Current developments for audit committees

2005

PricewaterhouseCoopers

To Our Clients and Friends

Over the past two years, audit committees have worked to incorporate required changes into their charters and agendas, and now are shifting attention to their ongoing effectiveness. As audit committees witness the continuing scrutiny of directors' actions when corporate crises come to light, they're taking a hard look at whether—and how—they're balancing their roles between monitoring management and advising management. And they're demonstrating their commitment to the job, by meeting more often and for longer periods, and ensuring meeting discussions are substantive.

Companies have been working to address what is arguably the Sarbanes-Oxley Act's biggest impact—404 compliance. First-year Section 404 is proving to be a major challenge for both companies and auditors as they climb the steep learning curve—interpreting new standards under the scrutiny of the media and shareholders. And audit committees are learning along with them, playing a key role in monitoring progress and remediation efforts.

While much focus understandably is on 404 compliance, numerous other issues also warrant audit committee attention. So, in addition to supporting the role of audit committee oversight of the new 404 reporting, this publication highlights some of the other significant governance developments and their implications, to help committees cope with ongoing regulatory, legislative, and other changes in the business environment.

What are some of those changes? Shareholders are demanding a greater voice in the selection of directors. Amendments to the Sentencing Guidelines require greater board-level involvement in programs to prevent and detect criminal conduct. There's a modified director independence definition from the NYSE to consider. The SEC is publishing its comment letters and companies' responses, and requiring more real-time disclosures in 8-Ks. And the most sweeping tax reform bill in more than 15 years is in effect, with major financial reporting implications and limited windows to take advantage of certain provisions.

Globally, companies are facing the challenge of adopting international accounting standards in 2005, with their auditors preparing to apply international auditing standards not long thereafter. And while standard setters both in the United States and abroad continue to work on convergence, U.S. audit committees work to understand how new accounting rules will affect financial reporting going forward.

We believe timely, relevant information is critical to your oversight responsibilities, and we will continue to share our knowledge and insights through publications such as this. We are committed to helping you enhance audit committee performance, the financial and business reporting process, and, ultimately, the quality of corporate reporting. We would be pleased to help you with these objectives in any way we can, bringing the full benefit of PricewaterhouseCoopers' experience and resources. In this spirit, we currently are researching how leading audit committee practices have evolved in the post-Enron era. Look for the results to be published in the third edition of *Audit Committee Effectiveness – What Works Best*, due out in the summer of 2005.

P. Gregory Garrison
Americas Leader,
Assurance and Business Advisory Services

Catherine L. Bromilow
Partner,
Corporate Governance Group

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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.s-oxinternalcontrolinfo.com	Provides resource guides developed by the four largest accounting firms to help investors understand the complexities of internal control reporting and highlight the areas where questions may arise. Such guidance may be of interest also to audit committee members and other directors.

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Executive summary: Key themes for 2005

The various participants in the capital markets—companies, management, directors, investors, bankers, regulators, lawyers, and accountants—all have witnessed considerable upheaval over the past few years. And each plays a vital role if we are, collectively, to restore investor confidence in the system. The first consideration is whether we even want the best system. And if we do, what does having the "best system" mean? Does it mean having the highest compliance hurdles? Or does it mean a system that emphasizes almost exclusively the flow of capital? No one is certain, and there is no consensus.

As directors discharge their duties, they should reflect on their role in restoring investor confidence and supporting strong capital markets. One screen is whether their confidential boardroom decisions are ones they can stand behind with pride. Are their key decisions—from approving compensation packages to concurring on what information the company will disclose—supportive of sound capital markets? Are they right for the company over the long term? Do they help restore investor confidence? If the answer is no to such questions, rethink. Directors join accountants and lawyers as the key gatekeepers investors are looking to. If we fail, individually or collectively, the repercussions will be serious.

Director accountability

While this publication covers developments up to the end of November 2004, we'd be remiss not to address the breaking news, as we go to print, of the WorldCom and Enron directors' settlements. Some argue those two companies represented unique failures, of a magnitude we don't expect to see repeated. Others see the settlements as a worrying precedent—one that will drive good directors away from board service. Whatever the ultimate outcome, these settlements highlight a key challenge many directors struggle with: how to balance the role of advising and counseling management with the fiduciary duty to monitor and oversee management. It's a balance many boards and committees are still trying to get right, and one that is fluid as the business environment changes and as a company's specific circumstances change. But it merits frequent consideration as to whether, on the issue under discussion, directors have the balance right.

Tone at the top

Ethical leadership remains the ingredient consistently lacking among many of the companies that faced crises over the past few years, as management put personal interests ahead of shareholders' interests. Thus, it's vital audit committees scrutinize the ethical standards management demonstrates and requires of employees. Ignore unsatisfactory results on employee surveys on ethics and explain away repeated whistleblower hotline tips at your peril. Some argue the most important role of the board is to hire management. Make sure your management team deserves the job.

404, 404, 404

The original deadline was delayed, smaller accelerated filer companies now have an extra 45 days for their first 404 report, and companies have known about 404 since the summer of 2002—but the amount of work companies have had to perform to ready themselves for compliance still has been daunting. Audit committees should monitor the status of issues the company is dealing with, the resources the auditors are devoting, how management is classifying and planning to remediate deficiencies it has found, and the impact they will have on management's assertions and the auditors' report. And while we have no answers yet as to how the market will react to companies reporting material weaknesses—or to companies that simply don't get 404 done—we do know this requirement is not going away. Audit committees should focus not only on how companies get through year one, but also on what management has learned that will help it streamline subsequent years' efforts. Committees should encourage management to view 404 as a value-adding process. And audit committees of companies that aren't filing with the first wave will want to ensure management gleans all the learnings it can from observing the experience—and pain—of accelerated filers.

American Jobs Creation Act

The biggest tax reform act in over 15 years has important implications for U.S. businesses. Companies have a limited time to repatriate foreign earnings under advantageous tax treatment. And while companies will start enjoy-

ing new deductions for qualifying domestic production activities, there are new limitations on certain tax write-offs—relating to personal use of corporate facilities. All told, these tax changes will have an impact on cash flows, treasury decisions, profitability calculations, and financial reporting. Audit committees will want to understand how management plans to leverage and address the new tax provisions, and what impact they'll have on current and future financial reports. Directors will need to ensure proper oversight and approval of investment plans, as required in the Act. And be aware of how management is addressing the new rules for tax shelters.

Governance developments

Revisions to NYSE governance rules will drive different assessments of director independence, perhaps changing committee composition. Committees also will want to update charters as rules around their responsibilities and processes are clarified. Directors will be aware of how the landscape for governance expectations has changed during the 2004 proxy season, and how legal expectations for board-level involvement are evolving through federal sentencing guideline amendments and are being redefined through landmark court cases.

Regulation driving transparency

The SEC continues to push companies toward greater transparency. Not only will the SEC release previously confidential comment letters, but it's also requiring companies to report more information on Form 8-K, more quickly, and at greater levels of detail. These new rules build on prior-year requirements for greater MD&A disclosure and restrictions on using non-GAAP measures. Directors should tune in for the SEC's views coming out of the first year of 404 filings.

Voluntary transparency

We have long urged companies to think carefully about what information investors would benefit from, and to provide it. To aim for disclosure in critical areas that is best in class. Is the company communicating information—both good and bad—that investors need in order to make informed decisions and to understand management's plans for the business? What's holding the company back from providing best in class disclosure? Standard setters, for their part, also are challenging companies to provide the fulsome disclosure investors need.

Financial reporting

High-quality financial reporting is vital to the capital markets. At the end of the day, audit committees can't escape their primary purpose—overseeing financial reporting. They'll recognize the important developments in the areas of expensing stock options, imminent changes to accounting for business combinations, and the continuing trend toward fair value accounting. They'll also pay attention to, and challenge as appropriate, the assumptions management uses in estimating postretirement benefits, a significant—and growing—obligation for many companies. And they'll continue to focus on areas that historically challenge reporting, including financial instruments, judgments and uncertainties, and revenue recognition.

Relationships with auditors

As audit committees have accepted the full scope of their new responsibilities to "own" the audit relationship, they're meeting more often with the external auditors and ensuring they approve only those nonaudit services that do not impair the auditors' independence. They also are attentive to indications that a focus on 404 may be straining the auditors' relationship with management, and will make sure auditors and management are working together to produce the best possible product. And committees are ensuring they maintain direct contact with auditors, opening up two-way communications in both challenging and more tranquil times.

Audit committee effectiveness

At the end of the day, audit committee members are the only ones who can guarantee their

own effectiveness. Audit committees are meeting more often and for longer periods to ensure they have adequate time to discharge their responsibilities effectively. But they're also taking a proactive role when they think improvements are warranted—taking control of the agenda; insisting meetings focus on discussion, not presentation; holding robust executive session discussions that get to the heart of issues; and requiring management to rethink information packages.

State of the (governance) nation

By now, most audit committees have embraced the form and structure changes driven by Sarbanes-Oxley and exchange listing rules. And we're seeing them operationalize their new responsibilities through more questioning, more meetings, more education, and often, more "homework." The biggest event on the horizon at the time of this writing is companies' first year of reporting under Section 404, and so the entire next section is devoted to that topic. But in addition to 404 and the other developments in the governance arena[1] discussed below, it's useful to put the past year in some perspective.

- Institutional investors flex their muscles. While institutional investors long have recommended certain governance structures, 2004 saw high-profile—and at times heated—proxy battles surface. One large investor organization drew intense scrutiny when it opposed the renomination of a well-respected director. Others adopted voting policies that many companies believed to be overly aggressive and, at times, ill-informed, some of which they've since reconsidered. Institutional investors, with their sizable holdings, have long worked to influence company actions and governance, often through behind-the-scenes negotiation. In the past year, they've demonstrated their appetite for doing so in a more public venue. Boards should be prepared for such activism to continue.

- The rise of the corporate governance officer. A few years back, only a few pioneering companies making a public commitment to effective corporate governance had CGOs. Now, more companies are adding this position—a role essentially focusing on helping the board ensure it is meeting its commitments, promoting communications both internally and with shareholders, and ensuring the board is adopting appropriate governance processes to support its effectiveness. In fact, the Gartner research group predicts 75% of Fortune 500 companies will have a CGO by the end of 2006.

- Lessons from the 2004 proxy season. It wasn't just institutional shareholders who were active in proxy battles. Several other high-profile battles raged, putting corporate governance, the separation of chair and CEO roles, and director nomination in the spotlight. Plus, concern over executive compensation practices continued.

- Business practices under scrutiny. While prior years saw states' attorneys general take aim at investment banking and the mutual fund industry, this year, practices at insurance companies, estimates of reserves at oil and gas companies, and clinical testing practices at pharmaceutical companies are under scrutiny. The ultimate impact on investor and consumer confidence is still to be determined.

- Move toward delisting and deregistering. Last year we mentioned the possibility of foreign issuers delisting and deregistering, in reaction to the regulatory burden imposed by Sarbanes-Oxley. Apparently foreign companies aren't the only ones. Some evidence now is emerging of a marked increase in the number of companies deregistering in 2003. Although this may be an anomaly, it bears tracking as many companies are only now fully realizing the costs and resources required for compliance under the new regime.

- Emergence of corporate governance ratings. The trickle has become a veritable deluge. More firms are rating public companies specifically on governance, although how analysts and investors will use such ratings is unknown. And while such ratings analyze a number of factors as surrogates for good governance, the reality is a board's effectiveness truly can be judged only from within the boardroom.

What are the lessons for directors? One is to be comfortable that management is properly engaging the company's institutional shareholders, participating in constructive dialogue, considering concerns, and developing well thought out responses to the concerns—responses that go beyond a knee-jerk dismissal

[1] The information and considerations presented herein are for general information only and do not constitute legal advice. Readers should refer to the actual text of the various statutes, provisions, rules, and regulations referenced throughout this document for specific language and consult with securities counsel regarding their specific facts and circumstances and any questions of compliance.

to ones that look at issues through the eyes of shareholders. Another lesson is to consider carefully shareholder votes that draw near-majority or greater support. Although the board and company may not legally be required to follow such votes, if so many shareholders take the time to support a proposal, the board may not wish to ignore such results from the people who own the company. A final lesson is to ensure management's and the board's decisions can stand up to scrutiny. As one pundit put it, if you're not willing to explain it to your mother or you wouldn't want to see it on the front page of the newspaper, don't do it!

Organizational sentencing guidelines

The Federal Sentencing Guidelines—in place now for over a decade—define the components of effective corporate compliance programs. Why is this important? Because if a company has a robust, customized compliance program, courts are allowed to take that mitigating factor into account if the company is found guilty of illegal activity, and reduce fines.

On November 1, 2004, as directed by the Sarbanes-Oxley Act, the United States Sentencing Commission adopted amendments to the Sentencing Guidelines to strengthen existing criteria for establishing and maintaining an effective program to prevent and detect criminal conduct. Among the sentencing provisions Sarbanes-Oxley calls for enhancing are those relating to fraud and obstruction of justice, conspiracy to commit criminal fraud, and corporate responsibility for financial reports.

The changes have two dimensions: The programs themselves must improve, and boards of directors must exercise more robust oversight of the programs.

At a conceptual level, companies need to exercise due diligence and promote a culture that encourages ethical conduct and a commitment to comply with the law. The box shows the elements companies should embrace in redeveloping compliance programs.

Seven criteria for an effective compliance program

The company should:

- Establish standards and procedures to prevent and detect criminal conduct
- Assign overall responsibility for overseeing compliance to the board
- Make reasonable efforts, exercising due diligence, not to delegate authority to anyone who has engaged in illegal activities or other unethical conduct
- Institute compliance and ethics training for all levels of the company
- Take reasonable steps to achieve compliance, specifically, establish and maintain auditing and monitoring systems designed to detect criminal conduct, and periodically evaluate the effectiveness of the program
- Encourage adherence to the program through appropriate incentives
- When criminal conduct has taken place, take reasonable steps to respond to and prevent further similar incidents

Significantly, under the new guidelines, in addition to reporting criminal conduct, personnel are required to "seek guidance" regarding potential or actual wrongdoing. Also, the amendments refer to mechanisms that allow for anonymity or confidentiality in reporting, as ways of meeting the requirement that personnel be able to report misconduct without fear of retaliation.

