plans, with a two-phase project.

Phase I, anticipated to result in a final standard by the end of 2006, is expected to spotlight the funding status of postretirement benefit plans by requiring that the overfunded or underfunded status of plans be fully recognized on the balance sheet as an asset or a liability—rather than disclosed in the notes to financial statements, as at present. This direction corresponds with a focus on bringing previously off-balance sheet assets and liabilities into the financial statements, as already seen in areas such as accounting for stock options and variable interest entities.

Phase II, which is likely to be done jointly with the IASB, will reconsider all elements of accounting for postretirement benefit obligations and is expected to take several years to complete. The most significant issue to be addressed in Phase II is whether to eliminate the smoothing mechanism available to companies under current standards. Eliminating it would require companies to report actual pension asset returns and would introduce significant volatility into earnings.

Even though defined benefit plans are on the decline and employee-funded plans are becoming the primary "pension" plans in the United States, this project is expected to generate great interest among companies that still offer defined benefit plans and/or retiree medical benefits, with the value of the obligations in these plans at an estimated $400 trillion.

As noted in the discussion of *SEC Focus on Reporting*, earlier in this section, the SEC continues to pay close attention to pension accounting and reporting, asking companies for disclosures about how they determined assumed discount rates and about the need for a minimum liability related to benefit obligations, as well as for more details about various assumptions and about funding requirements.

SEC off-balance sheet study

In June 2005, the SEC released its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrange-*

[14] See discussion of key issues in accounting for postretirement benefits in *Current Developments for Audit Committees 2005*, available at www.pwc.com/uscorporategovernance.

ments with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers. The report discusses the implications of off-balance sheet accounting, special purpose entities, consolidation issues, transfers of financial assets with continuing involvement, retirement arrangements, contractual obligations, leases, contingent liabilities, and derivatives.

It identifies several goals for those involved in financial reporting, including:

- Discouraging transactions and transaction structures for which the accounting is inconsistent with the underlying economics
- Expanding the use of objectives-oriented standards—sometimes referred to as principles-based standards
- Improving the consistency and relevance of disclosures
- Focusing financial reporting on communicating with investors, rather than merely complying with rules

In keeping with those goals, the report recommends improvements to specific accounting and reporting requirements, designed to increase both the transparency and usefulness of financial reports, and based in some cases on reducing accounting choices and complexity. Underlying the recommendations is the SEC's focus on "full and fair disclosure." Thus, the recommendations emphasize transparency of volatility, along with relevant explanations.

Among the recommendations:

- The accounting for defined benefit pension plans and other postretirement benefit plans should be reconsidered. Currently, the trusts that administer these plans are exempt from consolidation by sponsors, effectively resulting in the netting of assets and liabilities in the balance sheet. In addition, companies have the option of delaying recognition of certain gains and losses related to retirement obligations and assets used to fund them.
- The accounting for leases, which follows an "all or nothing" recognition approach, should be reconsidered. As a consequence of this approach, lease arrangements that are similar economically may be accounted for differently.
- The feasibility of reporting all financial instruments at fair value should continue to be explored.
- The FASB should continue its deliberation as to whether companies should consolidate other entities, including SPEs, in which they have an ownership or other interest.
- Certain disclosures in SEC filings should be better organized and integrated.

Impact on audit committees

Audit committees will want to pay special attention to the adequacy of companies' disclosures—particularly those the SEC is focusing on. They should be prepared for substantive discussions with both management and auditors about management's intent, if the company has decided to repatriate earnings under the amnesty offered by the American Jobs Creation Act. Committees will start to see the effects as companies adopt the new standard requiring expensing of stock options. And they'll be monitoring developments in the use of fair values, and accounting for business combinations, pensions, and tax uncertainties. Finally, audit committees will want to monitor developments resulting from the SEC's report on off-balance sheet accounting, with its far-reaching recommendations.

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