

The Sarbanes-Oxley Act of 2002

Understanding the Independent Auditor's Role
in Building Public Trust: A White Paper



This white paper provides general or summary information about aspects of the Sarbanes-Oxley Act of 2002, and current and proposed rules, regulations or standards of the U.S. Securities and Exchange Commission, the Public Company Accounting Oversight Board and other associations or bodies. The information and considerations presented do not constitute the provision of legal advice. Boards of directors, audit committees and companies are encouraged to reference the foregoing statute, rules, regulations and standards, and to consult with legal counsel concerning their responsibilities with respect to applicable provisions thereof.

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I. Preface

Recent corporate scandals have dramatically eroded investor trust in corporate reporting, a factor contributing to a slowdown in U.S. capital market performance that began even before the first of many companies started to unravel. Responding aggressively to the situation, the United States Congress enacted the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), intending as it did so to reduce corporate malfeasance and protect investors. This hallmark legislation set forth a new system of checks and balances, and is seen by many as a foundation for rebuilding investor confidence.

Today's corporate stakeholders expect more: greater assurance, more oversight and clear evidence of internal controls. The confidence of the investing community will only be restored once the gap between what investors expect in terms of corporate governance and reporting and what they have received in the past has been closed. Sarbanes-Oxley provides impetus for closing the expectation gap by altering and expanding the responsibilities of key participants in the corporate reporting process.

Important as this legislation may be, it should not be considered the only guard against corporate failure and fraud. Investors expect the accounting profession to act responsibly on its own, and current trends indicate that it will do so. Sarbanes-Oxley does affect the independent auditor's relationship with companies under audit – aspects of the law represent the first major legislative update for the profession in nearly 70 years. Where the Securities Exchange Act of 1934 empowered the SEC with broad authority over many activities in the capital markets, Sarbanes-Oxley focuses on improving the accuracy and reliability of corporate reporting. Indeed, if properly embraced by independent accountants, management and audit committees, Sarbanes-Oxley is likely to be a catalyst for stronger and more transparent corporate reporting.

This white paper explores the obligations and role of the independent auditor in the corporate reporting process[†] – as mandated by Sarbanes-Oxley and subsequent SEC rules – with the intent to help inform other members of the corporate reporting supply chain regarding these changes. As part of this discussion, we also focus on the means by which independent auditors, audit committees and management can work together to ensure that these new obligations are met. The paper further speaks to opportunities, in selected areas, for management, audit committees and our profession to go beyond current requirements in order to achieve a deeper level of transparency in corporate reporting – and to implications of the new independent oversight of the accounting profession.

[†] Please see the first and second white papers in this series, "The Sarbanes-Oxley Act of 2002 – Strategies for Meeting New Internal Reporting Challenges", which explores the expanded responsibilities of management, and "The Sarbanes-Oxley Act of 2002 and Current Proposals by NYSE, Amex and NASDAQ – Board and Audit Committee Roles in the Era of Corporate Reform", which details the roles of boards of directors and audit committees. For further reference, please see our book entitled, *Building Public Trust – The Future of Corporate Reporting*, by Sam DiPiazza Jr. and Robert Eccles, published in New York by John Wiley & Sons, 2002.

Restoring Faith in the Corporate Reporting Supply Chain

From corporate management to small town investors and all those in between, the corporate reporting supply chain consists of everyone who produces or consumes corporate reporting and analysis. And, like all supply chains, it is only as strong as its weakest link. Investors have lost a degree of faith in the veracity of the information that passes through the corporate reporting supply chain, a loss that needs repairing. Corporate management, boards and audit committees, internal and external auditors, analysts and other investment professionals all have a duty to strengthen the process and rebuild investor trust by executing their respective roles, keeping in mind both legal obligations and the heightened expectations of investors.

Figure I-1: The Corporate Reporting Supply Chain^{††}



Sarbanes-Oxley mandates specific actions to improve corporate reporting, establishing parameters for how the key players in the chain must interrelate. By working together within the framework of Sarbanes-Oxley, each participant will play a critical part in providing investors information on which they can reliably base their investment decisions. However, investor faith will be restored more quickly and fully if all participants not only comply with the letter of the law, but also commit to the core business values investors want to see driving corporate reporting and governance: transparency, accountability and integrity.

Transparency

A spirit of transparency means that companies willingly provide information needed by shareholders and other stakeholders to make decisions. Information is transparent when it provides the reader with a clear understanding of the company's financial condition, results of operations, cash flows and other aspects of its business.

Accountability

Transparent information must be accompanied by a firm commitment to a culture of accountability among all participants in the corporate reporting supply chain. Each must take responsibility, in collaboration with all others, for carrying out a fundamental role in this chain.

^{††} Standard Setters refers to organisations that set accounting and auditing standards, as well as others in similar roles. Market Regulators include governmental agencies and other bodies that set and enforce rules relating to corporate reporting. Enabling Technologies contribute to the widespread distribution and use of reported information.

Integrity

Transparency and accountability depend on people of integrity trying to “do the right thing”, not just what is expedient or even permissible. Without personal integrity as the foundation for reported information, there can be no public trust.

Participating in a More Robust Reporting Process

The need to meet investor expectations is at the heart of the sweeping changes mandated by Sarbanes-Oxley. By increasing the focus on the responsibilities and accountability of key players in corporate reporting, the legislation and other activities it has triggered in the regulatory environment move to close the gap between the degree of trustworthiness investors want and what they have received in the past regarding corporate reporting and governance. Though Sarbanes-Oxley does not change the responsibility for internal controls and disclosure – which is in the hands of management – boards of directors, audit committees and external auditors must work together more closely than ever to provide vigilant oversight and thorough assurance on the financial reporting process and the information shared with investors.

In essence, Sarbanes-Oxley mandates a system strengthened by checks and balances among the key players in the corporate reporting supply chain. As participants comply with the new requirements, they move closer to the goal of rebuilding investor trust. But to meet the objectives of Sarbanes-Oxley, each participant must understand not only their own role, but also the obligations of the other participants who contribute to the corporate reporting process.

1. Company Executives

Sarbanes-Oxley contains several provisions highlighting the important roles a CEO and CFO play with respect to reports filed with the SEC. For example, it reaffirms that the CEO and CFO carry the primary responsibility for company reports filed with the SEC and institutes a requirement for them to report on the completeness and accuracy of information contained in the reports, as well as the effectiveness of specified internal controls.

2. Boards of Directors and Audit Committees

Sarbanes-Oxley establishes new responsibilities for the audit committee in its capacity as a committee of the board of directors, including the appointment and compensation of the external auditor and oversight of the auditor’s work for the purpose of preparing or issuing an audit report or related work – thereby strengthening oversight and the independence of the external auditor from management. The audit committee must pre-approve all services provided by the external auditor, after first determining that the services do not pose a conflict with the auditor’s independent role. Moreover, each audit committee must comprise independent directors, as defined, and the company must disclose, among other things, whether at least one member of the committee meets the specified criteria of an “audit committee financial expert” and, if not, the reasons why. Thus, Sarbanes-Oxley attempts to strengthen and position the audit committee for its increased responsibilities.

3. Independent Auditors

The Securities Exchange Act of 1934 established the requirement that companies who wish to raise capital on a U.S. public stock exchange engage external auditors to provide independent assurance to shareholders on the fairness of the presentation of the company's financial statements in accordance with generally accepted accounting principles (GAAP). Passage of Sarbanes-Oxley reaffirms the necessity for the financial statement audit process and the need for the auditor to be independent of management, both in fact and appearance. It establishes that the external auditor reports directly to the audit committee and limits the scope of services the external auditor may provide to the companies it audits. Further, Sarbanes-Oxley expands the auditor's reporting responsibility to include an attestation of the newly required management assertions on the effectiveness of the company's internal control over financial reporting.

Thus, Sarbanes-Oxley has a significant impact on the public accounting profession. Both the increased responsibilities of the external auditor and the limit on the scope of services the auditor may provide significantly change the way the public accounting firms operate.

How This White Paper Can Help

This white paper focuses on the ways in which Sarbanes-Oxley affects those in the public accounting profession, and how this in turn impacts others in the corporate reporting supply chain. As leaders in this profession, it is critical that we analyse and communicate our understanding of the relevant aspects of this important legislation and its pertinence to our role in this chain. We look at changes in the following key areas:

- Strengthening auditor independence
- Increasing the depth of audit services and the value of the audit to shareholders
- Establishing new oversight for the auditing profession

For Sarbanes-Oxley to achieve its objectives of improving the accuracy and reliability of corporate reporting, its long-term impact must include increasing the effectiveness of the independent auditor's assurance on the communications between businesses and the investment community. Though some aspects of the changes mandated by Sarbanes-Oxley have yet to be finalised, we believe this paper offers insights into specifics of what will be expected of independent auditors and how audit committees, management and, tangentially, other stakeholders should anticipate that these changes will affect their relationships with a company's independent auditors.