In addition to the seven requirements, companies periodically should assess the risk of criminal conduct occurring and allocate resources to activities that pose the greatest threat in light of the risks. Specifically, they should evaluate the nature and seriousness of potential criminal conduct, the likelihood that certain criminal conduct may occur because of the nature of the business, and prior history. And to be effective, this process must be ongoing.

A central component is that, for the compliance and ethics program to be effective, the board of directors must take ultimate responsibility for it. How? By actively overseeing it. By being knowledgeable about the content and operation of the program and overseeing its

implementation and effectiveness. By ensuring safeguards are designed to prevent and detect criminal conduct.

It's important to note that these rules don't apply solely to for-profit companies. Indeed, they extend to all organizations operating federally. In the absence of a board of directors, any comparable governing body takes responsibility. Finally, the amendments provide additional guidance directed at smaller organizations, and encourage larger ones to promote the adoption of compliance and ethics programs by smaller ones, including those they transact business with.

NYSE governance rule changes

Companies' deadline for adopting the New York Stock Exchange governance rules approved in November 2003 was October 31, 2004. The rules required substantive changes for many companies, and have generated some concern and many questions. To help companies interpret them, the NYSE issued Frequently Asked Questions guidance in early 2004. In August 2004, the NYSE proposed amended rules, to address certain areas of particular concern.

In November 2004, the SEC approved changes to the NYSE governance rules. The changes clarify and enhance the listing standards.

Director independence. A significant change is around independence requirements, primarily relating to relationships between directors and the company's internal and external auditors.[2] Specifically, a director is not independent if any of the following apply:

- The director or an immediate family member is a current partner of the company's internal or external audit firm
- The director is a current employee of the company's internal or external audit firm
- The director has an immediate family member who is a current employee of the internal or external audit firm and participates in the firm's audit, assurance, or tax compliance (but not tax planning) practice
- The director or an immediate family member was within the last three years (but is no longer) a partner or employee of the internal or external audit firm and personally worked on the company's audit within that time

Interestingly, the change both tightens and eases the independence requirements. It tightens them by removing the condition that a family member be employed in a "professional capacity" by the audit firm. Under former rules, a director could be independent even if a family member was a partner in the external audit firm, as long as the partner did not work in a professional capacity. Conversely, the changes will allow a director to be considered independent even if a family member is an employee of the audit firm, as long as the person performs only consulting, advisory, or tax planning services—and is not involved with assurance.

The new rules also clarify issues around charitable contributions. The former rules precluded a director from being independent if he or she was affiliated with another company that received payments from the director's organization of over $1 million or 2% of that company's gross revenues. The new rules clarify that charitable contributions are not considered "payments" under this test. Companies must, however, disclose in their proxy statements contributions that exceed these limits made to organizations directors are affiliated with.

Listed companies have until their first annual meeting after June 30, 2005 to replace a director who was considered independent for committee service under the old rules, but no longer is.

Additionally, companies must identify in their proxy statements which of their directors are independent.

Audit committees. Charters are to reflect wording changes that clarify audit committees' responsibilities—they now must *meet to review* and discuss companies' financial statements and *review* the company's *specific* MD&A disclosures.

[2] This section discusses only significant changes from the rules adopted in November 2003. See the full requirements for independence in the NYSE rules, www.nyse.com/pdfs/section303A_final_rules.pdf.

Compensation committees. The amendments confirm that the non-CEO compensation the committee is required to recommend to the board relates to compensation of executive officers.

Certifications and affirmations. The CEO's annual certification that he or she is not aware of any violation by the company of the corporate governance listing standards now can be qualified, if needed. Companies' annual written affirmations must take a specified form. And companies must submit interim written affirmations whenever there's a change to the board or any committees.

Audit committees and boards should reassess their activities and membership in light of these changes. First, certain directors who weren't deemed independent under the old rules, may be now, qualifying them for service on key committees. But some directors previously considered independent may no longer be, and boards will have to make that assessment and reallocate committee membership, as needed. Audit and compensation committees should determine whether to amend their charters to better clarify new requirements. Directors also will want to be aware of any qualifications management includes in its certifications to the NYSE on compliance with the governance rules, and how the company plans to address those noncompliance issues.

Enterprise governance

In February 2004, the International Federation of Accountants' (IFAC) Professional Accountants in Business Committee (PAIB) issued *Enterprise Governance: Getting the Balance Right.* It looks at why corporate governance often fails and, more important, how to ensure that it doesn't. It is a companion to the IFAC report *Rebuilding Public Confidence in Financial Reporting*, which is described in last year's publication.[3]

The PAIB research covers 27 case studies, drawn from 10 countries and a wide range of industries. Each focused on both corporate governance and strategy, analyzing what went wrong in failure and what went right in success. The box shows the key findings.

Key factors figuring prominently in both success and failure

Corporate governance

- Culture and "tone at the top"
- CEO
- Board of directors
- Internal control

Additionally, poorly designed compensation packages were associated with a tendency toward aggressive earnings management.

Strategy

- Choice and clarity of strategy
- Execution of strategy
- Agility in responding to abrupt changes in or fast-moving market conditions
- Ability to transact mergers and acquisitions

The report maps the relative importance of each of these factors to success or failure in the different case studies.

Among the areas the PAIB explored further are issues around board performance, strategic oversight, and the acquisition process.

Board performance

The report recognizes that changes to board structure—largely driven by recent corporate governance reforms—don't guarantee improved board performance. It notes attention is shifting now to director orientation and training, widening the pool of potential candidates, and increasing attention to boardroom dynamics. And, with more focus being placed on board, committee, and director performance evaluations, the report outlines the different types of questions, tools, and measures available.

The challenges to effective performance are significant. With high expectations of boards, the complexity of today's businesses, and limited time available, it's clear directors are feeling the pressure. Moreover, the emphasis on independence means directors often have less direct knowledge of the business, putting them at risk of being even more influenced by management's view.

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

Boards need to balance three key tasks, changing the relative emphasis as circumstances change:

- Monitoring management
- Decision making
- Providing advice

The PAIB's conclusion: Boards should ensure they make the most effective use of their knowledge, given time constraints, to add value to the companies they oversee—going beyond simply ensuring they're complying with applicable governance requirements.

Strategic oversight

The case studies confirm that while bad governance can ruin an entity, good governance is not a strong factor in all successes—implying good governance can't ensure success. That's why good strategy is vital. Accordingly, the report suggests a number of tools and techniques that can help. And, it sets out circumstances often surrounding strategic failures: when incremental changes in company strategy lag behind the fast-changing environment; when companies fail to proactively formulate strategy and instead simply react to developments; and when companies faced with an "abrupt change" in their environment can't make the needed transformation.

To ensure proper oversight of strategy, boards should focus discussions with management on:

- **Strategic position.** The market, competition, regulatory and political environments, market share, capabilities, stakeholders
- **Strategic options.** The three or four options under active consideration, which may relate to changes in geographical focus, products, and market sector; growth targets; price/quality decisions
- **Strategic implementation.** For the strategy selected, critical success factors, identifying when board involvement is needed, points at which strategy merits reconsideration
- **Strategic risks.** Likelihood and impact of risks in the strategy, plans to address them

The acquisition process

The case study analysis found unsuccessful mergers and acquisitions were the most significant issue in strategy-related failures. The PAIB report describes the eight stages of the acquisition process. Boards should focus on a few key areas:

- Ensure the business case for the acquisition fits with the strategy, management can articulate the rationale clearly, and the rationale makes sense. Also, management's integration plan should be reasonable, describe timelines and resources needed, and give the board confidence of management's ability to deal with key risks.
- Before signing off on the deal, ensure management performs proper due diligence, the deal reflects the business case the board approved, and the integration plan is sound.
- Request a post-integration audit, and review with management why any parts of the acquisition failed and how they'll improve during future acquisitions.

On the radar—access to the proxy

As described in last year's publication,[4] and as driven by rules introduced in late 2003, companies now are required to disclose a great deal of information about their nomination processes and about how security holders can communicate with the board.

In October 2003, the SEC proposed a rule that would require companies to include in their proxy materials director nominees submitted by shareholders. This proposal—referred to as access to the proxy—was intended to be an outlet for shareholders to use when they are dissatisfied with the company's proxy process. It set forth a sliding scale of the number of nominees shareholders would be able to propose, based on the size of the board. Both shareholders and their nominees would have to meet specified eligibility requirements.

As might be expected, the proposal was controversial, garnering over 500 comment letters, including almost 200 from individuals and over

[4] See Nominating Committee Disclosures and Board Communication Channels in *Current Developments for Audit Committees 2004*, available at www.pwc.com/uscorporategovernance.

100 from corporations, corporate executives, and corporate directors. Generally, institutional investors, unions, and pension and other funds supported the proposal, while companies, law firms, and business associations opposed it.

In March 2004, the SEC hosted a roundtable to discuss the proposed rules, and then solicited additional comments on both the rules and the viewpoints expressed at the session. And it got almost 200 more comment letters, the majority of which were supportive of the proposed rules.

While the SEC has not re-exposed revised proposals or given any indication of what the next steps are, corporate directors should be aware this issue continues to generate a great deal of discussion, reflecting both support and concern.

Another year, another cautionary governance tale

Last year's publication highlighted former SEC Chairman Richard Breeden's report *Restoring Trust*, which outlined his recommendations as Corporate Monitor at WorldCom—now MCI. Mr. Breeden figures prominently in another report about another troubled company. He is Counsel and Advisor to the Special Committee of the Board of Directors of Hollinger International Inc.

The Special Committee submitted its report[5] to the SEC and the U.S. District Court in August 2004. The report—over 500 pages long—describes the issues and the Special Committee's findings. In a nutshell, the Committee found the controlling shareholders transferred to themselves and their affiliates more than $400 million during the previous seven years. Describing the situation as a "corporate kleptocracy," the report notes the aggregate cash taken represented 95.2% of Hollinger's entire adjusted net income during 1997–2003.

While the report makes serious charges against the controlling shareholders, with numerous allegations before the courts at the time of this writing, it also finds the board's oversight was sorely lacking.

While the complex related party transactions that are the subject of particular focus are described in detail in the report, specific governance issues raised in the report include:

- Although the controlling shareholder, who also was the CEO, held only a minority equity position, multivoting shares gave him voting control and the authority to select directors. The CEO had longstanding social, business, or political ties with most of the directors.
- The board apparently accepted the view that Hollinger was the CEO's company. This view extended to allowing the CEO to determine how much he and others would receive from the company. It was reinforced by the fact that the CEO had recruited directors to the board.
- The board and/or audit committee approved the related party transactions, but often received information that was false or omitted material facts about the transactions.
- The audit committee didn't appear to question the management fees paid, apparently trusting senior management to be honest. The board's "consistent inaction" meant it didn't question the noncompete payments or management fees. Nor did it hire independent compensation consultants.
- When the board received a memo from corporate counsel stating it had been misinformed about noncompete and break fee payments in late 2000, it apparently accepted at face value that the misleading information was "inadvertent." The board then approved a modified variation of the original payments.

Interestingly enough, the Hollinger story reads like a case study that the PAIB could have included in its *Enterprise Governance* publication, with factors such as tone at the top, the CEO, and the board all playing key roles in the governance failure.

In November 2004, the SEC filed an enforcement action against Hollinger International's former Chairman and CEO, and its former Deputy Chairman and COO, and against Hollinger, Inc., a related holding company.

[5] The report is available at www.sec.gov/Archives/edgar/data/868512/000095012304010413/y01437exv99w2.htm.

Impact on audit committees

Directors have been the focus of attention from many quarters this year—institutional investors and other shareholders, governance rating firms, and states' attorneys general, to name a few. Audit committees will want to understand what shareholders are saying—and be sure management is listening too. And they'll want to have confidence that their decisions, as well as management's, can withstand close scrutiny. With the new access to the proxy proposal still under SEC consideration, directors will want to keep an eye on developments in this area.

Amendments to the Federal Sentencing Guidelines are increasing directors' responsibilities, by requiring more robust board oversight of corporate compliance and ethics programs. The amended guidelines call for the board to take ultimate responsibility for the effectiveness of these programs.

The NYSE amended its governance rules this year too, affecting director independence definitions and required disclosures, among other things. The board may find that a director who was independent previously, no longer is. And audit committees will need to be alert to specific changes impacting their processes and responsibilities.

The international community has been heard from as well, in the form of a research study that looks at successes and failures in corporate governance and strategy, offering recommendations for boards. The report instructs boards on improving their performance and their strategic oversight, especially in the area of mergers and acquisitions. And the Hollinger International report serves as yet another wake-up call to directors that their actions may be scrutinized when crises hit.

Special focus—report on internal control

Company management, auditors, and audit committee members are in the midst of the most significant new reporting requirement many will face in the course of their careers—the new internal control reporting mandated by Sarbanes-Oxley Section 404.

The assessment process has taken more time, staff resources, and executive attention than many companies—or their directors—anticipated. And at the time of this writing, significant uncertainty remains. How many companies will report they have ineffective internal control over financial reporting? How will the market react to such reports? How many companies will not complete their reports by the filing deadline? Will the focus on internal controls ultimately result in fewer restatements and less fraudulent financial reporting? Only time will tell.

We do know, though, much of the story on the substantial costs companies face as they work toward compliance. Successive surveys have seen cost and resource estimates rise dramatically as companies work toward completing their assessments. All told, 404 represents an enormous effort on the part of companies and their service providers.

Recognizing the challenges that many companies are experiencing in completing timely assessments of internal control, the SEC has taken several measures to provide relief. Under the SEC's original accelerated filing deadlines introduced in 2002, another 15 days would have been shaved off companies' 2004 reporting deadline, compared with 2003. Many companies and their advisors were concerned that the shorter period would exacerbate the challenges of the new 404 reporting. Accordingly, the SEC delayed by one year the final phase of acceleration, so companies with December 31 year ends will have to file their 10-K annual reports with the SEC by March 16, 2005—the same filing deadline as last year. The final acceleration will apply for 2005 annual reports.