II. Strengthening Auditor Independence

Asserting Investor Primacy

Investor and other stakeholder scepticism with regard to auditor independence rose markedly in the pre-Sarbanes-Oxley environment. Many observers came to feel that relationships between management and independent auditors had – in some instances – become too familiar, possibly compromising the objectivity of the auditors.

The Sarbanes-Oxley legislation attempts to create a more independent environment for auditors to make their contribution to the corporate reporting supply chain. In many ways the provisions of the Act pertaining to auditor independence reassert the primacy of investor interests, reminding all parties of their responsibilities to protect and safeguard the interests of investors. Sarbanes-Oxley contains significant provisions for SEC issuers designed to strengthen both the fact and the perception of auditor independence. These include:

- Direct reporting responsibility between the independent auditor and the audit committee, not management, of the company under audit
- Pre-approval by the audit committee of all services provided by the independent auditor
- Limits on the type of non-audit services that accounting firms may provide to companies under audit
- More clearly defined disclosures of the fees paid to auditors for all services
- Restrictions on the employment of audit engagement team members by companies under audit
- More frequent rotation of the lead audit partner, concurring review partner and other audit partners

The SEC has added a requirement that prohibits audit partner compensation related to sales of non-audit services to companies under audit. Whether brought about by Sarbanes-Oxley or the SEC implementation rules, changing roles and increased independence create added responsibilities and challenges for key players in the corporate reporting supply chain. This begins with the audit committee and includes both management and the independent auditor.

A New Reporting Relationship

Under Sarbanes-Oxley, a company's external auditor will report directly to the company's audit committee, which has new and expanded obligations to serve on behalf of the board of directors as the watchful guardian of shareholder interests. The legislation has placed direct responsibility on the audit committee for overseeing the activities of the independent auditor, declaring the audit committee, *"...directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer...for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee"*¹. For some committees who have historically approved, without extensive review, management's recommendations regarding the selection of the independent auditor and any additional services that are provided, this will be a significant change.

Realistically, auditors and management will still work together in day-to-day interaction as the audit progresses; however, the independent nature of their working relationship will be strengthened through greater involvement by the audit committee. Independent auditors have traditionally met with audit committees in the course of doing their audit work, so in most cases a working relationship will have already been established. Still, many audit committees will have to make accommodations for the additional time needed to achieve the level of governance that Sarbanes-Oxley requires, by increasing the time spent together in carrying out their duties and in the time spent directly with the independent auditor.

Where management has, in the past, been a conduit for the external auditor's communications with the audit committee, companies may find that the audit committee chair is now the appropriate person to form a direct working relationship with the lead audit partner. In this respect, Sarbanes-Oxley has forever altered the landscape of corporate governance by increasing the audit committee's oversight role on behalf of investors and other stakeholders. In our series of white papers on this subject, the paper entitled, "The Sarbanes-Oxley Act of 2002 and Current Proposals by NYSE, Amex and NASDAQ – Board and Audit Committee Roles in the Era of Corporate Reform", provides additional detail on this subject.

If the audit committee is to fulfil its expanded role, effective communications with the independent auditor will be essential. Getting the process started on the right foot may be the most important part. The very idea of "management by committee" sounds improbable at best – particularly management by a committee made up of independent directors, many of whom have significant full-time jobs outside the company. Yet this is precisely what Sarbanes-Oxley asks of the audit committee and the independent auditor. As a result, there is a need for a close working relationship with an exceptional level of direct communication between the two parties.

Independent auditors may employ a variety of methods to elevate the level, timeliness and quality of their communications with the audit committee, including recommending what those communications comprise, and how and when they will occur. Audit committees should recognise the interactive nature of effective communications and be prepared to interact regularly and candidly with the audit team, whose members will be expected to present them with timely and forthright communications about the audit.



Prior to filing the audit report with the SEC, independent auditors are now required to communicate the following to the audit committee²:

- All critical accounting policies and practices used by the company;
- All alternative treatments within generally accepted accounting principles for policies and practices related to material items that have been discussed with management of the issuer or registered investment company, including:
 - Ramifications of the use of such alternative disclosures and treatments; and
 - The treatment preferred by the registered public accounting firm;
- Other material written communications between the registered public accounting firm and the management of the issuer or registered investment company, such as any management letter or schedule of unadjusted differences.

Audit committees and auditors should agree on a comprehensive communications plan, and ensure it meets the needs of both parties throughout the audit process. Such a plan can be used to establish a foundation for open and honest dialogue, allowing each to carry out its respective responsibility in the corporate reporting supply chain. We recommend the following be included in the communications plan:

- Audit Services
- Risks and Controls
- Financial Reporting
- Corporate Governance

Auditors should have unfettered access to the audit committee. Committee members should likewise have open access to the lead audit partner, with whom they should meet on a routine basis. As this two-way communication is perfected, the audit committee will gain added value from the audit and be better able to represent investors. Audit committee members may also consider discussing potentially complex areas of the audit, such as tax and internal controls, directly with experts in that service area from the engagement team.

The audit committee must establish policies and procedures to pre-approve the independent auditor's services. Potentially, it must also identify additional independent members to serve on the audit committee, arrange time for meetings and work with management to review additional disclosures, as well as form their own point of view, on the material written communications and accounting treatments included in the company's external reports.

Multi-Disciplinary Audit Teams

Over the past several years, many auditing firms have enhanced the skill sets of their personnel to address the complex operations and associated financial impact of today's large companies. Multi-disciplinary engagement teams are now organised to match the variety of risks in the company under audit with a complement of industry, systems and business process, tax and/or financial risk management experts, all of whom share a core competency in independent auditing.

Simply stated, the complexities of modern corporations are mirrored within the auditing profession through the skill sets of its professionals. In order to ensure the highest audit quality, both the audit committee and the investing public should expect this expertise to be included in the audit process in a way that preserves the auditor's independence.

Pre-Approval of Audit and Non-Audit Services

Under Sarbanes-Oxley, all services – audit and non-audit – provided by the company's auditing firm must be pre-approved by the audit committee³. This requirement became effective on 6 May 2003, and audit committees must now disclose their pre-approval policies and procedures in the company's proxy/information statements. Services that commenced prior to that date that are now impermissible must be concluded by 6 May 2004.

Pre-approval requirements are applicable to services provided by the principal auditor to an SEC issuer audit client and its subsidiaries and to a registered management investment company. The audit committee should establish pre-approval policies and procedures, and it may consult with outside advisors to do so. The pre-approval process may be accomplished by any of the following three methods:

- A. The audit committee may establish a framework of engagements that are approved on a periodic basis, such as annually.
- B. The audit committee may approve individual engagements on an as-needed basis prior to engaging the independent auditor.
- C. The audit committee may use a combination of methods A and B.

If pre-approval of services is given pursuant to policies and procedures established by the audit committee (method A or method C):

- Those policies and procedures should be detailed as to – and descriptive of – the particular service;
- The audit committee should be informed about, and understand the substance of, each service; and
- Such policies and procedures should not include delegation of the audit committee's responsibilities to management.

To ensure that the checks and balances strengthened by Sarbanes-Oxley are as effective as possible, independent auditors must take a proactive approach to meeting this requirement. Likewise, audit committees must be aware of the scope of services that are permitted and be proactive about questioning and investigating where doubts about the permissibility of services exist, or where there are concerns that the scope of the engagement may impair the auditor's independence or objectivity. It is important to emphasise that the pre-approval rule relates to the service being performed and whether the service is permissible, not to the magnitude or amount of the fees.

A pre-approval waiver exists for de minimis non-audit services, provided that all such services:

- Do not aggregate to more than 5% of total fees paid in the fiscal year when services are provided;
- Were not recognised to be non-audit services at the time of the engagement; and
- Are brought to the attention of the audit committee promptly and approved prior to the completion of the audit.

The use of this exemption is expected to be rare.

Management also plays a key role in educating their personnel on the audit committee's pre-approval policies and procedures, and detailing all services provided by the independent auditor.

The pre-approval requirement may necessitate quick action, such as when the auditor's services are needed to address a time-sensitive matter. Instances can be foreseen in which the audit committee will not be scheduled to meet in the time required, so flexibility on the part of the auditor and the audit committee will be important to ensure the company's ability to engage the services it needs when they are needed. By completing and documenting pre-approval processes and granting pre-approval for a framework of detailed and descriptive services, audit committees can allow the independent auditor to execute certain services without case-by-case advance approval. However, to ensure that the spirit of the law is enforced and shareholder interests are protected, the audit committee should always consider the appropriateness of the service provided by the auditing firm relative to its role as the independent auditor of the company's financial statements.

In some cases, audit committees have already put in place pre-approval processes for all financial consulting services – not just those provided by their independent auditor. Pre-approval of all financial consulting services helps these committees provide an oversight function to ensure the best use of the company's resources for critical services provided by financial advisors.

Permissible and Prohibited Non-Audit Services

Restrictions on the scope of services that auditors could provide to companies under audit existed before Sarbanes-Oxley, but the scope of prohibited services has been expanded with the legislation's passage. This has resulted in a reorganisation of the operations of several of the major auditing firms, including the sale or spin-off of major business segments. New scope-of-service restrictions became effective as of 6 May 2003, the exception being cases where services permissible under old independence rules but prohibited under the new independence rules were in process under an existing contract. In such cases, the services must be completed by 6 May 2004.

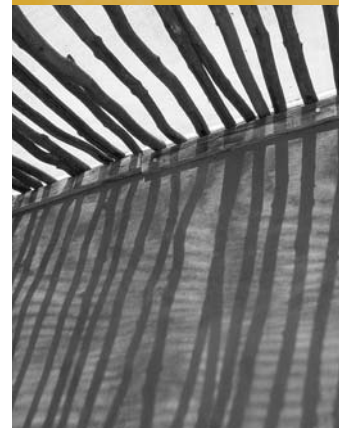
Although the restrictions have increased, there are services that can be provided by the independent auditor without impairing the auditor's independence or objectivity. In many cases, provision of these services can serve to strengthen the quality of the audit and may enhance communication with the audit committee. (Further, several types of non-audit services are permitted in instances where it is reasonable to conclude that the work provided will not place the firm in the position of auditing its own work. Under the Act, the independent auditor may perform internal audit outsourcing, actuarial, appraisal or valuation, financial information system design and implementation, and bookkeeping services for a company under audit – if pre-approved by the audit committee – but only where it is reasonable to conclude that the results of the particular service will not be subject to audit procedures during an audit of the company's financial statements.)

It is also important to note that the prohibited services as defined by the SEC independence rules are only prohibited if the service is provided to companies under audit (or its restricted affiliates as defined by the SEC independence rules) of the firm. Any and all non-audit services can be provided to non-audit clients of the firm, and “second supplier” strategies have already emerged in the marketplace. The likelihood that in the future any company will use the services of only one of the big auditing firms has been greatly reduced with the enactment of Sarbanes-Oxley.

Broadly speaking, the independence requirements are proscriptive in nature and specific to some services. They also consider three guiding principles, listed below, to measure other potential services:

- Independent auditor may not audit its own work;
- Independent auditor may not function in the role of management (auditor is not acting either temporarily or permanently as a director, officer or employee of the audit client or performing any decision-making, supervisory or ongoing monitoring functions for the audit client); and
- Independent auditor may not serve in an advocacy role for the company under audit (auditor may not provide services that make it part of the “team” to advance or defend the audit client's interests).

A summary of the specific prohibited services is included in Appendix A.



The new rules treat tax services as a unique category of non-audit services. The SEC has concluded that tax services – including tax compliance, tax planning and tax advice – may continue to be provided by an auditing firm without impairing the auditor's independence, provided, as with all services, the audit committee gives its pre-approval. As in other contexts, however, audit committees should review the specific services to be provided. For example, the SEC has indicated that representation of a company in a tax court, district court or federal court of claims would impair the auditor's independence and is prohibited because it would involve the auditor serving as the company's advocate.

Congress and the SEC have been very thoughtful about the scope of services they believe impair an auditor's independence and objectivity. Those services aside, the skilled professionals in a company's auditing firm can still provide much value-added advice and counsel to the audit committee and management. Appendix B contains examples of services that are generally not prohibited.

Disclosure of Audit and Non-Audit Services

In order to give investors a full understanding of the relationship between the auditing firm and the company being audited, the SEC affirms that the fees paid for all audit and non-audit services and the types of services performed should be disclosed to investors in proxy statements and annual reports. (Incorporation by reference from the proxy statement to the annual report is permissible.) Unlike prior requirements to disclose fees, which have led in the past to misunderstandings over confusing definitions of services, the SEC provides more specificity and clarity, using plain language intended to increase transparency.

Disclosures must include fees paid and services performed over the two most recent fiscal years. They are divided into four categories to help investors understand the scope of services performed by the auditor. The four categories are:

- **Audit fees** – Audits of financial statements, quarterly financial statement reviews and services rendered in conjunction with statutory engagements and regulatory filings, including comfort letters, §404 attestation reports (excluding advisory services), consents, domestic and international statutory audits, services rendered by tax professionals to the extent necessary to comply with generally accepted auditing standards (GAAS), and assistance with and review of documents filed with the SEC. In general, audit fees include fees for audit and review services in accordance with GAAS, plus fees for services that generally only the independent auditor can reasonably provide.
- **Audit-related fees** – Employee benefit plan audits, internal control reviews that are not a part of the audit such as "SAS No. 70", attest services not otherwise required by statute or regulation, due diligence related to mergers and acquisitions, and consultations regarding financial accounting and reporting standards. In general, audit-related fees cover assurance and related professional services that are traditionally performed by the independent auditor.

- **Tax fees** – Services that generally incorporate tax compliance, tax planning and tax advice, including tax return preparations, refund claims, tax payment-planning services, assistance with tax audits and appeals, advice related to mergers and acquisitions, and requests for rulings or technical advice from tax authorities.
- **All other fees paid to the auditor** – Services provided by the independent auditor not otherwise classified, including permissible non-audit research and advisory services.

These categories should improve investors' understanding of the work that external auditors do for the companies under audit, and offer greater transparency regarding the fullness of the relationship between the company and its external auditor. As an example, under previous SEC rules, many of the audit-related services included by Sarbanes-Oxley in audit fees were actually labelled "non-audit". The new definitions provide greater clarity.

Companies must also disclose, by category, the percentage of the auditor's fees where the de minimis exemption was used so that investors are fully informed. The proxy disclosure requirements are effective for periodic annual filings for the first fiscal year ending after 15 December 2003.

Restrictions on Employment Relationships

Another area of concern over auditor independence is the opportunity for employment relationships between the independent auditor and a company under audit. This has been addressed by Sarbanes-Oxley and subsequent regulations issued by the SEC through the mandate of a one-year cooling-off period before any member of an audit team may be hired by the audited company into a "financial reporting oversight role"⁴. This rule is intended to help remove the potential appearance of a lack of independence on the part of the ongoing audit engagement team with respect to their former colleague.

Historically, companies have preferred to hire individuals who have an understanding of the company's business and operations, and with whom they have had experience. This long-standing practice recognises that public accounting firms provide significant staff training programmes, and that they manage levels of turnover as a normal cost of doing business. In essence, the profession is the "pipeline" for future financial executives in the corporate community.

Hiring from the auditing profession is not expected to decline or stop, as the training and experience gained through auditing are deemed excellent preparation for the next generation of financial executives serving corporate investors. Therefore, a balance must be struck to achieve the overriding objectives of having highly skilled financial executives within the corporation while preserving the independence of the external auditing firm from its corporate clientele. Sarbanes-Oxley seeks to achieve this balance through the institution of a cooling-off period prior to hiring audit engagement team members. (See "Understanding the Cooling-Off Period", highlighted on page 14.)



Understanding the Cooling-Off Period

Sarbanes-Oxley requires a one-year cooling-off period for audit engagement team members that is not based on the one-year anniversary of when an audit engagement team member stopped providing service, but starts on the first day after the SEC audit client files its periodic annual report (e.g., Form 10K, 10KSB, 20F or 40F) and ends when the company files its next annual report on which the person in question was not a member of the audit engagement team. For example, if an auditor provides services for an issuer's 31 December 2002 fiscal year-end audit, and provides no services after the issuer's 2002 periodic annual report is filed with the SEC on 31 March 2003, the cooling-off period would end on 31 March 2004 when the company files its annual periodic report for 2003. However, if the auditor provided services in conjunction with the issuer's 2003 annual reporting period (for example, the first quarter review), the cooling-off period would end in 2005 one day after the company files its annual report for 2004. The cooling-off period applies even if the auditor initially takes a non-financial reporting oversight role and subsequently takes or is promoted to a financial reporting oversight role within the cooling-off period.

Exemptions to the cooling-off period are:

- Audit engagement team members, other than the lead or concurring partner, who provided *ten or fewer hours* of audit, review or attest services during the engagement period;
- Audit engagement team members employed as a result of a business combination, provided the employment was not in contemplation of the *business combination* and the audit committee of the successor issuer is aware the person previously was a member of the audit engagement team; and
- Audit engagement team members employed by the audit client due to an *emergency or other unusual situation*, provided that the audit committee determines the relationship is in the best interest of investors.

Audit committees may want to discuss with management the impact, if any, this change is likely to have on the staffing of various financial reporting oversight functions. Immediate staffing shortages within a company's financial oversight realm will need to be filled without violating the spirit or intent of the Act. Auditing firms, on the other hand, must evaluate the impact of this change on their staffing and training programmes. The good news is that turnover may be reduced for a period of transition; however, there may be longer-term effects on personnel policies and procedures, such as confirmation through the exit process that professionals are not in violation of provisions of the Act, or changes in hiring and training practices to ensure that staff are fully informed of the rules and the impact these rules may have on their personal careers.