Companies with public equity floats below $700 million will enjoy special dispensation this year. On November 30, 2004, the SEC granted such companies—if their fiscal year ends lie between November 15, 2004 and February 28, 2005—an additional 45 days to complete and file their 404 reports. Although they'll still have to file their financial statements with the SEC within the 75-day window after year end, they'll have additional time to complete and file their 404 reports.

Final auditing standard for 404

In June 2004, the SEC approved the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*

Notably, the Standard provides for the following:

- The auditor is required to evaluate management's documentation, and perform tests, of controls over all relevant financial statement assertions related to significant accounts and disclosures at each financially significant location or business unit. This required scope generally encompasses a large portion of a company's operations and financial position.

- Auditors will not perform a separate evaluation of audit committees' effectiveness. Instead, the evaluation is part of the consideration of the control environment and monitoring components of internal control. Ineffective audit committee oversight is considered at least a significant deficiency—and a strong indicator of a material weakness. See additional discussion about the evaluation of audit committees later in this section.

- If a company acquires another company close to year end, the SEC permits management to exclude the acquired business from its 404 assessment in that year, on the grounds there isn't enough time to assess the controls of the newly acquired business. Similarly, the acquired business can be excluded from the scope of the auditors' work, without creating a scope limitation.

- Smaller and medium-sized companies, as well as large ones, are required to maintain effective internal control over financial reporting. The Standard refers to COSO[6] for guidance on special control considerations for smaller and medium-sized companies.

[6] COSO refers to the Committee of Sponsoring Organizations of the Treadway Commission, which released *Internal Control – Integrated Framework* in 1992.

The Standard also outlines the extent to which auditors can use management's testing of internal control; directs auditors to perform walkthroughs for major classes of transactions; requires sufficient controls testing to cover locations and business units constituting a large portion of the company's operations or financial position; and provides guidance on identifying significant accounts and disclosures, relevant financial statement assertions, significant processes, and controls, and on testing operating effectiveness.

To a large degree, the Standard provides principles-based guidance and avoids being prescriptive. Thus, it requires a great degree of interpretation and judgment. Both the SEC and the PCAOB have issued Frequently Asked Questions documents setting forth their respective stances on selected issues related to 404 compliance and auditing.

Assessing control issues

All companies have internal control issues of one kind or another—no process or system runs perfectly over an extended period and no person performs flawlessly. The challenge for companies and auditors is evaluating the issues, to determine whether they should be classified as either a significant deficiency or a material weakness.

The Standard describes circumstances that are each strong indicators of material weaknesses:

- Restating previously issued financial statements to correct a misstatement.
- The auditor identifying a material misstatement in financial statements that wasn't initially identified by the company's internal control over financial reporting—a strong indicator of a material weakness even if management subsequently corrects the misstatement.
- Ineffective audit committee oversight of the company's external financial reporting and internal control over financial reporting.
- Ineffective internal audit or risk assessment functions—especially for very large or highly complex companies, where such functions have to be effective if the companies are to have effective monitoring or risk assessment components of internal control.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function.
- Identifying fraud of any magnitude on the part of senior management.
- Significant deficiencies that have been communicated to management and the audit committee but remain uncorrected after some reasonable period of time.
- An ineffective control environment.

If management remediates control issues before year end, it could still get a clean opinion. But what happens if the company has control issues at the end of the reporting period? First, using the framework described below, management should determine whether the issues are of such consequence that they merit being classified as material weaknesses (i.e., there is more than a remote likelihood of a material misstatement). If a material weakness exists, management can't conclude it has an effective system of control. And it must describe the material weakness in its report. Furthermore, the auditors' report will describe the material weakness and must contain an adverse opinion on the effectiveness of the company's internal control over financial reporting. If, however, management reached the same conclusion, then the auditors can find that management's assertion about internal control is appropriate.

Framework for evaluating exceptions and deficiencies

Representatives of nine accounting firms and a professor at Georgia State University released a framework for evaluating process/transaction-level and information technology general control exceptions and deficiencies.[7] It provides conceptual guidance to both companies and auditors. It emphasizes the continuing need for judgment and recognizes that, given the same set of facts, reasonable people might reach different conclusions.

At the time of this writing, additional guidance is still to come on evaluating deficiencies in the softer components of COSO and on aggregating deficiencies.

[7] A Framework for Evaluating Control Exceptions and Deficiencies is available from the Center for Public Company Audit Firms, on the American Institute of Certified Public Accountants website, www.aicpa.org/cpcaf.

We believe this framework represents the best guidance available for evaluating exceptions and deficiencies and we strongly encourage its use.

Auditors' reporting under the new standard

The Standard requires auditors to express two opinions in all reports on internal control over financial reporting—an opinion on management's assessment and an opinion directly on the effectiveness of internal control. So while auditors need to evaluate management's assessment—including the extent and substance of management's documentation—they also must independently test the effectiveness of internal control.

The end game? An auditors' report that contains an opinion on both whether management's assessment is fairly stated and whether the company had effective internal control over financial reporting as of its year end.

At the time of this writing, it's not clear whether auditors will combine their report opinions covering 404 with their reports on the fairness of a company's financial statements. Where there are physically two reports, both must carry the same date.

This same-date requirement will be important for some companies.

Auditors' reports on financial statements are dated as the last day of "fieldwork." However, companies often announce earnings within a month after year end, and substantially before the company completes and files its 10-K annual report with the SEC. But the 404-related audit work will not be wrapped up within a few weeks after year end. Why? Because auditors can't complete the testing of controls over the period-end financial reporting process until the 10-K is complete, thus delaying the date of the auditors' report. Also, auditors' final communication of significant deficiencies and material weaknesses to audit committees must occur before the audit report is issued.

This change in dating of auditors' reports raises the issue of whether companies will release earnings before their auditors have completed all audit work—that is, before the date of the auditors' report. Early indications are that no significant delays will occur in releasing earnings.

And of course, given the special first-year dispensation to companies with public equity floats under $700 million, delaying the 404 report filing deadline by 45 days, auditors' 404 reports for some companies won't be issued at the same time as the reports on the financial statements.

Monitoring 404 progress

It's useful to remember just how much work management is required to perform for 404 compliance. Management's assessment extends to all significant account balances and disclosures, barring only those that, either individually or in the aggregate, couldn't result in a material misstatement. Thus, management has to:

- Identify all the balances and disclosures to include in its report scope, related financial statement assertions, and significant processes and related accounting and control activities pertaining to classes of transactions that affect those accounts, disclosures, and assertions—looking across all of the company's operations and locations around the world.
- For each significant account balance and disclosure, document both the design of related controls—covering all five COSO components—and its testing processes.
- Evaluate and correct deficiencies in either the design or operation of controls.
- Determine the form and content of its report, and the impact of any deficiencies that remain uncorrected at year end.[8]

We have observed companies frequently, over the course of 2004, missing key milestones of their 404 project plan. Why is complying with Section 404 so difficult for companies? Partly because few companies have ever done a comprehensive documentation of their internal controls, so that process alone is daunting. And partly because they're finding—through their own internal testing, as well as their auditors' testing—more problems than expected. A PricewaterhouseCoopers survey of large multinational companies released in July 2004 found that 79% still had to make improvements—to

[8] See full discussion of management's requirements under 404 in *Current Developments for Audit Committees 2004*, available at www.pwc.com/uscorporategovernance.

financial reporting processes, computer controls, and security controls—to comply with Section 404. And those remediation efforts then have to be tested.

To reinforce the importance of meeting the deadline, some audit committees are holding frequent—weekly or bimonthly—calls with company management and auditors to monitor progress.

So how should audit committees monitor 404 progress?

- Understand whether the company's progress is in line with the project plan. If not, how is management going to ensure the resources are applied to catch up? Will the new timeline leave sufficient time for the auditors to perform their testing? If the answer to either question is unsatisfactory, what are the implications?

- Understand the control deficiencies identified and their significance, concur with the information about control issues being disclosed, and understand management's plans to ensure issues are remediated. Audit committees need to recognize that not all companies will have the time to remediate all control issues. Some simply will run out of time, and the question will become whether the problem merits reporting as a significant deficiency or a material weakness.

- Although the push is on for first-year compliance, many committees and management teams are focusing on year two and beyond, as discussed under Looking Forward.

Audit committees' frequently asked questions regarding 404

Project status

Is the company likely to complete the 404 process successfully?
Are the company's schedule and monitoring robust enough? Will the company make it?
What is the nature and extent of control deficiencies being identified?

The auditors' assessment process

Will the auditors have sufficient resources at the end of the year to test all the corrections made as a result of initial testing? Are the resources scheduled by name?
What will the audit fees be?
How will the auditors review the audit committee? Is this review really necessary?

Assessing and addressing internal control issues

What is a significant deficiency? A material weakness?
How will management evaluate the significance of a control deficiency? How will the auditors?
When would a control issue not be considered a possible deficiency?
Where does the company stand with material weaknesses and significant deficiencies?

Reporting

How will significant deficiencies and material weaknesses be communicated to the audit committee on a timely basis?
What kind of disclosure is needed?
How do 302 and 404 interact?
What happens in comfort letters and 10-Qs if an issue is found? Do 404 reports get updated?

Improving internal control, the 404 process

Where does the company stand on achieving efficiencies from the process?
Does the company need a chief compliance officer?
What is the right process for management's review of allegations and complaints with the audit committee? Doesn't the committee need to review all allegations, including those concerning human resource issues?
What is the company's defense if remediation actions are not taken?

Looking forward

What percentage of U.S. public companies are likely to get a clean 404 opinion in 2004?
Will the regulators eventually reconsider and reduce some of the requirements?
What economic value is being created by the 404 process?

The box gives a sense of the types of questions audit committees are asking about 404, drawn from a poll of PricewaterhouseCoopers partners who serve major companies.

Audit committees that haven't asked these questions should consider them. And many questions apply equally to future years.

Post-404 relationships with auditors

The stress brought about by the sheer volume of work and uncertainty of first-year 404 compliance aside, another concern surfacing is that auditors have distanced themselves from clients in important ways, diminishing their value as trusted advisors—that the sense of teamwork has been lost.

How did this happen? It's partly a reaction—some say overreaction—to the new paradigm. One concern is that providing accounting advice to audit clients may create a potential independence issue. This stems from the prohibition on auditors being part of their clients' internal control systems—said another way, if a company can't arrive at appropriate accounting or financial reporting conclusions without the extensive help of its auditors, it may lack appropriate controls over its financial reporting process. Whatever the concern, the principles are clear: Companies are responsible for making their own judgments and preparing their financial reports.

PricewaterhouseCoopers believes that advising audit clients in a proactive manner on new or complex accounting issues continues to be an important part of the service we provide to our audit clients. Timely and robust dialogue on complex issues is essential and expected by both management and audit committees. We believe that proactively sharing our perspectives on accounting issues does not impair our independence, and that our clients would be underserved if we provided our perspectives and thinking on an issue only after a client had fully developed its own solution. Otherwise, how could our clients benefit from the rich and robust experiences we've gained by serving many companies across virtually all industry sectors?

That said, new protocols are warranted in certain communications between management and auditors. For example, it would be a serious issue if the auditors found a material accounting or reporting error that management hadn't identified. Thus, management should clearly communicate (ideally in writing) the status of draft financial statements and related notes when providing them to the auditors, acknowledging any information contained that isn't yet final or is missing and will be provided at a later time.

Internal audit

While much of the focus is on the changing external auditor relationship, many audit committees also are aware of important changes to the internal audit department's work. This year has seen internal audit called upon to perform significant work in helping companies achieve 404 compliance.

Given internal audit's expertise in testing, and the need for extensive resources to assist management in documenting and testing controls under 404, many companies found it necessary to divert internal audit from its original plan and have it play a significant role in the 404 project. Management and audit committees understood this meant other important risk areas internal audit typically covers, went largely unaddressed. Ideally, internal audit has reprioritized its work given the new 404 demands, and ensured audit committee buy-in concerning areas it dropped from its plan. But both management and the audit committee must recognize, 404 aside, the importance of internal audit's traditional role and responsibilities in providing objective assessment on a wide range of issues. Accordingly, many companies are assessing the long-term role of internal audit in the 404 assessment process.

Implications of PCAOB standard for audit committees, management

Although the Standard sets rules for auditors, it has a "trickle down" effect, as it makes specific statements that have implications for audit committees, boards of directors, and management.

Effectiveness of audit committee oversight

As discussed earlier, the auditors' evaluation of the audit committee's effectiveness focuses on

the committee's role in the control environment and monitoring components of internal control.

- The *control environment* relates to integrity, ethical values, management's philosophy and operating style, assignment of authorities and responsibilities, and attention and direction the board provides. Related audit committee activities include demonstrating ethical behavior, for example, by addressing director conflicts of interest, and insisting management be fair and transparent in financial reporting. Many committees approve their companies' code of conduct and stress through discussions the importance of ensuring compliance with the code. And they judge, by reviewing complaints received, whether the ethical conduct messages are spreading throughout the company.

- *Monitoring* ensures internal controls continue to function over time. The audit committee's support for an effective internal audit function is one way it contributes to monitoring.

It has long been leading practice for boards and committees to evaluate their performance—and that of individual directors—and NYSE rules now require an annual assessment of audit committee performance. The PCAOB Standard also expects boards of directors to evaluate the performance and effectiveness of audit committees.

Boards ideally should look, at a minimum, at the factors the auditors are directed toward. These are shown in the box.

Then, the results of the board's evaluation will factor into the auditors' evaluation of the effectiveness of the audit committee's oversight—along with the results of management's evaluation and any evaluation the committee itself has performed. Auditors supplement these sources of information with their own observations during audit committee meetings and from discussions with the committee or its chair between meetings.