Audit Partner Rotation

The practice of rotating audit partners has long been used by the profession to help ensure independence, integrity and general audit quality. Prior to Sarbanes-Oxley, the requirement for lead audit partner rotation was at least every seven years, with a two-year cooling-off period. Sarbanes-Oxley requires that audit partners be rotated more frequently and adds a rotation requirement for concurring partners and other audit partners (as defined). This is intended to strengthen individual auditor independence, and, if conducted intelligently, will not result in any diminishment of the knowledge base the audit team brings to engagements. Specialty, or technical consulting partners – that is, partners who consult with the audit engagement team regarding technical or industry-specific information – are not subject to the rotation requirement.

Expansion of the rotation requirements, combined with the ongoing need for an appropriate base of knowledge about an audit client's industry, indicates that some additional costs for relocating the appropriate resources are likely to be incurred and passed on to consumers. These increases are needed to address the business and audit risks facing the independent auditor while protecting investor interests. Appendix C illustrates partner rotation requirements in the U.S.

Audit Partner Compensation

The SEC has ruled that an audit partner may not earn or receive compensation based on selling non-audit services to companies under audit. In taking this step, the SEC is addressing the perception that audit engagements were used, in part, by accounting firms as vehicles for selling other services, and the potential risk that partners were more focused on sales of special services than on audit quality. The final SEC rule on this point strictly prohibits compensating an audit partner for selling non-audit services to his or her audit clients. This brings into sharp focus just how seriously regulators take the independence of the auditing profession, by determining how individual audit partners will be compensated.

Impact on the Corporate Reporting Supply Chain

With all the changes mandated by Congress through Sarbanes-Oxley and implemented by the SEC, the fundamental questions are whether auditor independence will be reaffirmed, and if the auditing profession's role in the corporate reporting supply chain will be strengthened. We certainly hope so. It is up to the accounting profession, audit committees and management to ensure that the cost of these changes is not wasted. This means not only complying with the letter of the law, but also making a commitment to the core business values investors want to see driving corporate reporting and governance: transparency, accountability and integrity.

Key Points to Consider

By members of the corporate reporting supply chain relative to:

Strengthening Auditor Independence

Strengthening auditor independence requires actions and behavioural changes on the part of management, the audit committee and the auditor.

Management

- Recognise the changing reporting relationship of the auditor (directly to the audit committee) and embrace this change as being in the best interest of investors.
- Prior to hiring an individual for a financial reporting oversight role, consider the Act's requirement for the cooling-off period and any impact it may have on the audit relationship.
- Collect all necessary information to properly disclose fee information for the company's filings.

Audit Committee

- Develop a working relationship with the independent auditor that promotes candid communication and discussion.
- Anticipate increased time required by the committee to appropriately carry out its responsibilities relating to auditor independence.
- Analyse and understand all services (audit and non-audit) prior to pre-approval.
- Confirm with the independent auditor on a yearly basis that internal procedures are in place for partner rotation and compensation.

Independent Auditor

- Establish direct communications and working practices with the audit committee.
- Perform the necessary steps to obtain audit committee pre-approvals.
- Align personnel policies with the rules – partner compensation, partner rotation and reassignment policies, and policies regarding staff and partner cooling-off periods.
- Confirm the reporting of accurate fee information by the company.
- Educate partners and staff around the world about prohibited and permissible services for SEC registrants, no matter where the registrants are located.
- Reconfirm commitment to the highest quality participation in the corporate reporting supply chain.

III. Increasing Audit Services Depth and Shareholder Value

Attestation on Internal Control over Financial Reporting

In Title IV, §404, Sarbanes-Oxley establishes the responsibility of the external auditor to provide an independent opinion to shareholders and the board of directors on management's assertion on the effectiveness of the company's internal control over financial reporting – in addition to the traditional financial statement audit opinion. Prior to Sarbanes-Oxley, the auditor's assessment of a company's internal control over financial reporting in a financial statement audit was limited in scope and purpose, so this change represents a significant increase in the depth of services provided by independent auditors for the purpose of protecting investor interests.

Historically, consideration of a company's internal control enabled the auditor to plan the financial statement audit and determine the nature, timing and extent of tests to be performed. However, components of internal control were neither assessed nor tested to a level needed to render an opinion on management's assertions regarding their effectiveness in achieving specified objectives. For the investing public, and some regulators, this difference was not always recognised or well understood. Thus, an expectation gap existed.

Closing the Internal Control Expectation Gap

An explicit opinion on internal control over financial reporting was outside the scope of the financial statement audit opinion in pre-Sarbanes-Oxley financial statement audits, and this may have contributed to the expectation gap between what an auditor's report was perceived to encompass and what it actually delivered. In some cases, investors believed that an unqualified opinion on the financial statements also indicated that the company was well controlled by management.

In fact, an auditor was only required to gain a sufficient understanding of a company's internal control to plan the audit and determine the nature, timing and extent of tests to be performed – those directed at components of internal control and other types of tests. The auditor's assessment of control risk influenced the extent to which testing of internal control was performed.

In the absence of reliable controls, a company's financial statements could still be free of material misstatement. An auditor could perform substantive tests of details on the company's books and records to supplement or replace tests of controls. When appropriate, the company would record audit adjustments in the financial statements to have these statements present fairly, in all material respects, the financial position, results of operations and cash flows of the company. Since there was no requirement to disclose the nature of testing, investors may have assumed more testing of internal control than was performed – and further, that the financial statements issued had not required adjustment due to finding of the audit process. Management and audit committees were more fully informed through reviews of all proposed audit adjustments, among other things.

Now, management's assertion and the related auditor's report on internal control over financial reporting for U.S. public companies will create much greater transparency for investors about the effectiveness of management's own systems and processes. In order to attest to management's assertion on this aspect of a company's internal control, auditors will need to evaluate the design and operating effectiveness of internal control over financial reporting and express an opinion about whether, as of the company's balance sheet date, management's assertion about the effectiveness of such control is fairly presented.

A broader and deeper consideration of internal control over financial reporting of the company under audit will undoubtedly help rebuild trust in the quality of management's financial reports. At the same time, expanding the role of the auditor so significantly will raise the cost of audits – an expense ultimately borne by investors. Certainly, achieving a high degree of audit readiness with respect to internal control effectiveness will be a significant undertaking for many companies in 2003 and beyond⁵.

How Attestation Leads to Improved Governance and Controls

Before a company is ready for audit, it must have records and documentation available for inspection by the independent auditor. The auditor's tests of controls include the following four methods, in ascending order of reliability: inquiry of the corporate managers who perform control functions, observation of the control process in action, examination of control process documentation and "reperformance", or repeating the performance of the control.

The independent auditor is responsible for issuing an opinion regarding management's assertions about the effectiveness of internal control over financial reporting. To achieve the appropriate level of assurance, the auditor's testing must include a significant amount of examination and reperformance. Mere reliance on inquiry or real-time observation is not a sufficient basis on which to render an auditor's opinion.

Management's own assessment of the effectiveness of internal control over financial reporting forms the basis of the independent auditor's evaluation, requiring the company under audit to take steps to ensure that its controls are not only reliable but also auditable. Auditable controls are:

- Suitably designed to achieve the objective of reliable financial reporting using established criteria; and
- Appropriately documented so that the controls can be fully examined and tested.

By their very nature, comprehensive assessment processes such as those mandated by Sarbanes-Oxley §302 and §404 will result in a much deeper understanding of a company's disclosure controls and procedures, as well as its internal control over financial reporting, than executive management and the independent auditor have typically had in the past. Their conclusions about the effectiveness of controls, as specified in SEC rules, will be made available to investors.



Providing Assurance for Additional Controls

While Sarbanes-Oxley §103 limits the auditor's evaluation of internal control to the objective of reliable financial reporting, in the future, companies may seek assurance and attestation on other objectives of internal control. Investors are likely to regard such expanded control assurances favourably, especially when provided for objectives considered vital for specific industries. Access to independent attestation on a broader range of management processes and representations will result in greater transparency and better protection for investors and others who provide the company's operating capital.

For example, in the retail industry, a robust, effective supply chain management programme is both strategically and financially critical. Access to an assessment and attestation with respect to the efficiency and effectiveness of this portion of a retailer's operations would provide great value to stakeholders. Similarly, a diversified financial services company might find value in providing its stakeholders extended assurance about controls over compliance with certain laws and regulations. A proactive approach by management to obtain and share the results of an independent assessment – not only of financial matters, but also of the non-financial areas of operations and compliance objectives – provides company stakeholders a means to enhance their overall assessment of the company's broader business processes.

Similarly, our research has found that investors, analysts and financial managers believe *quality of management* essential to developing a full understanding of risk and opportunity in a company. Because internal control is a significant management responsibility, added reporting on this critical management process provides a new window into the overall quality of management.


Benefiting from an Internal Controls Maturity Framework

Many companies discover that the more auditable their controls are, the more dependable they are. Some companies find it useful to apply an internal controls maturity framework, such as the one shown in Figure III-1, so they and their auditors can benchmark whether controls over significant financial accounting and reporting areas are weak, merely adequate or substantially rigorous. Use of this type of framework would be supplemental to the use of a widely accepted control framework, such as the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, which must be used when publicly reporting on management's evaluation of the effectiveness of controls.

Figure III-1: Internal Controls Maturity Framework



The Internal Controls Maturity Framework is more fully explored in the first of our Sarbanes-Oxley white papers, "Strategies for New Internal Control Reporting Challenges"⁶.



In addition to the use of the Internal Controls Maturity Framework, management may also benefit from employing new and emerging technologies to carry out the evaluation of controls required by Sarbanes-Oxley §302 in each quarterly reporting period. Management may be inclined to install “continuous auditing” processes within their systems to enable ongoing monitoring of the control processes and data flow. But, what about when information must be manually transcribed or transferred from one system to another?

One solution that supports the notion of continuous auditing is an emerging technology known as eXtensible Business Reporting Language (XBRL). Many internal control processes for financial reporting are manual in nature, meaning extended procedures are required for management to conduct an appropriate evaluation of the controls over the information. Automation of financial reporting, as well as aggregation, consolidation and assessment processes through XBRL, may enable a more effective control environment for management, as well as facilitate the independent assessment by the auditor. (XBRL is discussed in more detail in the section of this paper entitled, “Automating the Business Reporting Supply Chain”.)

Key Points to Consider

By members of the corporate reporting supply chain relative to:

Attestation on Internal Control over Financial Reporting

Management

- Prepare the assertions required by §404 and the SEC implementing rule by fully documenting and testing the processes in place within the company that are designed to achieve reliable financial reporting.
- Determine that the company’s controls are auditable. Well-documented and well-designed controls tend to be readily auditable and therefore more effective.
- Consider using technologies to facilitate the testing of internal controls.
- Consider using a framework for understanding and categorising the maturity of internal controls as part of evaluating their effectiveness using suitable criteria.

Audit Committee

- Become well versed in the level of management control over financial reporting in order to oversee the §404 process, both by management and the independent auditor.
- Discuss plans for attestation of controls with the external auditor during the initial audit planning discussion.
- On behalf of investors, consider expanding both management’s and the auditor’s consideration of internal control to additional areas.

Independent Auditor

- Increase the value of the audit by providing the additional required attestation on internal control over financial reporting.
- Scope the work to the appropriate level in order to close the expectation gap regarding internal control over financial reporting.
- Communicate forthrightly with the audit committee and management regarding weaknesses in internal control, and report to investors following prescribed standards.

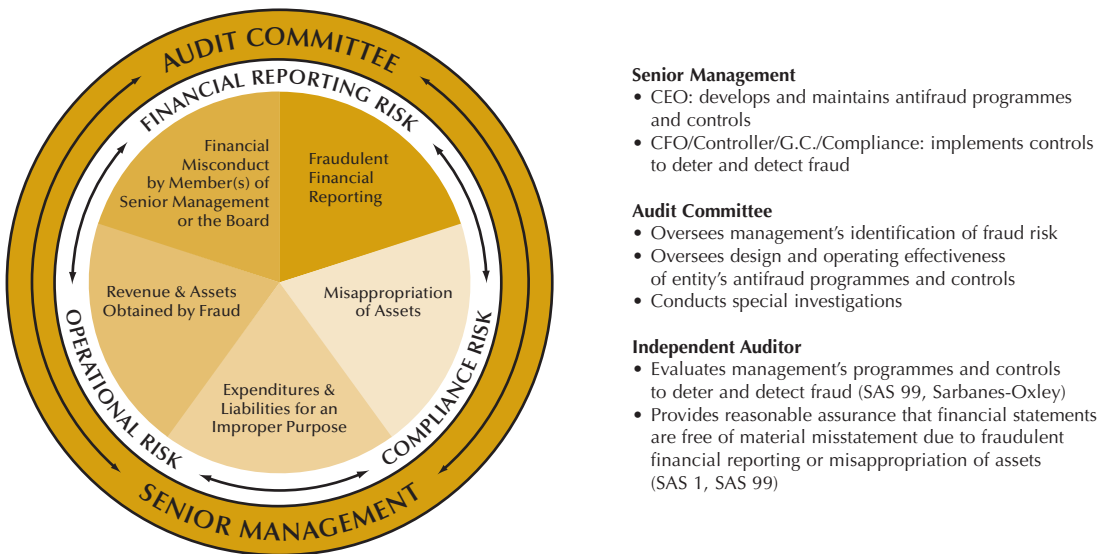
Deterring and Detecting Fraud

Influence of Sarbanes-Oxley Legislation

Sarbanes-Oxley poses new requirements pertaining to fraud deterrence and detection for several key players in the corporate reporting supply chain. For example, §302 of the legislation requires management to notify the audit committee and the independent auditor of any fraud – whether or not material – by a member of management or others who have a significant role in the entity's internal control structure.

This aspect of the legislation puts the responsibility for fraud deterrence and detection squarely on management, though it does not relieve either the audit committee or the auditors of responsibility in this area. The board of directors and audit committee are ultimately responsible for overseeing management's assessment of fraud risk and the entity's programmes and controls with respect to mitigating that risk, while the audit committee would be expected to investigate alleged wrongdoing brought to its attention. Figure III-2 illustrates the various responsibilities for fraud deterrence and detection.

Figure III-2: Fraud Responsibility Matrix



In addition to the certification and disclosure requirements of §302, Sarbanes-Oxley §404 and the related SEC implementing rule⁷ require that management assess the company's internal control over financial reporting, and publicly report their conclusions about its effectiveness. It also requires the independent auditor to attest to management's assertion. The SEC rule implementing the provisions of §404 clarifies the SEC's expectations for a company's consideration of fraud risk as part of its assessment, which includes:

- Controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements;

- Controls related to the initiation and processing of non-routine and non-systematic transactions;
- Controls related to the selection and application of appropriate accounting policies; and
- Controls related to the prevention, identification and detection of fraud.

Prior to the SEC having issued its final rule in this area, the American Institute of Certified Public Accountants (AICPA) had weighed in on the subject with a proposed Statement on Standards for Attestation Engagements entitled, "Reporting on an Entity's Internal Control over Financial Reporting"⁸, which provides that controls that are significant for the purpose of evaluating the effectiveness of internal control should include antifraud programmes and controls⁹.

The Expectation Gap over the Independent Auditor's Role

With respect to the independent auditor's role in fraud detection, the new requirements, along with the recent spate of corporate scandals, have renewed focus on the expectation gap over auditor responsibility. Where professional auditing standards require the auditor to "obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud"¹⁰, the expectation gap arises from sharply differing views over what appears at first to be a clear standard. Uncertainties include:

- What is "reasonable assurance"?
- What books and records are covered by the term "financial statements"?
- What is "material"?
- What types of misconduct constitute "fraud"?

Read literally, the standard could result in an unqualified audit opinion, even if fraud is present in the company being audited, provided any wrongdoing is not material to the financial statements, and as long as the accounting accords with generally accepted accounting principles.

Inherent to the expectation gap is that the focus and emphasis on fraud diminish as one moves across the corporate reporting supply chain. Corporate management ideally seeks to prevent any type of fraud and misconduct, by or against the entity. The audit committee, in addition to its oversight of management's processes, has the responsibility for establishing and responding to employee "whistleblower" allegations relating to any accounting matters. Independent auditors, by contrast, focus on fraud and misconduct that impact the financial statements in a material way. This has given rise to the expectation gap between what investors think auditors do, and what they have done in the past.

Closing the Fraud Expectation Gap

The recently issued Statement on Auditing Standards No. 99 (SAS 99) substantially changes auditor performance and seeks to improve the likelihood that independent auditors will detect material misstatements due to fraud in a financial statement audit. While SAS 99 retains the standard that the auditor's responsibility is to plan and perform the audit to obtain reasonable



assurance about whether the financial statements are free of material misstatement – whether caused by error or fraud – it has the potential to substantially close the gap if auditors fully embrace the letter and spirit of this new standard.

Closing the expectation gap is critical to restoring public trust. Management, boards of directors and auditors must understand and strive to meet the expectations of investors and other stakeholders regarding fraud. In particular, the auditing profession will need to:

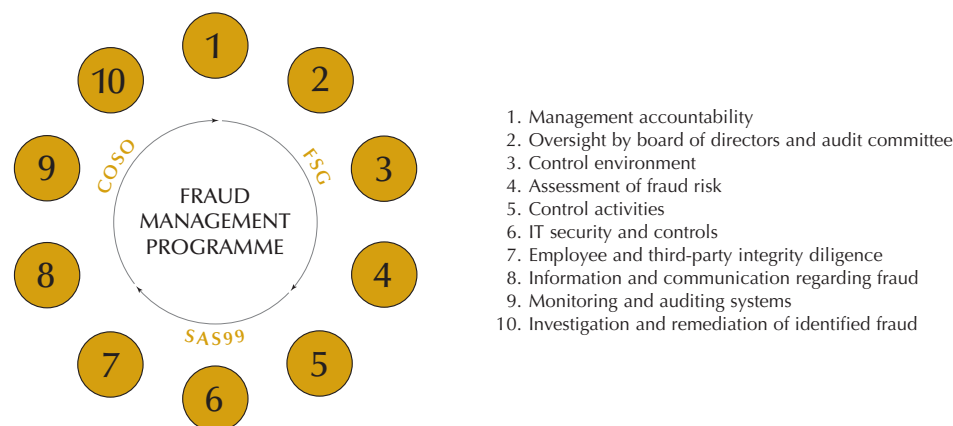
- Provide specialised fraud training for auditors regarding the deterrence and detection of financial statement fraud;
- Evaluate management’s controls to deter and detect fraud as part of the attestation on management’s assertions on internal control over financial reporting;
- Develop enhanced substantive procedures to detect fraud, including the use of computer assisted techniques; and
- Recognise that because the bulk of misstatements due to fraud involve participation by, or knowledge of, senior management, there is a need to pay particular attention to incentives, opportunities, risks and controls at the top.