Factors in assessing audit committee effectiveness

- The independence of audit committee members from management
- The clarity with which the committee's responsibilities are articulated and how well the audit committee and management understand those responsibilities
- The committee's involvement and interaction with the independent auditors and with the internal auditors, as well as interaction with key members of financial management, including the CFO and chief accounting officer
- Whether the committee raises the right questions and pursues them with management and the auditors, including questions that indicate an understanding of critical accounting policies and judgmental accounting estimates
- The committee's responsiveness to issues the auditors raise

Fraud

Auditors are responsible, under 404 rules, for evaluating controls specifically intended to address the risks of fraud. In discussing fraud, the 404 Standard points to management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud. And it clarifies the expectation that the audit committee, in its oversight of financial reporting, plays a key role in reducing fraud risk. How can audit committees do that? Leading practices include:

- Ensuring management sets the right tone at the top; evaluating management integrity

- Understanding the company's susceptibility to fraudulent financial reporting

- Understanding and being comfortable with how management responds to fraud risks

- Understanding the types of fraud most prevalent in the industry

- Discussing compensation plans and targets with the compensation committee

- Taking an active role in overseeing complaint processes

- Comparing its understanding of how the business performed against reported results

The message is clear: Audit committees play an important role in reducing the risk of fraud.

Early internal control information

Companies with internal control issues are not putting off disclosure until their 404 reports are ready. The ongoing 302 certification process is a key source of information on deficiencies. Additionally, management's documentation and testing of internal controls for 404 are bringing new information to light.

Compliance Week tracks internal control disclosures.[9] The trend over 2004 shows companies disclosing an escalating number of significant deficiencies and material weaknesses. Small companies—with less than $100 million in revenue—are making the vast majority of these disclosures. The box indicates the most common disclosures, based on *Compliance Week*'s November 2004 report. The report also notes it's common for companies making disclosures to include multiple problems.

Most commonly disclosed internal control problems

Financial systems and procedures

- Financial close process
- Account reconciliations
- Inventory processes

Personnel-related

- Poor segregation of duties
- Inadequate staffing
- Lack of adequate training or supervision

The November 2004 report notes that almost half of the control issues reported relate to financial systems and procedures, with just over one-quarter personnel-related. Among other issues reported in smaller volumes are documentation deficiencies and information technology control weaknesses. The report commented on the high degree of specificity most companies are using in describing control issues.

The types of issues companies are reporting are consistent with what we're seeing among the companies we serve. Spreadsheet use is another area where ensuring proper controls has been a challenge. See the appendix for discussion of how the proliferation of spreadsheets impacts 404 compliance.

Market reaction to internal control reports

The big unknown is how the market will react to the new 404 reports. First, some companies simply won't get done by the deadline, and the market will have to consider how significant the impact will be on companies with deficient SEC filings. Second, how will the market assess the many companies—with estimates at the time of this writing ranging from 5% to 30%—that will report one or more material weaknesses? Although, to a certain extent, only time will tell, various education efforts are under way for securities analysts and market makers in early 2005, to help them better understand the new internal control reporting.

One major rating agency indicates it is considering placing material weaknesses into two different groups. One category would include material weaknesses whose effects are limited to a single account balance—the view being that the auditor can expand auditing procedures to limit the risk that a material misstatement is present in the financial statements. The other category would include systemic issues—a weak control environment, poor tone at the top, ineffective audit committee, or ineffective financial reporting process—issues that don't allow the auditor to audit around the problem as easily. The agency's early view is that it may take some rating action for material weaknesses reported in the latter category.

Looking forward

As discussed earlier in this section, companies are expending considerable time, effort, and money to comply with first-year 404. If there's one thing observers and participants agree on, it's that companies can't apply such intense effort every year. Management has to build efficiencies into the process or it will be unable to devote needed attention to operating and

[9] Published online at www.complianceweek.com.

growing the business. Additionally, although further acceleration of the periodic reporting filing deadline has been postponed this year, it will take effect in future years, requiring companies to become more efficient in finalizing control assessments.

What factors weigh into achieving future compliance?

- Identify any manual remediation "work arounds" put in place for year-one compliance, and incorporate fully into underlying control processes.
- Recognize that, even with documentation in place, management must ensure it remains relevant. And controls in any new businesses developed or purchased will have to be documented. Clear documentation standards and protocols; a centralized, automated repository; and assigning responsibility for monitoring and updating documentation, when necessary, are keys to easing this process going forward.
- Enhance automation and monitoring capabilities. While companies must have controls designed to prevent errors from occurring in the first place, controls that flag discrepancies and generate exception reports for management follow-up are very efficient ways to ensure controls continue to operate effectively. Increased automation enhances the efficiency, as well as effectiveness, of these controls.
- Draw up a plan to ensure adequate levels of management testing, with special focus on processes that have changed or increased in importance during the year. Since documentation is largely done, move testing forward in the year, allowing additional time to remediate any problems found.
- Ensure internal audit or other internal control specialists monitor and review controls surrounding information systems and business processes being developed or revised.

Moreover, if the company had significant deficiencies or material weaknesses in year one, audit committees will want to monitor closely the status of management's fixes. And committees will discuss with the full board and management any implications for share price, company reputation, and shareholder/regulator concerns.

Regardless of whether year one identified problems, audit committees also will want to understand the resources needed for compliance in year two and beyond, and how management will take advantage of process efficiencies. In the long run, companies will achieve sustainability when process owners are responsible for controls—including design, documentation, and operating effectiveness. Self-assessment processes are one approach, but leveraging technology also will be important.

Ultimately, audit committees will want to see management turn the effort expended on 404 into a value-adding process.

Impact on audit committees

As the first-year deadline for 404—representing the most important new reporting requirement in decades—draws near, audit committees will want to continue monitoring progress, discussing issues with management and auditors, and playing their own role in the internal control framework with their rigorous oversight.

Audit committees may be assessed on whether their companies have material weaknesses and how quickly actions are being taken to remediate such deficiencies. Systemic control issues that are not addressed by a company ultimately may prompt investors to remove their support from the re-election of the company's audit committee members.

Audit committees also will want to pay close attention to management's programs and controls to prevent fraud. The PCAOB has made clear its expectations that audit committees will be proactive in overseeing efforts to reduce fraud risks.

Finally, as year one of 404 reporting passes into history, audit committees will need to turn their attention to future years and understand how management is planning for year two, which will bring more challenges, including the final phase of the accelerated filing deadlines.

The SEC continues to push toward having companies provide more timely—and robust—disclosure. Over the past few years, we've seen requirements for accelerated reporting deadlines, improved management discussion and analysis, and increased transparency around pro forma measures. This year, the theme continues with new rules and practices calling for the release of additional information, and more quickly.

Releasing SEC comment letters

The Sarbanes-Oxley Act mandates the SEC review each registered company's filings at least every three years. The SEC also reviews filings relating to major transactions and registration statements. And it periodically targets selected disclosures for all companies in a specific industry. When the SEC has concerns or questions about a company's accounting or disclosure, it issues a comment letter. These letters may request clarification about an issue or require the company provide additional disclosure.

In the past, the SEC released comment letters only if requested under the Freedom of Information Act. But beginning with disclosure filings after August 1, 2004, the SEC is releasing comment letters and companies' responses on its website—thereby increasing transparency. Both comment letters and responses, including interim correspondence—the multiple rounds of comments and responses that often are involved in resolving issues—will be released publicly 45 days after the SEC has completed its review. The only exception to this automatic release will be if the SEC's Division of Enforcement is reviewing a company's filing, regarding a restatement, for example. In such cases, comment letters and responses automatically are confidential.

So why is the release of SEC comment letters noteworthy? For a few reasons. First, companies at times include highly confidential information in their response letters—information they wouldn't necessarily want competitors or others to see. Companies can address this concern by filing any such confidential information as a supplement to their response letters, not including it in the body of the letter. A second concern with releasing comment letters is they may include assertions—based on SEC conjecture—about issues with the company's reporting. So, read alone without the company's response, they could damage company credibility. Unfortunately, there is little companies can do about this risk except to take clear stances in response letters. Additionally, knowing their comment letters will be publicly released, may prompt the SEC to word initial requests circumspectly.

Companies may request confidentiality for certain parts of their responses to comment letters. Such sections will not be made public automatically, although they will be disclosed to individual requesters under Freedom of Information. A key to a successful request for confidentiality is to request confidentiality narrowly—on specific information only, not on major sections of the response letter.

The SEC is asking companies whose filings it comments on for written representation—"Tandy" language—that they will not use the comment process as a defense in securities-related litigation. That is, companies are to acknowledge that even if the SEC's comment letter process concludes there's no issue with the company's reporting, it doesn't mean the SEC is prevented from bringing a future enforcement action.

Audit committees of companies that receive comment letters should discuss with management the nature of the request and management's approach to responding, including any strategies for protecting particularly sensitive company information.

Additional Form 8-K disclosures

Companies use Form 8-K to disclose certain corporate events occurring between quarterly filings. The SEC has expanded the list of required events companies must report. This move provides investors with more timely information about significant corporate events, in keeping with the "real-time issuer disclosure" mandate in Section 409 of Sarbanes-Oxley.

The new rule took effect August 23, 2004 and applies prospectively. It not only adds new and expands existing items to be reported, but also requires companies to file sooner—within four business days of the triggering event. A limited safe harbor is available for certain events

requiring management's assessment of materiality or determination of whether a required disclosure has been triggered. Some examples of new disclosure requirements are shown in the box. In November 2004, the SEC released a Frequently Asked Questions document regarding implementation and interpretation of the new 8-K disclosure requirements.

These disclosure requirements have some important implications. They compel companies to disclose information—like terms and conditions of material agreements—that may be competitively sensitive.

Even more important are the implications for underlying processes—how companies identify events and information that now must be disclosed and how they ensure such events are surfaced to the right people, allowing the company to file the 8-K within the four-day deadline.

Some fundamental questions for audit committees to explore with management: Is there a clear understanding of who within the company has the authority to commit the company to material agreements? Do those individuals understand the new rules? What processes are in place to determine whether impairments or amendments to agreements that are identified intraquarter are material? Does senior management or the board need to take back the authority to commit the company in more situations? Such questions reinforce the importance of having an effective, appropriate process in place. One possible solution is to charge the disclosure review committee—which usually meets near quarter end to ensure the quarterly results and management's 302 certifications are appropriate—to be active throughout the quarter and review possible 8-K disclosure events.

Examples of required new Form 8-K disclosures

- Information—including dates, counterparties, and description of terms and conditions—about material agreements the company enters into that aren't in the ordinary course of business, as well as material amendments to such agreements
- Information about material agreements that aren't in the ordinary course of business that the company terminates early, including circumstances around the termination and any penalties
- Information—including dates, obligation amounts, terms of payment, and descriptions of the transaction and other material terms and conditions—about material direct financial obligations and material obligations through off-balance sheet arrangements that the company enters into
- Notification and information—date, amount of obligation, terms of payment, and description of the event—about any "triggering event" that accelerates or increases a direct financial obligation or an obligation under an off-balance sheet arrangement
- Information about material costs relating to a commitment to an exit or disposal plan, disposition of long-lived assets, or employee termination plan, including commitment date, description of action, and estimated amount or range of amounts to be incurred, categorized by each major type of cost
- Information about material impairment charges identified—other than as part of quarter- or year-end reporting—including decision date and estimated amount or range of impairment charge
- Information about any notices received from the company's principal listing exchange that the company is not complying with listing rules or standards, or is in the process of being delisted, including notice date, rule the company failed, and the company's intended action
- Notification and information—conclusion date and description of the facts—when the board or management decides that previously issued financial statements cannot be relied on; similar information, including which financial statements can no longer be relied on, if the external auditor notifies management its audit or review report(s) cannot be relied on

American Jobs Creation Act

In October 2004, the President signed the American Jobs Creation Act of 2004 into law, representing the most sweeping business tax changes in more than 15 years. Including both international and domestic reforms, it will affect most U.S. companies, with nearly $137 billion in tax relief estimated over the next 10 years.

In part, the Act helps respond to an ongoing trade dispute with the European Union over the U.S. export tax incentive, the "extraterritorial income exclusion," which the World Trade Organization ruled illegal. In repealing that exclusion, the new law should help end EU trade sanctions in early 2005.

Many of the Act's international reforms are designed to enhance U.S. companies' global competitiveness. Taken as a whole, these provisions—including partial relief from the complex foreign tax credit and anti-deferral rules—will significantly reduce U.S. taxes on foreign income.

While companies will welcome tax relief, the Act is complex and presents a number of challenges, particularly in the international provisions and limited windows for complying with incentives to repatriate foreign earnings. Many provisions have financial accounting implications, which we discuss in *Developments Affecting Financial Reporting*. Importantly, the Act contains many provisions that take effect almost immediately, requiring management analysis and decision making, with certain decisions required before the end of calendar 2004 or shortly thereafter.

This section discusses some of the major provisions, but is not intended to replace professional tax advice that addresses a particular company's facts and circumstances.

An indication of the magnitude of the Act's impact is shown in the box.

American Jobs Creation Act provisions

Major tax relief

- Over $76 billion for domestic manufacturing, new deduction
- $43 billion through international tax reform and simplification
- $13 billion, mostly through other business-oriented tax modifications
- $5 billion temporary state sales tax deduction for individual taxpayers who itemize deductions
- $10 billion "buyout" for tobacco growers

To be paid for by

- Repealing the extraterritorial income exclusion provisions—raising $49 billion
- Restricting leasing to "tax-indifferent" parties—raising $27 billion
- Extending customs fees due to expire—raising $19 billion
- Clamping down on tax shelters, improving tax enforcement and compliance—raising about $50 billion

Homeland investment incentive

The Act creates a temporary incentive for U.S. multinationals to repatriate foreign earnings, bringing funds back to the United States. The incentive allows a dividends-received deduction of 85%—subject to certain limitations—for dividends from controlled foreign corporations. Among the keys:

- The amount eligible for the deduction excludes the "regular" dividend a company has been receiving from foreign subsidiaries—generally calculated as the average over the preceding five years, excluding the highest and lowest years. Thus, if a company had received an average annual dividend from foreign subsidiaries of $100,000, and decided to repatriate $150,000 in 2005, the maximum available for the deduction would be $50,000.
- The funds subject to the special deduction must be reinvested in the United States, with the investment approved by both the CEO or president and the board. Acceptable investments generally include, but are not limited to, worker hiring and training; infrastructure;

research and development; capital investment; and actions to ensure the company's financial stability for job retention or creation. The funds cannot be used for executive compensation.