Effective Fraud Management Programmes

Clearly, management cannot and should not certify or assert to the effectiveness of controls unless satisfied with the quality of their company’s fraud management programmes. The company’s auditors, moreover, will need to evaluate and test fraud controls as part of the \$404 attestation. However, no single, commonly accepted, external standard is presently available to use in assessing whether a company’s fraud management controls and programmes are effective.

In the absence of such a standard, we have developed our own internal control framework drawn from the (i) Committee of Sponsoring Organizations (“COSO”) of the Treadway Commission¹¹, (ii) United States Federal Sentencing Guidelines (“FSG”) for Organizations¹², and (iii) Management Antifraud Programs and Controls, Guidance to Help Prevent, Deter, and Detect Fraud¹³. Our control framework encompasses ten criteria (five of which are from COSO) for an effective fraud management programme, as shown in Figure III-3.

Figure III-3: Ten Criteria for Effective Fraud Management



Key Points to Consider

By members of the corporate reporting supply chain relative to:

Detering and Detecting Fraud

Management

- Ascertain that the company, under the CEO and CFO's direction, has in place effective controls over the deterrence and detection of fraud within the organisation, including controls over the actions of the most senior executives.
- Test and evaluate the effectiveness of the company's fraud deterrence and detection systems as part of the assertion on internal controls over financial reporting.
- Immediately report any incidence of fraud involving anyone who has a significant role in internal controls, to both the audit committee and the external auditor.

Audit Committee

- Understand what management is doing to restore investor trust in the area of fraud, and how the audit committee or independent auditor can help.
- Allocate enough time at committee meetings to discuss the company's fraud risk factors, and understand what fraud deterrence or detection procedures the auditor expects to conduct. Note whether the audit team is adequately assessing management controls for deterring and detecting fraud.
- Conduct a periodic, thorough evaluation of the company's fraud management programmes. The evaluation should not be a "checklist" exercise, but rather a comprehensive, substantive review that will ultimately strengthen the control framework.
- In light of the above, as well as any feedback from the committee's "whistleblower" process, consider whether all significant fraud risks are being addressed – not just those that may lead to a material misstatement in the financial statements.

Independent Auditor

- Communicate to the audit committee a clear assessment of fraud risk.
- Assess the entity's fraud risks, evaluate its antifraud programmes and controls and conduct substantive procedures to respond to risks not mitigated by existing controls.
- Build heightened scepticism into the audit process where the risk of fraud is higher, reinforcing the principles behind the rules.
- Develop and implement new procedures, techniques and specialised fraud training for auditors.

Boards of directors – specifically audit committees – in their oversight capacities are advised to conduct a thorough evaluation of the company's fraud management programmes as part of fulfilling their fiduciary duties. Criteria such as those listed above may help determine whether or not the programmes in place are effective.

Reaching Beyond – Achieving Transparency in Corporate Reporting

One cannot consider the incidences of financial reporting fraud today without hearing greater demands for improved transparency in corporate reporting. No wonder: If investors really understood what was going on inside the company, wouldn't they be in a better position to understand and assess the risk of fraud – and to make better-informed investment decisions?

In the past, auditors and management have focused much of their attention on the presentation of financial information and its consistency with established standards and rules. As recent events have revealed, however, mere compliance with established presentation and disclosure

standards does not always result in information believed sufficient or understandable by investors and other stakeholders. Transparency in its fullest sense means more than just information about a company's financial performance.

The idea of increased transparency – information about a broader range of the company's activities or conduct, as well as additional details about aspects of the company's operations – is easily seen in the Sarbanes-Oxley legislation and related SEC implementation rules. We believe a reasonable expectation accompanying both the law and subsequent SEC rulemaking is that auditors will work with audit committees and management to encourage, wherever possible, more transparency in a company's reporting to investors.

Quality and Transparency at the Heart of New Regulations

The SEC implementation rules for Sarbanes-Oxley make it clear that increased transparency is central to the new regulations:

By increasing transparency regarding key aspects of corporate activities and conduct, the proposals are designed to improve the quality of information available to investors¹⁴.

Indeed, the SEC challenges companies to go beyond what is currently required by generally accepted accounting principles in their rules regarding management's quarterly certifications under §302 of the Act:

The certification statement regarding fair presentation of financial statements and other financial information is not limited to a representation that the financial statements and other financial information have been presented in accordance with "generally accepted accounting principles" and is not otherwise limited by reference to generally accepted accounting principles. We believe that Congress intended this statement to provide assurances that **the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles** [emphasis added]¹⁵.

Defining Transparency – A Framework for Discussion

As there is currently no single, accepted transparency standard, any definition of transparency must be subjective. However, we can offer a basic proposition of the concept and its application to reporting and auditing practices. This can be considered a framework to facilitate a discussion of corporate reporting that moves beyond generally accepted accounting principles and other required disclosures.

We believe transparency in corporate reporting occurs when information is provided to a company's stakeholders at a level sufficient to view the company through the eyes of management, giving investors the opportunity to gain insights they need for decision making. Transparent corporate reporting means a clear and candid discussion that would include, but not be limited to, the following:

- Risks and opportunities facing the business and the markets in which it operates
- Company strategy
- Value drivers and related performance measures of the business
- Management's outlook for future business growth



Readers of transparent corporate reports should be able to understand how all significant factors are accounted for in the company's strategy, thereby equipping themselves to make an informed judgment as to whether the company presents an opportunity of acceptable risk and value.

Delivering Transparency in Corporate Reporting

Over the past several years, we have been researching the issue of transparency to better understand what investors and other stakeholders need from corporate reporting. Based on our findings, we developed the ValueReporting™ Framework shown in Figure III-4, as a means of encouraging a greater openness and clarity in reporting.

Figure III-4: ValueReporting Framework



The **ValueReporting Framework** consists of four categories of information:

- **Market Overview** – Describing the industry dynamics facing the company, including the competitive, regulatory and macro-economic environments.
- **Strategy** – Covering the company's strategy, goals and objectives, organisational design and governance structure.
- **Value Creating Activities** – Describing the activities and relationships that underpin financial performance, including key non-financial areas relating to customers, people, innovation, brands and the supply chain, and environmental, social and ethical concerns.
- **Financial Performance** – Presenting the metrics used by management to monitor financial performance, and linking them to the company's strategy. This section should clearly detail issues such as business segmentation and the relationship between risk and return, as well as the ability to generate cash and reconcile internal performance measures to those reported externally to stakeholders.

By going beyond the elements of traditional financial statements, such a framework provides greater room for management to analyse and directly address the broader concerns of investors. Its use helps deliver a deeper sense of the health of the company through metrics, industry information, strategy and likely outcomes, assisting investors in understanding the rationale behind management decisions.

Of course, transparency is not just concerned with the content of corporate reporting. Clear and effective communications are also critical. Effective corporate reporting uses effective communications, characterised by the following:

- **Clear and candid** – Written in simple, understandable language, using relevant content and without exaggeration.
- **Consistent and comparable** – That is, from period to period; management should also include a discussion of the information compared to past results, industry norms and management expectations.
- **Compliant** – Written with the intent to meet or exceed the requirements of all disclosure regulations.
- **Aligned** – Linking external reporting with internal reporting, so that users of the information can view the company through the eyes of management.
- **Complete and material** – Providing information that is presented in a complete, fair and balanced way, and is material to the decision-making needs of investors and other stakeholders.
- **Broad** – Encompassing both financial and non-financial information about the business, its environment and its performance.
- **Strategic** – Including a discussion on management's strategy for generating value in the long term, and outlining value-creating activities.
- **Forward-looking** – Presenting short-term and long-term goals and objectives, against which performance can be measured.

Automating the Business Reporting Supply Chain

Transparency of information involves the breadth of content and the format in which that content is provided to its intended users. New technologies are emerging that can provide investors with information on companies in a ready-to-use format, independent of the paper documents that have been viewed historically as “corporate reporting”.

One of the greatest strides in this area has been made by an international consortium of over 200 participants in the corporate reporting supply chain, a group that collaborated on the creation of XBRL. (XBRL is the eXtensible Business Reporting Language technology mentioned earlier in our discussion of internal controls.) Its uses are many, but here we will focus on two main aspects of XBRL:

- Potential impact on the transparency of reporting
- Reusability of data by investors for rapid independent analysis

Today, the process of consolidating business information for financial reporting or analysis remains largely dependent on manual, paper-intensive procedures. Information is typically prepared for use through manual tasks, leaving the corporate reporting supply chain reliant on processes that are slow, costly and error prone. Such processes tend to produce information tied to specific documents, rather than leaving it reusable and broadly accessible by investors.

Compounding the problem, various reports or analyses performed by management or stakeholders often use identical and sometimes overlapping information, so that the same data must be manually gathered and entered many times. By facilitating direct communication among diverse business reporting systems and software, XBRL demonstrates the potential to reduce, and in some cases eliminate, the need for manual preparation tasks. Software-to-software (i.e., provider application to user spreadsheet) information transfer offers the ability to incorporate more information into a report or analysis without additional, incremental cost, leaving more time to use the information for analysis and decision making.

Sarbanes-Oxley §409 calls for real-time disclosures of material changes in a company's financial condition. Because such an increase in reporting frequency is difficult without fast access to quality data, XBRL may be the tool to help companies overcome this hurdle. More frequent information distribution leads to more frequent analysis by end users, so moving data into a more user-friendly format should be a goal of companies wanting to achieve the greatest level of transparency with their stakeholders.

For companies who choose to use XBRL, greater volumes of business information can be more cost effectively accumulated, analysed and shared, so that management, internal and external auditors and a wide range of company stakeholders and investors all benefit. More information on XBRL is available at www.xbrl.org.

Strengthening Corporate Reporting Through Transparency – The Independent Auditor's Role

Because Sarbanes-Oxley encourages companies to embrace transparency in their corporate reporting strategies, independent auditors should be prepared to help companies as they think about their reporting objectives and the means necessary to achieve them. Independent auditors are in a unique position to provide an objective point of view on the degree to which a company's reporting is transparent to investors, and where their practices stand in relation to other companies. By sharing their observations with management and audit committees, independent auditors will be able to supply companies with insights into internal and external factors that should be taken into account in providing external stakeholders the information they need to make informed decisions.

Companies are responsible for setting corporate reporting goals and implementing and managing the activities necessary to achieve them. However, we consider the following activities to be within the scope of the role of the independent auditor:

- Observing and reviewing a company's current level of transparency and sharing observations with management and the audit committee
- Sharing best-practice examples of companies at the forefront of transparent reporting
- Providing research and thought leadership on industry-based reporting
- Helping clients craft a blueprint for meeting transparency objectives

Indeed, as the spirit of transparency becomes more entrenched in corporate communications, we envision that the independent auditor will be asked to provide some level of verification of information that moves beyond the financial statements. As corporate reporting becomes more

open and easily understood by investors, as well as subject to auditor attestation, confidence in the information that flows through the corporate reporting supply chain is likely to increase.

Transparency in corporate reporting offers the potential for enhanced management credibility, more long-term investor relationships, increased analyst following and improved access to capital. Understandably, though, some companies will embrace transparency more fully than others. Based on our research, investors believe that given two identical companies' performance, the team that chooses greater transparency should realise a lower cost of capital by reducing the risk of uncertainty created where information is not readily available. By helping companies understand transparency in the context of reporting, independent auditors can play an important role in building investor trust in the post-Sarbanes-Oxley environment.

Key Points to Consider

By members of the corporate reporting supply chain relative to:

Achieving Transparency in Corporate Reporting

Management

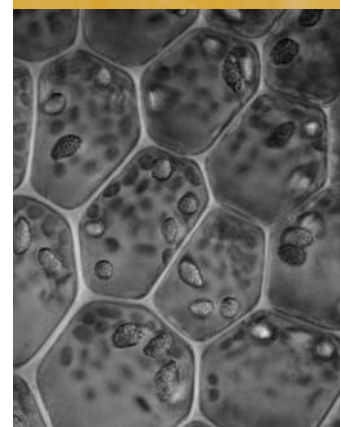
- Increase transparency by reporting to stakeholders clearly and candidly on a broad range of business attributes, working with the independent auditor to do so.
- Think about the critical information used in running the business, and whether this same information is needed by investors to understand the investment risks and rewards.
- Consider the use of XBRL to make information more user-friendly for management and investors.

Audit Committee

- Review the information used by the audit committee to understand the business, and consider whether investors need the same level of disclosure.
- Represent investors in demanding and delivering greater transparency from company management.
- Initiate discussions with management and the independent auditor to help address the following points:
 - Whether corporate reporting is sufficiently transparent to meet the needs of stakeholders
 - Whether the company's reports provide the level of information that investors need to understand the business, including its opportunities and risks
 - Whether readers of the financial reports can understand the company's performance

Independent Auditor

- Work with management and the audit committee to achieve greater transparency for investors.
- Provide assurance on non-financial information used by management for external reporting.
- Collaborate with preparers, consumers and other supply chain participants in the development of non-financial measures.



IV. New Oversight for the Auditing Profession

In a marked change for the auditing profession, Sarbanes-Oxley takes the responsibility for setting standards for the auditing of public companies and for oversight of auditing firms away from professional associations and places it in the hands of the Public Company Accounting Oversight Board (PCAOB), which is itself subject to the oversight of the SEC.

Historically, the auditing profession has been a self-regulating profession, with the responsibility for setting auditing standards such as quality control, ethics and generally accepted auditing standards (GAAS) in the U.S. resting with the AICPA. This organisation has also set the peer review standards that have formed the basis of inspections for auditing firms.

Enforcement, through monitoring and discipline of the profession, was shared by the AICPA and state boards of accountancy, with the SEC having additional authority over civil misconduct for auditors of public companies. In April 2003, certain of these responsibilities with regard to public companies were assumed by the PCAOB.

In addition, by virtue of specific provisions in the Sarbanes-Oxley Act, the PCAOB has obligations that it must fulfil as it executes its responsibilities. Actions taken by the PCAOB will be subject to clearance by the SEC and to public exposure through the SEC process. Although the AICPA process also included public exposure, the PCAOB's process and the SEC's public exposure will increase the likelihood of public participation by a broader range of constituencies, enhancing the perception that any new standards are in the public's best interest.

Though the particulars of how the PCAOB will execute its authority are still unknown, it is clear that the PCAOB will be very active, and could revise the entire current code of auditing standards. Thus, the PCAOB's impact on the auditing profession will be significant, and by extension, its impact on the entire corporate reporting supply chain, including audit committees, management and investors, could also be far-reaching.

Added costs to public companies through support fees, and to auditors in the form of registration and annual fees, are certain. But potentially more important is the fact that the PCAOB could set certain expectations for the performance of management and audit committees by requiring auditors to check that performance. Also, inspections of firms conducted by the PCAOB might well mean scrutiny of a larger number of individual auditing engagements, possibly leading to a second opinion on audit decisions and to even tougher audits.

Activating a Role in Standard Setting

Among the standards impacted by Sarbanes-Oxley, GAAS have the potential to greatly impact stakeholders throughout the corporate reporting supply chain. Significant changes to these standards could alter both the way in which audits are conducted and the means by which auditors work with management and audit committees.

In the past, GAAS were set by the Auditing Standards Board (ASB), a senior technical committee of the AICPA. Relatively little criticism of these standards appeared during the recent corporate reporting and auditing failures, most having been attributed by the public to improper implementation of existing accounting standards, including a perceived lack of robust auditing independence or adherence to established ethical standards, and to fraud on the part of management. However, in the current environment, the auditing profession itself is perceived to have not always acted in the public interest, and that perception extends to standards setting.

One of the PCAOB's primary responsibilities, then, is to establish or adopt auditing and other standards. Having approved interim auditing standards by endorsing the existing GAAS, the board has announced plans for their future review. Given the complex nature of auditing, we expect the board will consider the profession's expertise and input as it contemplates modifications to, and establishes new, auditing standards. The PCAOB is expected to establish one or more formal advisory groups made up of members of the profession and other interested parties as it fulfils this responsibility.

Adoption of Global Auditing Standards

Whether in the near or long term, the establishment of global auditing standards is not least among the issues the PCAOB is certain to grapple with in the future. Currently, International Standards on Auditing (ISAs) are issued by the International Federation of Accountants, in which U.S. accountants are represented by the AICPA. The ISAs are now broadly used in countries where well-developed standards might not otherwise exist. But equally, in more recent years, a number of major countries have either adopted the international standards in favour of their own standards, or have undertaken substantial efforts toward convergence with ISAs. The establishment and adoption of global standards by all countries is widely regarded as desirable for several reasons: global standards would raise audit quality in some countries, cross-border filings would be easier and the meaning of audit reports issued from any country would be clearer to global investors.