- If the reinvestment doesn't comply with the requirements, a 35% tax generally will apply.

- Companies can choose to repatriate funds in either 2004 or 2005. Given how late in the calendar year the Act was passed and a variety of unanswered questions, observers believe most companies will choose to exercise this incentive in 2005.

Audit committees and directors will want to ensure management has a grasp on the timing and amount the company plans to repatriate, along with an understanding of domestic reinvestment plans. Astute committees will ensure that corporate treasury departments are involved in the discussion, and that relevant assumptions about funding sources and foreign currency—particularly given the weakening of the U.S. dollar in currency markets in the fall of 2004—are considered.

Qualified production activity deduction

The major domestic provision in the Act is a tax deduction for specified production activities in the United States. The production activities must meet a number of tests to qualify. The deduction is geared to manufacturing of tangible personal property, but it extends also to software (computer, film, music), construction services (engineering, architectural), utilities (electricity, natural gas, potable water), and agriculture. The deduction is available starting January 1, 2005. The box shows the basics of the deduction calculation.

The deduction is limited in some important ways. First, the qualified production activity income can't exceed taxable income. Second, the deduction is limited to 50% of annual wages paid by the company.

Deferred executive compensation

The new rules around deferred compensation are quite complex. At a conceptual level, though, they require the executive to select the timing and form of payment at the time of the initial deferral. Starting January 1, 2005, if companies don't comply with the new rules, all vested amounts after that date will be subject to tax on a current—not deferred—basis. Other penalties also will apply.

Insiders' use of corporate facilities

The past few years have seen increasing focus on executive use of assets such as corporate aircraft. The Act weighs in as well in this area. This provision applies to insiders—directors, executives, and any shareholders owning at least 10% of the company's stock—and limits the company's deduction for costs of insiders using company facilities, such as airplanes, hunting lodges, and the like. How? By linking the maximum deduction to the amount the insider includes in his or her personal compensation. Thus, if a personal flight cost $10,000, but the CEO records a taxable benefit of only $1,000, the company cannot deduct the $9,000 difference. This is another provision that became effective upon the Act's signing, so companies should be tracking such insider use now—or reconstructing records and starting to track such activity on a go-forward basis.

Tax shelters

Changes to rules in 2003 require companies to self-identify if they are involved in certain tax shelters. The Act includes provisions to elimi-

Qualified production activity deduction calculation—illustration

Gross receipts (from selling the products)		$ 1,000,000
Less:		
Cost of goods sold (related to the receipts)	$ 600,000	
Other direct deductions (marketing, advertising)	70,000	
Other allocable deductions (general and administrative)	30,000	700,000
Qualified production activity income		300,000
x rate (see Note)		0.03
Qualified production activity deduction		$ 9,000

Note: The rate is 3% for 2005, growing to 9% by 2010.

nate some of the subjectivity in making these determinations, enhance enforcement, and increase sanctions.

Companies should pay particular attention to the new tax shelter penalty provisions.

- The new penalties are significant. If a company fails to disclose a reportable transaction,[10] it faces a nonwaivable $200,000 penalty. It also faces a potential 30% accuracy-related penalty—and must disclose that penalty in SEC filings. And, the statute of limitations may be extended on those transactions.
- There are new requirements for and an expanded definition of material advisors—those who provide material aid, assistance, or advice regarding any reportable transaction, and receive a certain level of fees. Material advisors now must file information reports with the IRS. New penalties will apply for failing to do so. Some companies—particularly those in the financial services industry—are bound by these requirements, and so will need to ensure they have measures to comply.
- The IRS has greater enforcement authority under the new Act.

Also, indications are the IRS will take a different, more aggressive tack in tax audits, focusing beyond the forms filed with returns, to determine whether companies have processes in place to identify all potential reportable transactions and disclose them.

The new rules around tax shelters tie to tax record retention rules passed in 2003, which may have escaped audit committees' notice. These are described in the box.

Tax record retention rules

Concerns about "abusive" tax shelters and other tax avoidance schemes focused Treasury Department and IRS attention on document retention relating to such transactions.

While all taxpayers generally must retain documents for federal tax purposes, the rules are stricter for reportable transactions entered into on or after February 28, 2003. Companies must retain:

- Marketing materials related to the transaction
- Written analyses used in decision making related to the transaction
- Relevant correspondence and agreements between the taxpayer and any advisor, lender, or other party to the transaction
- Documents discussing, referring to, or demonstrating the purported or claimed tax benefits arising from the transaction
- Any documents referring to the business purposes of the transaction

Companies must retain these documents until the expiration of the statute of limitations—generally three years—applicable to the final taxable year for which disclosure of the transaction is required. Those failing to comply with these retention provisions may find themselves unable to provide necessary documentation to the IRS upon request. If so, they may receive an Inadequate Records Notice from the IRS, and may face federal civil and criminal penalties.

Audit committees will want to understand the extent to which the company may be involved in reportable transactions, and consider management's controls over identifying and reporting the relevant transactions and protecting the underlying documents, as required.

Sarbanes-Oxley 404 implications

Although the tax return preparation and approval processes themselves generally are not covered by 404, there still remain implications for companies' 404 compliance efforts. To a large extent, these relate to the processes to ensure accurate financial accounting, reporting,

[10] There are six categories of reportable transactions: listed transactions (e.g., tax avoidance transactions), confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions involving a brief asset holding period.

and disclosure of ongoing tax matters and, importantly, the impact of changes in tax statutes, provisions, and regulations. Particular focus is required for:

- Controls around the repatriation of foreign earnings. The numbers may be large, and companies need proper process and controls around them. Also, if the numbers prove material and related controls change, companies should consider whether they need to disclose a change in their internal control processes in the certifications required by Section 302.
- Qualifying production activity deduction. Companies need to ensure the proper controls are in place for differentiating which revenues and direct and indirect costs relate to the qualifying activities, so they can record the deduction accurately.

And, although the amounts aren't likely to be material, audit committees will want to keep an eye on executive use of corporate facilities, getting assurance that the proxy reporting on the subject is complete and accurate—for company reputation reasons, if no other.

Audit committees should recognize that the new Act places an enormous burden on corporate tax departments, and will want to discuss how management will obtain the resources needed to address the myriad issues and challenges. Committees will want to be satisfied that management understands the new provisions, and is positioned to comply with all applicable requirements as well as take advantage of all tax-saving opportunities. As companies are required to reflect the effects of the Act in the quarter when it was enacted, audit committees will look for the preliminary impacts to be reflected in financial reports as early as the fourth quarter of 2004.

For more information about the Act, and PricewaterhouseCoopers' insights into its impact on businesses, see *The American Job Creation Act of 2004*, available at www.pwc.com/us-tax.

Taxes on the radar screen

Requirements for senior executive certification and attestation may expand. The Jumpstart Our Business Strength (JOBS) Act proposes to have the CEO sign a declaration to accompany the company's federal annual tax return. The proposed declaration would state the company has processes and procedures in place to ensure the tax return complies with the Internal Revenue Code of 1986 and the CEO was provided reasonable assurance of the accuracy of the tax return in all material respects. Observers predict that this Act, which already has passed in the Senate, could pass in the House of Representatives in early 2005.

Although the final version of the JOBS Act may differ, legislators have demonstrated their appetite in the current environment for measures to hold executives accountable. In the event such a CEO tax declaration is adopted, the controls public companies have ensured are in place for 404 should provide a beginning foundation for that declaration. But management should bear in mind that although a good amount of the information feeding into the tax return preparation process is likely to be well-controlled and to have been tested under 404—as it pertains to preparing financial statements and related disclosures—the return preparation and approval processes themselves may not have been covered. And private companies will want to consider carefully whether they need to improve controls and processes to reduce the risks associated with signing any declaration.

Impact on audit committees

The regulatory focus on disclosure continues, with SEC comment letters and companies' responses now available on the SEC's website, and with more disclosures required on Form 8-K. Some of this information may be sensitive from a competitive standpoint or in other respects, and audit committees will want to understand the implications for the company and ensure that management has considered available ways of protecting the company.

New tax legislation—the American Jobs Creation Act, signed into law in October—brings other challenges. The law is complex, and complying with its provisions and availing the company of its benefits will require careful attention on management's part. The committee will want to be sure management is giving this the attention it deserves. And the committee needs to ensure management is complying with the tax shelter reporting and disclosure rules,

as well as the tax record retention rules, passed in 2003, which require documentation relating to reportable transactions to be retained for longer periods. Finally, proposed legislation may require the CEO to provide new certifications regarding the company's tax returns.

Evolving regulatory oversight

The Public Company Accounting Oversight Board (PCAOB) regulates accounting firms that issue audit reports on public companies. Its duties—registering accounting firms, inspecting them, establishing auditing and related standards, and conducting investigations—are described more fully in last year's publication.[11]

Only eight registered U.S. accounting firms have more than 100 public company audit clients. It's those eight firms that the PCAOB will inspect annually. This frequent inspection makes sense, as the Big Four accounting firms alone audit almost 80% of U.S. public companies, accounting for almost 99% of public company sales revenue. The PCAOB will inspect the other approximately 800 U.S.-based accounting firms at least once every three years.

In 2003, the PCAOB performed "limited procedures" inspections of the Big Four. The PCAOB issued the public portion of its inspection reports in August 2004. Full scope inspections commenced in 2004.[12]

During the inspections, in addition to evaluating firm-wide policies and programs, the PCAOB examines a number of specific audit engagements, reviewing auditing procedures as well as related financial statements. And, for a sample of audits under review, inspectors request interviews with audit committee chairs. Why? Because the PCAOB inspectors want to understand the auditor's relationship and communications with the committee. The box shows the types of information the PCAOB is seeking in such interviews. The PCAOB stresses that just because it selects an audit for review, that doesn't imply it's necessarily higher risk than others. The PCAOB also emphasizes it is inspecting audit firms, not the companies or audit committees.

At PricewaterhouseCoopers, our policy is to inform company management and the audit committee if the PCAOB selects their engagement for review. We then follow our professional standards for communicating with them if any significant issues arise during the inspection process.

Emerging auditing standards

Although the PCAOB sets standards, the SEC must approve them.

The SEC approved Standard No. 1, which alters wording in auditors' reports, in May 2004. Thus, audit opinions for public companies now say that the engagement was "conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States)."

Of course, the most significant new audit standard released in 2004 was Standard No. 2, for Section 404. See the discussion about the standard and its implications in *Special Focus—Reporting on Internal Control.*

Standard No. 3 governs audit documentation. It is effective for fiscal years ending on or after November 15, 2004. It includes a "reviewability" standard—there must be sufficient information in the audit documentation to enable an expe-

Topics addressed during PCAOB interviews with audit committee chairs

- The frequency and nature of discussions between the auditor and the audit committee
- The audit committee's expectations and evaluation of the auditor
- Auditor communications regarding critical accounting judgments, including revenue recognition policies
- Communications about audit adjustments, related party transactions, and sensitive management estimates
- Audit committee philosophy regarding approval of nonaudit services

[11] *Current Developments for Audit Committees 2004* is available at www.pwc.com/uscorporategovernance.

[12] The inspection reports are available on the PCAOB's website, www.pcaobus.org.

rienced auditor who was not involved with the engagement to:

- Understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached
- Determine who performed the work, when it was completed, who reviewed it, and when

The standard sets a high threshold for demonstrating that work was done in the absence of supporting documentation. If work was performed, the auditor must have persuasive other evidence, and can't rely on oral explanation alone. And the standard defines retention periods and sets deadlines for documentation to be completed.

Also during 2004, the PCAOB defined certain terms describing the degree of responsibility that its standards—both new ones and AICPA auditing standards adopted as interim standards—impose on auditors. Accordingly, the words "must," "shall," and "required" indicate *unconditional responsibilities*, and "should" indicates *presumptively mandatory responsibilities*—meaning the auditor must comply with them unless he or she can demonstrate that the standard's objectives were met by alternative actions. Finally, words such as "may," "might," and "could" describe actions and procedures that the auditor has a responsibility to consider.

Looking forward

During 2004, the PCAOB established a Standing Advisory Group—a 30-person group to advise on future standard-setting projects. Members are drawn from industry, regulatory bodies, shareholder and pension groups, academia, and law and accounting firms.

Future standards include two expressly required by Sarbanes-Oxley, dealing with concurring partner review of specific engagements and with overall quality control over compliance with professional accounting and auditing standards. The PCAOB has shared with the Standing Advisory Group its plans to address, in order of priority: auditor independence and tax services, financial fraud, GAAS hierarchy/codification, communications with audit committees, engagement quality/concurring partner review, related parties, consistency of application of GAAP, confirmations, fair value, elements of quality control, and risk assessment.

Spotlight on auditor independence

For the past few years, the issue of auditor independence has come under intense scrutiny. Post-Enron, the SEC—as directed by Sarbanes-Oxley—issued new rules prohibiting auditors from providing a number of specified services to audit clients, setting audit partner rotation and compensation provisions, and requiring new disclosures.[13] The focus has shifted to other independence questions in 2004.

Contingent fees

In 2004, the SEC clarified its position on contingent fees and their effect on auditor independence. Essentially, accounting firms are prohibited from receiving a contingent fee from an audit client. Exceptions include fees fixed by courts or other public authorities or, in tax matters, fees determined by judicial proceedings or findings of government agencies. The SEC clarified that such exceptions cannot be based on whether an accountant reasonably expects a government agency to consider issues affecting an audit client, but apply only when fee determination is taken out of the hands of the accounting firm and audit client, and made by a body acting in the public interest.

The SEC made clear its view that finding-based, value-added, and similar fees are contingent fee arrangements—and thus are prohibited.

Tax services

In its review of auditor independence in 2000, the SEC concluded tax services generally don't create the same independence risks as other nonaudit services. Tax services are viewed as being unique—there are detailed tax laws that must be consistently applied and the Internal Revenue Service has the authority to audit any tax return. When drafting the rules mandated by Sarbanes-Oxley a few years later, the SEC again noted the close relationship between audit and tax services and confirmed the latter don't conflict with auditor independence.

[13] Described in *Current Developments for Audit Committees 2004*, available at www.pwc.com/uscorporategovernance.

The marketing of tax strategies, however, has been of concern to regulators who worry that providing certain tax services possibly hinders auditor independence. The PCAOB, as part of its mandate to set independence standards, held a roundtable on tax services and independence in July 2004, and is proposing additional rules for auditors in the area of tax services.

At the end of the day, the issue is ensuring the auditor maintains independence in the provision of tax services. Auditor-provided tax services may support audit quality through firsthand knowledge of tax issues and by high-quality tax resources auditing companies' tax provisions. When considering whether to use auditors for tax services, audit committees should consider which services may impair independence and which services may increase the overall quality and integrity of the financial statements.

Impact on audit committees

The auditing profession continues to be front and center in regulators' focus, and audit committees are sharing in the scrutiny, given the relationship they now have with companies' auditors. Recognizing the importance of this relationship, the PCAOB includes interviews with committee chairs as part of its audit firm inspection program. And audit committees will want to understand how new auditing standards the PCAOB issued this year, dealing with 404 and with audit documentation, affect their companies.

The issue of auditors' providing permitted nonaudit services remains in the spotlight. Committees need to consider their position on this issue and be clear on their thinking, whether they decide to continue using their auditors for permissible nonaudit services, or not. And they must remain alert to further developments concerning issues of auditor independence—particularly given the scrutiny around tax services.

Global GAAP—the journey continues

The train has left the station. The business world is moving toward one set of high-quality global accounting standards—Global GAAP. Will it reach its destination overnight? No. Various constituencies still need to reach consensus on how to tackle complex accounting issues. And they need to negotiate around other barriers, such as political pressure and resistance to change. But despite these obstacles, one thing is certain: There's no turning back.

The Financial Accounting Standards Board (FASB) is working with the International Accounting Standards Board (IASB) toward converging U.S. accounting standards and International Financial Reporting Standards (IFRS) to establish Global GAAP—which U.S. regulators will accept without reconciliation to U.S. GAAP.

So, what progress has been made?

Developments in the United States

As evidence of the significant progress made on convergence, the FASB expects to issue its short-term convergence standards by the beginning of 2005, covering the treatment of asset exchanges, changes in accounting policies, inventory costs, and earnings per share.

And beyond these short-term convergence projects, the FASB and IASB also have made significant progress on the following two major projects:

- Business combinations. The IASB and the FASB ultimately will issue the same exposure draft—the first joint project for which this has been done—representing the first step toward using one common accounting language. Once issued in its final form, this standard will have similar implications for companies both in and outside the United States. The standard is expected to call for greater use of purchase accounting and greater recognition of assets and liabilities. More costs will have to be expensed rather than included in the cost of the acquisition. As a result, companies will have a harder time demonstrating the earnings uplift from the acquisition. Earnout structures also may be reconsidered. By their very nature, they currently are often intended to avoid overpaying for a target. This project would require earnouts to be measured initially at fair value—resulting in earnouts for which the target fails to meet its performance being recognized in income, with a potential charge for goodwill impairment. The project also will present challenging valuation issues and may lead companies to reconsider some of their deal structures.

- Equity-based compensation. While debate continues in the U.S. Congress, this project ultimately will require expensing stock options, the current treatment under IFRS. Thus, comparability will increase among companies on a global basis. See further discussion on accounting for stock options in *Developments Affecting Financial Reporting*.

Global trends

European Union (EU) regulations adopted in 2002 require over 7,000 listed companies in Europe to adopt IFRS in 2005, with comparative information for 2004. IFRS is no longer something for the future—the IFRS transition date for most companies passed on January 1, 2004. Other milestones for IFRS comparative information are following in quick succession. Companies need to make rapid progress with IFRS implementation, while the European Commission arranges for the standards to become mandatory under EU law.

IFRS 1, *First-time Adoption of International Financial Reporting Standards*, and amendments made in early 2004 allow companies to avoid some of the burden of reconstructing old records that were not required for previous national reporting. But the simplification doesn't minimize the challenge associated with transition; the process remains complex and time-consuming for many companies.

The Committee of European Securities Regulators is asking companies to provide markets with appropriate and useful IFRS information. Analysts and investors also are calling for more information about IFRS. Some investment analysts are reporting they'll include IFRS readiness in their evaluation of management performance. This suggests that if companies are unable to demonstrate they have "IFRS 2005" in hand, they risk reputational damage.

Be clear: IFRS implementation is the biggest accounting change in a generation. Those who have already made the change warn not to underestimate what's involved.

Audit committees should bear in mind that convergence of U.S. GAAP with IFRS will raise 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. Both the FASB and the IASB are committed to a wider use of fair values in financial statements, which will create more volatility in the income statement. Companies will need to ensure that they properly communicate the impact of fair values on their financial statements, as well as the assumptions used to determine these fair values and their sensitivities to future changes.

Audit committees also will want to check how management plans to cope with the new accounting requirements. Are there sufficient, competent resources? Resources not only knowledgeable about the convergence process, but also able to follow the IASB's projects to determine the potential impact on their business and to play a role in shaping and influencing the decisions made.

International auditing standards gain momentum

Outside the United States, there is increasing evidence global convergence of auditing standards is gaining momentum, as regulators and investors worldwide seek reassurance about the quality of audits. While not the only element needed to achieve that goal, globally recognized high-quality auditing standards are a cornerstone to uniformly high-quality audits.

The International Auditing and Assurance Standards Board (IAASB) is an independent standard-setting body under the auspices of the International Federation of Accountants (IFAC). It establishes high-quality auditing, assurance, quality control, and related services standards, publishing guidance for financial statement audits in International Standards on Auditing, or ISAs, and International Audit Practice Statements, or IAPSs.

Europe's ISA adoption plans

European countries are transitioning to global standards, with adoption of IFRS for listed companies in 2005 and of ISAs shortly thereafter, as part of the EU's strategy to create a truly pan-European capital market.

The European Commission's (EC) proposed Eighth Directive on statutory audit in the EU is described in more detail below. But it's noteworthy that it calls for mandatory use of ISAs, believing it would be inconsistent to have financial statements prepared under the same set of international accounting standards, but audited according to different national standards. Many also see ISAs as a sound basis to pave the way for international mutual recognition of audits performed in other countries.

That said, the proposed Eighth Directive fell short of endorsing the use of ISAs immediately. Why? Before fully endorsing ISAs, the EC wants to be satisfied they are of high quality and accepted internationally; have been developed with proper due process, public oversight, and transparency; and are "conducive to the European public good."

As part of ensuring that appropriate due process, IFAC approved IAASB governance changes in late 2003. An important element is the formation of a Public Interest Oversight Board (PIOB) to oversee IAASB and IFAC's public-interest activities. The PIOB's ten members will provide input to strategy and establish priorities for standard setting. The United States Public Company Accounting Oversight Board (PCAOB), Japanese Financial Services Authority, and EC are invited to participate as observers at IAASB meetings with the right to be at the table and to contribute to the discussions. The PCAOB in turn invited the IAASB to participate as an observer with speaking rights on its Standing Advisory Group, which advises on future standard-setting projects. The PCAOB also plans to consider relevant international standards on auditing in those projects, further aiding international convergence.

Although the EC originally planned to adopt ISAs in Europe in 2005, since the Eighth Directive likely won't be approved until mid-2005, and EU Member States would then have 18 months to implement it into national law, this effectively delays required adoption of ISAs until 2007 audits.

It does not, however, prevent national auditing standard setters from moving more quickly toward incorporating ISAs into national standards. Indeed, many European countries already are doing so. For example, the UK's Auditing Practices Board has issued an exposure draft that would embed ISAs into UK auditing standards beginning in 2005. Thus,

grassroots initiatives may outpace the EU regulatory requirement.

IAASB's program

In anticipation of the EU adoption of ISAs, the IAASB has been working at an accelerated pace to have revisions to its core standards in place for 2005. It issued risk assessment standards in 2003, and adopted the following standards during 2004:

- **Fraud.** ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*, aligns the fraud standard with the audit risk assessment standards. It also brings the international standard on fraud in line with U.S. auditing standards.

- **Planning.** ISA 300, *Planning an Audit of Financial Statements*, aligns standards on audit planning with the new risk assessment standards.

- **Quality control standards.** International Standard on Quality Control 1 (ISQC 1), *Quality Control for Firms That Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*, and ISA 220 (Revised), *Quality Control for Audits of Historical Financial Information*, become effective in June 2005. The ISQC defines the quality control policies and procedures firms must have in place, and ISA 220 focuses on engagement-specific procedures. Regulators in Canada and other territories already are looking to the ISQC as a benchmark in their inspection reviews.

ISAs likely to be released in 2005 include:

- **Auditor's report.** Revisions to ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, will 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. Work is under way on revising the standards and guidance on modified audit reports. Exposure drafts are expected in the first quarter of 2005.

- **Documentation.** An exposure draft revising ISA 230, *Audit Documentation*, issued in 2004, would make the documentation requirements substantially consistent with PCAOB Auditing Standard No. 3.

- **Group audits.** The IAASB continues to revise ISA 600, *The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements*, and related new IAPS, *The Audit of Group Financial Statements*, since the original exposure draft, setting out the nature and extent of the group auditor's responsibilities, proved highly controversial. A new exposure draft is expected in early 2005.

- **Review of interim financial information.** The IAASB also continues to work on its proposed new standard on reviews of interim financial information performed by the company's auditor, originally exposed in 2003.

The IAASB expects to approve in the near future exposure drafts of revisions to its ISAs on materiality, accounting estimates, and communications with those charged with governance—such as audit committees. Other projects under way include auditing related parties, special purpose audit reports, and management representations.

Challenges in adopting international standards

Achieving convergence isn't easy. An international study, commissioned by IFAC's Board, identifies the challenges to adopting and implementing IFRSs and ISAs and recommends actions to those in the financial reporting supply chain. *Challenges and Successes in Implementing International Standards: Achieving Convergence to IFRSs and ISAs* identifies the principal challenges as:

- Understanding the meaning of international convergence and dealing with national specificities

- Translating the standards into numerous languages

- Complexity and structure of international standards

- Frequency, volume, and complexity of changes

- Challenges for small and medium-sized companies and accounting firms

- Potential knowledge shortfalls within the global profession and the need to resolve matters of interpretation easily and quickly

The standard setters, recognizing the many challenges, are responding. For example, the IAASB proposes to define two categories of professional requirements: “requirements” and “presumptive requirements,” and to differentiate the corresponding language in various pronouncements—“shall” and “should,” respectively. The IAASB also is making other grammatical changes to avoid confusion between statements that establish professional requirements and those that are illustrative guidance. This effort coincides with PCAOB changes, described in *The Changing Audit Environment*.

PricewaterhouseCoopers continues to support efforts to converge both financial reporting standards and auditing and assurance standards across the world, providing resources and playing active roles in IFAC, IAASB, and IASC initiatives.

EU eighth company law directive

Spurred by concerns over damage to the credibility and reliability of financial statements in the wake of corporate scandals in the EU, the EC increased its focus on statutory audit policies. The proposed revised Eighth Company Law Directive will set the framework for future regulation of the audit profession in Europe.

The proposal introduces new requirements governing statutory auditing—designed to bolster audit quality and public trust in the audit function. Among these are the registration of audit firms and public oversight of the audit profession. The proposal also provides a basis for international regulatory cooperation with other oversight bodies, such as the PCAOB in the United States.

Importantly, the revised Eighth Directive proposes specific rules regarding audit committees. First, it would require all public companies—as well as entities like banks and insurance companies, and other companies meeting specified size criteria—to have an audit committee. At least one committee member would have to be independent and competent in accounting and/or auditing. The audit committee would select the audit firm to be proposed for appointment and review auditor independence. And, given how critical an effective internal control system is, the committee would be responsible to monitor that management’s processes ensure control activities are performed and that breakdowns in internal control are communicated and reported appropriately.

The proposal 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.

The box summarizes key elements of the proposal’s provisions affecting auditors.

Key requirements for auditors

- Comply with minimum ethical standards
- Adhere to auditor independence rules
- Perform statutory audits in accordance with International Standards on Auditing
- Group auditor responsible for the audit report on consolidated accounts
- Subject to system of public oversight and external quality assurance

Additional requirements for auditors of public companies

- Report to audit committee on key matters such as material weaknesses in internal controls
- Communicate specified information to audit committee regarding independence

The proposed Directive likely will be adopted in its final form by mid-2005 and transposed into the national law of EU Member States by the end of 2006.

Matters affecting foreign issuers

In the post-Sarbanes world, SEC and U.S. stock exchange rules increasingly make no distinction between foreign and domestic issuers—to a large extent, SEC rules no longer provide accommodations for foreign issuers. Thus, although this section focuses on new rules of particular concern to foreign issuers, see broader discussions of rules finalized in 2004 elsewhere in this publication.

404—internal control over financial reporting

The 404 rules for management's reporting on internal control are effective for foreign issuers for fiscal years ending on or after July 15, 2005.

Some non-U.S. companies file on domestic forms—10-Ks and 10-Qs. Why is this significant? Because those companies are expected to adopt 404 internal control reporting on the same timetable as U.S. companies. Thus, a non-U.S. company filing on domestic forms and also qualifying as an accelerated filer—generally, a company with market capitalization exceeding $75 million—would have to comply with 404 reporting starting with its first fiscal year ending on or after November 15, 2004. This requirement applies whether the company is required or voluntarily elects to file on such forms. But companies that voluntarily file on domestic forms can switch to reporting under the foreign system and instead file annual reports on Forms 20-F and 40-F. However, they should consult with legal counsel, as there may be contractual agreements, such as a trust indenture, that precludes making a change. Additionally, for some companies there could be a market reaction to such a change.

While the Section 404 and the SEC rules essentially are the same for both U.S. and foreign issuers, certain aspects of the SEC rules impact foreign issuers differently.

- Foreign issuers have additional time to implement the rules—compared with large U.S. companies—but they have the added burden of having to address the implications not only of internal controls over financial reporting in their primary financial statements, but also of internal controls surrounding U.S. GAAP information included in footnotes.

- Many companies, especially European ones, are changing to a new basis of accounting in 2005—International Financial Reporting Standards. And many companies likely will find it a significant challenge to implement all of the substantial changes required for IFRS conversion in sufficient time to complete their 404 testing.

- Management must base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body or group that has followed due-process procedures, including public comment. The SEC has identified COSO as being acceptable, but not mandatory—and most foreign companies are expected to use COSO. But to the extent a foreign company is using another framework, management must ensure it meets the criteria.

Clarifying NYSE governance disclosure requirements

The New York Stock Exchange listing rules adopted in 2003 didn't require that foreign issuers adopt the listing rules, but did require they disclose any significant ways in which their corporate governance practices differ from those required of U.S. companies. November 2004 amendments to NYSE listing standards clarify that the disclosure should cover the significant ways in which a foreign issuer's *actual* corporate governance practices differ—not simply the ways in which their home country practices differ, as the original guidance indicated. This disclosure should be a brief, general summary of the significant differences, not a detailed, item-by-item analysis of these differences.

First-time adoption of IFRS

Typically, the SEC requires that foreign companies seeking to register for the first time in the United States provide three years of financial statements—unless they are providing U.S. GAAP statements, in which case only two years are required. Subsequently, all existing foreign registrants must provide three years of financial statements, unless the company is filing under the Canadian multijurisdictional system and provides the information to comply with the requirements in Canada.

The SEC has proposed to allow foreign issuers a one-time accommodation for financial statements prepared under IFRS. It would permit foreign issuers to present only two years, instead of three, of audited IFRS financial state-

ments in filings in the first year they apply IFRS. This would apply to foreign issuers that have not previously 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.

The accommodation is meant to facilitate foreign companies' transition to IFRS and to improve the quality of their disclosure. It's important because it would be difficult for companies to reconstruct some of the specific information they would need if they had to apply IFRS back three years. But the accommodation is conditional on companies presenting certain disclosures such as condensed U.S. GAAP information for three years. In addition, the proposed rules would require all companies adopting IFRS, regardless of whether they use the accommodation, to provide certain additional disclosures.

Litigation

The 2003 *PricewaterhouseCoopers Securities Litigation Study,*[14] as well as a review of 2004 cases, indicates the number of securities class actions filed by shareholders against foreign issuers is growing. According to the latest information available at the time of this writing, 26 foreign companies listed on U.S. exchanges have been sued in securities class actions through September 30, 2004. That number eclipses the complete 2003 total of 15 cases, and surpasses the 23 foreign companies sued in 2002. Among the principal reasons for this trend: plaintiff law firms' increased familiarity with the issues and willingness to pursue private litigation; and more frequent SEC reviews of foreign companies' filings—as mandated by Sarbanes-Oxley—which could lead to more frequent challenges of a foreign issuer's accounting. These and other factors increase the likelihood that a foreign issuer could be sued in the United States.

Directors should be aware of this growing trend, and ensure management recognizes the new risks. Companies not currently registered need to consider these factors in evaluating the costs and benefits of registering with the SEC. However, even companies that aren't registered with the SEC face private litigation in the United States for violations of securities laws.

Delisting and deregistering

Last year's publication outlined the challenges foreign issuers face when deregistering. Evidence suggests those challenges are not deterring a growing number of foreign issuers from delisting and deregistering—the number of foreign issuers registered with the SEC was actually lower at the end of 2003 than 2002.

Companies that delist from an exchange are still subject to the SEC's reporting obligations unless they can deregister. The current rules don't allow a company to deregister unless the number of shareholders in the United States is below 300. Certain non-U.S. industry groups are lobbying for rules that would let a company deregister if the percentage of its shares either traded in the United States or held by investors in the United States fell below a specified threshold. The SEC has indicated it likely will propose a rule to ease a company's ability to deregister.

PCAOB audit documentation standard

Public Company Accounting Oversight Board Auditing Standard No. 3, *Audit Documentation*, is effective for audits of companies with fiscal years ending on or after November 15, 2004. Standard No. 3 establishes general requirements for documentation that an auditor should prepare and retain, and requires all necessary auditing procedures be completed before the report release date, with "archiving," or completion, of that documentation within 45 days thereafter. The report release date is the date the auditor grants permission to use the auditor's report in connection with the issuance of a company's financial statements.

Are there any unique issues for foreign issuers? Yes. A number of foreign companies issue their home country GAAP financial statements well before they issue the U.S. GAAP information that is included in Form 20-F. This practice raises a number of issues—among them, the dating of the auditor's report and report release date.

Discussions with the SEC and the other major accounting firms are continuing as to how these rules should be applied to foreign issuers.

Auditor oversight

All firms that audit companies listed in the United States must register with the PCAOB and become subject to its oversight. As at November 15, 2004, 509 non-U.S. accounting firms have registered from over 70 countries—representing one-third of all registered firms.

[14] The full text of the study can be found at www.10b5.com/2003_study.pdf.

Differing privacy laws, travel logistics, and language concerns make foreign inspections significantly more challenging than domestic ones. Accordingly, the PCAOB's rules allow it to rely to varying degrees on non-U.S. regulators. The PCAOB will place more reliance on those foreign accounting regulators that have a high level of rigor and of independence from the accounting profession. And the higher the reliance, the less involvement the PCAOB expects to have directly with the foreign inspections. The PCAOB adopted final implementation rules for this international cooperation framework of accounting firm oversight in June 2004.

Impact on audit committees

International accounting and auditing standards are about to become reality, with EU companies poised to adopt International Financial Reporting Standards in 2005, and their auditors preparing to apply international auditing and assurance standards soon after. Adding to those convergence efforts is a new EU proposal for audit requirements that will affect both the audit profession and audit committees' membership and responsibilities. Of course, accounting and auditing standards aren't the only thing on the agendas of audit committees of foreign issuers. Committees are monitoring progress being made to comply with upcoming Section 404 requirements on management reporting on internal control. Audit committees, witnessing the unexpected time and effort being required by U.S. companies, are challenging management to ensure the resources and plan are adequate and will allow foreign issuers to comply by the deadline. And foreign issuers are noting other ways in which they increasingly are feeling the effects of operating in U.S. and global markets—seeing increasing litigation and feeling the impact of rules such as the new PCAOB documentation standard.

Developments affecting financial reporting

Accounting for the American Jobs Creation Act

The key provisions of the American Jobs Creation Act are described in *Regulation and Taxes—Two Certainties of Corporate Life*. The Act, representing the biggest change to tax laws in more than 15 years, also has important accounting implications.

Homeland investment incentive

The question is when to account for the one-time dividends received deduction available to companies under the Act. One major issue is that historically companies have taken advantage of an exception under APB Opinion No. 23 to indicate they planned to reinvest foreign earnings indefinitely. This intention is key to not having to record a deferred tax liability.

Companies need to consider carefully the financial statement implications of any repatriation. Companies will record a liability for taxes to be paid on repatriated earnings, and will need to consider the effect on deferred taxes. But some companies may not know by the end of their current reporting period whether or how much they ultimately will repatriate. Companies also must consider the impact a current repatriation will have on their future ability to rely on the exception under APB 23 as well as any pressure it puts on prior assertions. Management will have to address this issue in its representation letter.

On November 15, 2004, the FASB issued a draft Staff Position (FSP) allowing companies time to evaluate the effect of the Act on their reinvestment plans. However, when a company has concluded that some amount of earnings is likely to be repatriated, it must record the associated tax liability. In addition, the FSP requires current disclosure of the status of a company's plans, including expected completion date, as well as a range of reasonably possible amounts being considered for repatriation and the associated tax costs.

Qualified production activity deduction

The new deduction for qualifying production activities brings its own accounting challenges. The FASB issued another draft FSP in November 2004, stating that the deduction should be accounted for as a special deduction in accordance with FAS 109. Consequently, any benefit from the deduction would be reported in the period in which the deduction is taken for tax purposes. The FSP also indicates companies should consider the special deduction in measuring deferred taxes when graduated rates are a factor, as well as in assessing the need for a valuation allowance in certain cases.

Bottom line: Companies are required to consider the effects of the Act beginning in the period it was enacted, which means audit committees may start seeing its effects for periods ending as early as October 31, 2004.

Accounting for stock options

The FASB's project on accounting for stock options continues to be one of the most controversial and closely monitored projects in its history. Unlike the compromise reached during the debate that raged a decade ago—over FAS 123, *Accounting for Stock-Based Compensation*—companies now face the reality they will be required to treat stock options as an expense in the income statement. The FASB has made critical decisions that will have far-reaching implications for the way companies account for stock options, and expects to issue FAS 123R, *Share-Based Payment*, by December 31, 2004.

Choice of option pricing models

Under FAS 123R, companies will be able to choose either the Black-Scholes or the binomial model to measure the fair value of their stock options. Historically under FAS 123, most companies used the Black-Scholes model. While it is relatively simple to apply, critics argue it lacks flexibility in its assumptions—by requiring input factors to remain static over the life of the option—and often overestimates the fair value of stock options.

Alternatively, the binomial model provides greater flexibility in selecting assumptions, generally resulting in a more accurate estimate of fair value. But using a binomial model requires companies to perform extensive data analysis in order to develop the appropriate assumptions, and to develop or purchase software to perform the complex binomial calculations. The use of binomial models has been less common because companies historically have not tracked the required data or performed the necessary analysis. To the extent companies want the greater precision provided by the binomial model, they may begin to migrate toward using it.

Importance of assumptions

The fair value of stock options can vary significantly depending on the assumptions used—typically the assumptions are more important than the model selected. The assumptions used in 2004 will affect reported net income in periods beginning after June 15, 2005 for unvested awards at that date. Accordingly, whether companies already are recognizing stock compensation expense in their income statement or providing pro forma disclosures under FAS 123, they should consider carefully the assumptions used to develop their fair value estimates for 2004 financial statements.

The factors FAS 123R requires companies to use in their option pricing models are shown in the box.

Required factors for option pricing models under FAS 123R

- Exercise price of the option
- Current price of the underlying stock
- Expected term of the option
- Expected volatility of the underlying stock
- Risk-free interest rate during the expected term
- Expected dividend yield of the underlying stock

The exercise price is known based on the terms of the grant, and the current price of the underlying stock is known. The other four assumptions require companies to use reasonable judgment. Expected volatility and expected term are the most significant assumptions in determining fair value estimates and also require the most difficult judgments. Companies should assess their available data on these assumptions prior to applying both FAS 123 for 2004 financial statements and FAS 123R for 2005 financial statements. Assumption changes may be warranted due to a more thorough analysis of historical data and future expectations. Companies should use a combination of historical experience and reasonable expectations in developing their estimates.

Effective date and transition methods

Based on numerous requests, and given the resources public companies had to devote to Section 404 in calendar year 2004, the FASB postponed the effective date to interim and annual periods beginning after June 15, 2005.

Adopting the standard in the middle of a calendar year creates an unusual situation. Depending on a company's fiscal year end, the revised effective date results in a three- or six-month deferral, no deferral, or a three-month acceleration of the adoption. Companies with a September, October, or November fiscal year end now face the acceleration of FAS 123R's adoption. All companies should assess the impact of FAS 123R on their fiscal 2005 and 2006 projections and budgets, and reassess their implementation plans.

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

Three FAS 123R transition methods

Modified prospective—restating interim periods prior to adoption

- Recognize the expense of stock options, beginning with the third quarter of 2005, using FAS 123R. Restate the first and second quarters of 2005 using amounts from FAS 123 pro forma disclosures.
- Result: Stock option expense for the first and second quarters of the year is accounted for using FAS 123, and the third and fourth quarters using FAS 123R.
- This method improves comparability between quarters in calendar year 2005, but reduces comparability across years.

Modified prospective—without restating prior interim periods

- Recognize the expense of stock options, beginning with the third quarter of 2005, using FAS 123R. Do not restate the first and second quarters of 2005.
- Result: The 2005 annual income statement presents stock option expense under FAS 123R for the third and fourth quarters only.
- This method requires the least effort since the company is not restating prior quarters. But that lack of restatement may raise comparability issues across quarters, both in 2005 and for a number of subsequent years.

Three FAS 123R transition methods (cont.)

Modified retrospective—restating prior years and interim periods

- Recognize the expense of stock options, beginning with the third quarter of 2005, using FAS 123R. Restate all periods beginning after December 15, 1994 or all periods presented in public filings (i.e., three years for U.S. public companies) using the amounts from FAS 123 pro forma disclosures.
- Result: The 2005 annual income statement presents an annual amount of stock option expense (the first half of the year under FAS 123 and the latter under FAS 123R).
- This method requires the most effort, but because it restates prior financial statements, it significantly improves comparability.

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

Next steps

To prepare for adoption of FAS 123R, 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.
- Contemplate transitioning from the Black-Scholes model to the binomial model.
- Consider the alternative transition methods and develop a strategy to meet the needs of financial statement users.
- Take advantage of the delay in the effective date to adequately prepare for implementation of FAS 123R—including designing controls to meet the requirements of Sarbanes-Oxley Section 404.

Accounting for pensions and other postemployment benefits—key issues facing companies today

Many companies have significant pension and other postemployment benefit (OPEB) obligations and expense. In recent years, benefit expense has risen dramatically due to many factors, including stock market performance, lower interest rates, and rising health care costs—resulting in increased balance sheet liabilities and, for pensions, charges against stockholders' equity. In addition, the SEC, rating agencies, analysts, and shareholders have increased their scrutiny of benefits-related accounting and disclosures.

Moreover, the accounting rules[15] are complex and the related actuarial assumptions highly judgmental. While an actuary typically computes the obligations and expense for accounting purposes, management is responsible for establishing the related internal controls, providing underlying data, performing recordkeeping, selecting assumptions, making accounting decisions, and reporting financial results. And key assumptions, the application of the actuarial methodology, and critical accounting decisions all can significantly affect the amount of expense recorded. Unfortunately, too few audit committees are aware of the related issues and how to probe effectively.

At a high level, GAAP requires or permits companies to:

- Spread benefit costs over the employees' service period
- Recognize the cost of plan amendments over the remaining service period of active employees
- Defer gains and losses (from actuarial experience and actual asset returns), with minimum amortization required only if the deferred amount exceeds a specified limit (the so-called "corridor approach")

Generally speaking, expense for the year is the aggregate of:

[15] Key accounting pronouncements are FAS 87, *Employers' Accounting for Pensions*, and FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.*

- Service cost—the cost related to the current year of employee service
- Interest cost—one year's interest on the benefit obligation
- Expected return on plan assets—which reduces the cost
- Amortization of deferred plan amendment costs, actuarial gain/loss, or transition amounts

Additionally, special events—curtailments, settlements, and termination benefits—trigger the accelerated recognition of deferred prior service costs and gains and losses, often creating sizable one-time income or expense in the income statement.

The balance sheet asset or liability is based on the cumulative difference between expense recognized in the income statement and amounts funded or paid directly to plan participants. However, for pensions, if the plan is underfunded—essentially when the pension benefit obligation exceeds the fair value of assets in the plan—the underfunding is recognized as a liability, with the offsetting charge generally to stockholders' equity.

What drives the numbers?

Certain key actuarial assumptions and accounting methods have a major impact on the amount of obligations and expense. Management is responsible for selecting these assumptions and methods. The FASB has provided guidance, but there is considerable judgment involved, and the use of overly aggressive or overly conservative assumptions will have a significant impact.

The four key drivers are shown in the box.

Current FASB initiatives

In 2004, the FASB completed one project related to FAS 106 accounting, began another related to cash balance pension plans, and announced its agreement to work jointly with the International Accounting Standards Board (IASB) on a project to overhaul and converge pension/OPEB accounting rules.

Accounting for Medicare Act. In May 2004, the FASB issued Staff Position (FSP) FAS 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*. It provides guidance on accounting for the effects of the Medicare prescription drug legis-

Most important drivers for pension and OPEB calculations

Key Driver	GAAP Requirements	Survey Information[16]
Discount rate	Current yield on high-quality bonds (AA or better) at measurement date	2003: 6.0–6.25% 2002: 6.50–6.75%
Assumed asset return	Long-term expected rate of return on plan assets	2003: 8.5–9.0% 2002: 8.5–9.5%
Market-related value (MRV) of plan assets	Fair value or asset smoothing over period of up to five years	Variety of approaches, not disclosed About 25–33% of companies use fair value; for 2003 MRV was significantly above fair value
Health care cost trend	Long-term expected increase in employer's retiree health costs	2003: 9–11% increase in costs, trending to 5–5.25% increase over 4–8 years 2002: 9–12% increase in costs, trending to 5–5.5% increase over 5–8 years

[16] Survey information on the discount rate, assumed asset return, and health care trend assumptions is based on a PricewaterhouseCoopers survey of 2003 annual reports of approximately 200 large public companies. The ranges presented exclude both the bottom and top 20% of survey results. The market-related value information is based on an informal PricewaterhouseCoopers client survey.

lation by employers whose prescription drug benefits are actuarially equivalent to the drug benefit under Medicare Part D. It also covers related income tax accounting and includes complex rules permitting various prospective and retroactive transition approaches. For all public companies and for nonpublic companies that sponsor one or more plans with more than 100 participants, the FSP is effective as of the first interim or annual period beginning after June 15, 2004—third quarter 2004 for calendar-year-end companies—although earlier adoption is encouraged. The new rules generally result in lower retiree health care obligations and expense attributable to the new federal government subsidy that employers will receive starting in 2006. However, each employer's situation is different so the exact impact will vary from company to company depending on plan terms, demographics, and assumptions.

Accounting for cash balance pension plans. The FASB is considering the appropriate accounting for cash balance pension plans. Both IRS and FASB rules consider cash balance plans to be defined benefit plans. In a cash balance plan, each participant's pension benefit is reflected in a notional account balance similar to the account in a defined contribution plan. Currently, an actuarial methodology—rather than the sum of all participants' account balances—is used in practice to measure the employer's obligation. The FASB is deliberating whether a better approach would base the employer's obligation on participants' account balances, and also whether to revise the accounting rules for all plans that pay benefits in the form of a lump sum. However, the issues involved are complex, and it is unclear at the time of this writing whether the FASB will issue a standard on this subject, or consider these issues as part of the major project discussed below.

Project to readdress pension/OPEB accounting. In 2004, the FASB and IASB agreed in principle to begin a joint project to review accounting for pensions and OPEBs under their respective rules. While the two boards have not yet formally voted to add this project to their agendas, observers expect they will. A major initiative of this type typically takes two to three years to complete. The project will address all of the complicated rules in this area, including the following key issues:

- Should deferred recognition of the effects of plan amendments and actuarial gains and losses be eliminated, moving to mark-to-market accounting?
- Should the components of net pension/OPEB expense, which currently are reflected as a single item in operating income, be reported separately (e.g., service cost as an operating expense, interest cost as interest expense, and return on plan assets with other investment income)?

Business combinations—phase II

A few 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*. The second phase—nearing completion—addresses applying the purchase method of accounting and is intended to improve purchase accounting principles and practices, increase transparency of information in financial statements, and increase consistency with the FASB's Conceptual Framework.

The FASB is expected to issue an exposure draft outlining proposed changes by early 2005, with the final standard anticipated later in the year. The IASB and FASB will issue the same exposure drafts—reflecting growing cooperation and convergence between U.S. and international accounting standard setters.

The anticipated changes to current practice are significant and have important implications for companies planning deals. How? Under purchase accounting, companies will recognize more assets and liabilities, and have to address challenging valuation issues and to expense acquisition costs. Companies negotiating deals—and audit committees and boards being asked to approve them—will want to understand the accounting implications and consider the ramifications of these changes when structuring deals and calculating deal economics. See discussion in *The International Scene* for more detail.

Fair value measurements

The FASB is developing guidance on how to measure fair value. Why? To provide com-

panies with a consistent method for calculating the fair value of financial and nonfinancial assets and liabilities, instead of the disparate practices now included in various accounting standards.

The FASB's proposed definition of fair value is the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.

To assist entities in measuring the fair value of financial and nonfinancial assets and liabilities, the FASB is proposing the following prescriptive hierarchy:

- Level 1 – Fair value is estimated using quoted market prices for identical assets and liabilities

- Level 2 – Fair value is estimated using quoted market prices for similar assets or liabilities, adjusted for differences

- Level 3 – Fair value is estimated using multiple valuation techniques (market, income, cost)

The FASB issued an exposure draft in June 2004. It is anticipated that the final standard will be issued in the first half of 2005 and become effective for financial statements issued for fiscal years beginning after June 15, 2005, along with interim periods within those fiscal years. Earlier application would be encouraged. For the most part, these new provisions are to be applied prospectively.

Impact on audit committees

Audit committees should expect to see many changes in companies' accounting and reporting in the coming months, as new FASB requirements and tax rules take effect. The American Jobs Creation Act grants companies new tax deductions, and companies need to ensure they're applying the right accounting for these deductions and implementing well-controlled processes around them. And while the FASB has postponed to June 15, 2005 its controversial standard requiring the expensing of stock options, the midyear adoption presents its own complications. Audit committees also will want to watch the accounting for pensions and other postemployment benefits—where management has to exercise considerable judgment in assumptions and accounting methods, with important financial consequences—and which could change significantly following the upcoming IASB and FASB project on the topic. Further, audit committees will want to understand the implications of forthcoming rules on business combinations, discussing with management and auditors the impact for deals under way or under consideration.

Appendix: Spreadsheets—the good, the bad, and 404

Spreadsheets—programs like Excel® and Lotus 1-2-3®—are so often the tool of choice that they play a critical role in corporate finance departments. Why? Because they give analysts and accountants power over information they otherwise would not have, allowing them to extract data from disparate, often inflexible legacy information systems and consolidate that data into the form needed for analysis and reporting, thus providing significant efficiencies. Thus, while spreadsheets' ease of use and flexibility encourage their proliferation, that proliferation makes optimal controls impractical or impossible. These risks are especially noteworthy in light of Sarbanes-Oxley 404 provisions.

"Spreadsheet sprawl"

It's not unusual for individual analysts and accountants to use dozens of spreadsheets, with literally thousands used within a company's reporting processes. Further, so-called "power users" now use macros, complicated formulas, advanced features, and programmed dependencies between spreadsheets. Spreadsheets support complex valuation and other models, underlying, for example, derivative disclosures. So why should audit committees view this as problematic? Because, in most cases, there are inadequate controls over these spreadsheets.

Spreadsheets seldom are developed according to the same exacting standards required for most corporate financial systems, and often lack controls and processes to ensure both that they work properly in the first place and that changes made are appropriate. Even if they do contain appropriate logic, there typically are few controls to ensure they continue to function properly and with the correct data. In addition, since spreadsheets can be changed easily, unless a snapshot is archived as of a point in time, the support for key financial entries and/or disclosures could be lost or overwritten. The box describes a number of specific issues.

As some companies have discovered, errors in even relatively simple spreadsheets can result in material misstatements in their financial reports. Several large companies have either restated previously filed financial statements, publicly disclosed control deficiencies, been publicly censured by regulators for insufficient spreadsheet controls, or all of the above.

404 implications

In the past, management and audit committees either weren't aware of the exposures surrounding spreadsheets or weren't particularly concerned. With Sarbanes-Oxley 404, however, management must consider the adequacy of any corporate reporting process controls that could have material impact, including those surrounding spreadsheets.

Common control exposures with spreadsheets

- There is no complete inventory of spreadsheets critical to reporting processes.
- There is minimal or no documentation of a spreadsheet's purpose, calculations, logic.
- Assumptions built into formulas are not updated over time; for example, fixed constants are used where variables should have been used, or test data continues to be used as if it were live.
- There are few, if any, controls to restrict access.
- Input errors result from typos, incorrect data entry sources, outdated data, or simple cutting-and-pasting mistakes.
- Logic errors occur through use of inappropriate formulas.
- Interface errors result from mistakes in importing or exporting data.
- Sign or scaling errors are made on input or in formulas.
- There are inappropriately defined cell ranges, inappropriately referenced cells, or improperly linked spreadsheets.

The first step in understanding how spreadsheets are used and assessing the adequacy of related controls is to inventory the spreadsheets and evaluate their complexity, materiality, and linkage to the financial reporting process. Once the significant spreadsheets are identified, the second step is to evaluate the adequacy of controls over them, including any control deficiencies.[17] If deficiencies are identified, the third step involves considering remediation steps, and whether it's even possible to implement adequate controls over significant spreadsheets. If not, the company needs to consider whether spreadsheets related to significant accounts or with higher complexity should be migrated to a more formally controlled IT application environment. Even if there are no significant deficiencies, companies may wish to consider whether it's wise to reduce their reliance on spreadsheets as part of their financial reporting process.

Generally, the level of controls should be commensurate with the spreadsheet's use and complexity, and the required reliability of the information. Even spreadsheets categorized as low in complexity and importance should be controlled to some extent if they feed into financial records. While manual controls and processes can help mitigate the risks associated with spreadsheets, a robust IT environment usually is warranted for significant accounts and more complex spreadsheets.

Audit committees should have a sense of how extensively spreadsheets are used in preparing financial reports. They should discuss with management the status of control effectiveness over end-user computing, and the adequacy and implications of longer-term answers.

Enhancing internal control

If imposing controls in an environment of spreadsheet sprawl seems as hopeless as herding cats, take a different view of the problem: It's not about the spreadsheets, it's about the information. Information is entered into a spreadsheet, is manipulated within the spreadsheet, and then is exported or accessed through other applications. It's critical that the information, as it moves throughout the organization, is consistent, standardized, and current every time it is accessed, whether it is located in an internal data store, moves from spreadsheet to spreadsheet, or goes from spreadsheet to report. That requires a controlled information environment, including data standardization, documentation, web transport, and formulas.

The weakest link in reporting processes is the manual transfer of information from one location to another. Every time information is moved, it becomes increasingly difficult to trace it to its origin for verification and to locate the source of any discrepancies. Because information is decentralized, so are controls. Standardizing information reduces or eliminates the weakest link, giving all data an identity that all software can recognize and process, and leading to a hands-off environment in which software exchanges information directly, without manual intervention. The result: better information quality and integrity for both end users inside the company and external stakeholders.

The means of getting there: eXtensible Business Reporting Language (XBRL), the standardized language designed specifically for business information technology. XBRL provides standardized representations of both business detail (XBRL GL) and business reporting (like financial statements and tax returns). With information standardized at its source—"wrapped and mapped" in XBRL—it can be traced to its origin from any level of consolidation. Moreover, changes at the source can be updated automatically in every consolidation using the data.

By tackling both internal and external reporting dimensions, XBRL offers a mechanism for reducing or eliminating manual re-entry of business data, better controlling and intercepting errors in data moving either into or out of spreadsheets. XBRL permits "standardized custom programming," allowing users to develop spreadsheets that meet their specific needs without relying on a centralized group or waiting for limited IT resources. At the same time, XBRL maps to shared data definitions that make the spreadsheets interoperable.

XBRL standardizes the formulas used to express interrelationships between reporting items, improving the processing of data within a spreadsheet. Both the data and the formulas normally embedded within a spreadsheet can be made spreadsheet independent, allowing

[17] For a full discussion of implementing controls around spreadsheets, see the PricewaterhouseCoopers discussion paper *The Use of Spreadsheets: Considerations for Section 404 of the Sarbanes-Oxley Act*, available at www.pwc.com/internalauditsarbanes.

formula assessment and analytical results to be communicated upstream for further analysis.

Many spreadsheet programs have the means of adding capabilities for XBRL and other, related information standards. These capabilities include moving data access and storage responsibilities from the spreadsheet to centralized and controlled storage applications, reducing many of the risks of a manual spreadsheet environment, while maximizing the analysis and presentation power of spreadsheets. In addition, companies are finding that applications that already understand XBRL data, such as data extraction and analysis tools like IDEA®, provide cost-effective and efficient data-testing capabilities.

For more information on XBRL, see www.xbrl.org.

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