The European Union (EU) has also given the push for global standards a boost. Current expectations are that the EU will adopt the ISAs as the auditing standards for Europe starting in 2005, concurrent with their adoption of International Financial Reporting Standards (IFRS). The EU recognised that the advantages of adopting the IFRS for financial reporting in Europe will not be fully achieved if auditors are not also following a common set of auditing standards. In the United States, significant work has been done by the ASB to move toward convergence with ISAs, with no diminution of the quality of U.S. standards. Rather, the convergence effort has contributed significantly to the efforts to elevate the quality of international standards. It remains to be seen what impact the establishment of the PCAOB will have on this effort.



The Case for Principles-Based Standards

As it moves forward and begins to set auditing standards, the PCAOB must choose between two very different approaches. On the one hand, it could opt to set standards built around principles and essential procedures. Such principles-based standards would allow auditors to tailor the audit approach to fit the circumstances and risks of the entity. This approach recognises that auditing is not a mechanical process and that its quality depends on the application of sound professional judgment. Auditing standards based on principles guide the planning and application of appropriate audit procedures and serve to elicit thoughtful auditor assessment and sound judgment in the particular circumstances of each engagement. Principles-based standards would also be readily compatible with the goal of moving toward global standards, because they can be applied to fit the circumstances in different economies.

The alternative to principles-based standards would be a more “regulatory” or “check-the-box” approach, which would mean auditing standards would look increasingly like government regulations. Though such regulations might require auditors to do more, they would not necessarily lead to more effective or even more thorough audits. The danger is that such regulations might limit the ability of auditors to use their professional discretion in identifying the areas of highest risk for individual companies, and could enable companies to work around such procedures to deceive the auditors. A regulatory approach would also almost certainly complicate the effort to establish global auditing standards.

Existing U.S. standards, which are geared toward close examination of areas of risk, are principles based. Current auditing standards are based on sound audit concepts, and specific audits are tailored to best suit the characteristics of the company being audited and the environment in which it operates. There are, of course, essential procedures common to all properly conducted audits, but these are relatively few compared to the scope of a typical audit. The bulk of an auditor’s time is now spent in areas of the highest perceived risk of material misstatement. Any number of factors can contribute to the “risk picture” of a company; some risks may be ubiquitous throughout an industry, other risks might be a reflection of a company’s history or controls structure. Because this principles-based approach is designed to effectively focus the auditor’s expertise, we believe it is more likely to serve the best interests of investors than a more regulatory checklist approach.

Implications of New Independent Oversight

Because the PCAOB is only beginning to be fully functional, the implications of this new oversight body for the auditing profession cannot be predicted with any degree of certainty. However, some of the topics that the Board will almost certainly address in the short term come right out of the Sarbanes-Oxley legislation itself. For example, a standard for document retention is required by Sarbanes-Oxley §103. According to the Act, accountants auditing publicly traded companies need to keep their working papers and certain other documents for a period of at least seven years. The PCAOB is required by the legislation to adopt such standards, though as of this paper’s publication the board has not yet issued a ruling on document retention.

Another area likely for short-term action relates to inspections of auditing firms' work. The scope of these inspections may prove to be quite broad, even to the point of exposing auditing decisions on individual engagements to unprecedented re-examination. In cases where it finds misconduct on the part of auditors, the PCAOB has a range of enforcement options, including fines, censures of individuals or firms, the barring of individuals and firms from auditing public companies, and referral of individuals and firms to state licensing boards having the power to grant and strip professional licenses. The PCAOB may refer investigations to the SEC, other federal functional regulators and, at the direction of the SEC, to other federal and state law enforcement and regulatory bodies.

The PCAOB will also oversee the auditing profession by requiring domestic and foreign firms to register to maintain eligibility to audit public registrants. Currently, the registration system consists of eight rules, definitions and a prescribed registration form. The registration system will result in the collection of a significant database of information on accounting firms, their audit clients and personnel who perform audit and audit-related services. Appendix D has details on the registration policy as it currently stands.

V. Conclusion

In the nearly 70 years since the Securities Exchange Act of 1934 was passed, businesses have had certain bookkeeping and reporting responsibilities, and public accounting firms have provided the scrutiny and assurance that the financial reports created by management for investors were reasonable. It is a system of guardianship that has served the public well throughout its history – until recent business scandals called its efficacy into question.

As with many systems of checks and balances, time and pressure have impacted the Exchange Act's effectiveness. In today's fiercely competitive business climate, with a high-stakes global marketplace vying for investor capital, it has become clear to investors and the public alike that the auditor's role must be strengthened.

The Sarbanes-Oxley legislation offers a unique opportunity for the accounting profession to move to a higher level; to be, in effect, the *vanguard of corporate reform*.

It is an opportunity and a challenge both warranted and welcome.

We believe it is time to stand and be counted. Company stakeholders are demanding a business environment distinguished by the principles of *transparency*, *integrity* and *accountability* – and characterised by a true state of independence. These reforms have not been entered into lightly. Nor should they be taken lightly in return. Rather, they must be acknowledged, accepted and fully complied with, in the spirit in which they were intended.

We are among those in the profession who believe these changes will prove essential to supporting a healthy, effective corporate reporting supply chain – and thus to the rebuilding of investor trust in the capital markets.

The vitality of our global economy may depend on how well we succeed.



Appendix A: Prohibited Non-Audit Services

Bookkeeping*	<p>Auditors are prohibited from maintaining or preparing accounting records, preparing financial statements that are filed with the Commission or form the basis of the financial statements filed with the Commission, and preparing or originating source data underlying an audit client's financial statements.</p> <p>The previous exceptions permitting emergency bookkeeping have been eliminated.</p>
Financial Information Systems Design and Implementation*	<p>Auditors are prohibited from directly or indirectly operating – or supervising the operation – of an audit client's information system or managing the audit client's local area network. In addition, they may not design or implement a hardware or software system that aggregates source data underlying the financial statements or that generates information significant to the client's financial statements or other financial information systems taken as a whole.</p> <p>The conditions in the prior rules that if met enabled the auditor to provide such services have been eliminated.</p>
Actuarial Services*	<p>Auditors are prohibited from providing audit clients any actuarially oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts of the client.</p>
Appraisal and Valuation Services, Fairness Opinion and Contribution-in-Kind Reports*	<p>Auditors are prohibited from providing appraisal and valuation services, fairness opinion and contribution-in-kind reports to audit clients.</p> <p>The previous exception permitting a firm's actuaries to value an audit client's pension, other post-employment benefits or similar liabilities has been eliminated.</p>
Internal Audit Outsourcing*	<p>Auditors are prohibited from providing any internal audit service that relates to an external audit client's internal accounting controls, financial systems or financial statements.</p> <p>The previous exception permitting up to 40% of the client's total internal audit activities to be performed by the external auditor has been eliminated.</p>
Management Functions and Human Resources	<p>Auditors are prohibited from acting, temporarily or permanently, as a director, officer or employee of an audit client, and from performing any decision-making, supervisory or ongoing monitoring function for an audit client.</p> <p>Certain services are still allowed, including procedures or attest services and recommendations related to the client's internal controls, and interviewing a candidate and advising a client on the candidate's competence for financial accounting, administrative or control positions.</p>
Broker-Dealer, Investment Advisor and Investment Banking	<p>Auditors are prohibited from acting as an "unregistered" or "registered" broker-dealer, promoter or underwriter on behalf of an audit client, making investment decisions on behalf of an audit client, having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investments, having custody of an audit client's assets and performing analyst functions with respect to an audit client's stock.</p>

Legal Services	<p>Auditors are prohibited from providing any service to an audit client that could be provided only by someone licensed, admitted or otherwise qualified to practise law in the jurisdiction in which the service is provided. However, the rules are not intended to prohibit public foreign accounting firms from providing services that an accounting firm in the U.S. may provide.</p> <p>The previous exception permitting such services if they related to matters that were not material to the client's financial statements or were routine or ministerial has been eliminated.</p>
Expert Services Unrelated to a Audit	<p>Auditors are prohibited from providing an expert opinion or other expert service for an audit client or the client's legal representative to advocate the client's interests in litigation or in a regulatory or administrative proceeding or investigation, regardless of whether in a public proceeding or a private setting.</p> <p>Engagements intended to result in using the firm's specialised knowledge, experience and expertise to lend authority to the audit client's contentions or otherwise support the client's position in adversarial proceedings are also prohibited.</p>

* These services are permitted if it is reasonable to conclude that the results of the services will not be subject to audit procedures during the audit.

Appendix B: Examples of Services Generally Not Prohibited

The following services are generally not prohibited, though each company's needs and circumstances will be different. (Readers may note that this list is not intended to be all-inclusive, but is for illustrative purposes only.)

1. Operational audit services unrelated to internal accounting controls, financial systems or financial statements.
2. Advisory services to internal audit functions (strategy, peer reviews, etc.).
3. Audits or reviews of third parties to assess compliance with contracts.
4. Design and implementation services with respect to hardware or software systems (financial or other) that are unrelated to the audit client's financial statement or accounting records, or that aggregate source data or general information not likely to be material to the financial statement taken as a whole. (To ensure that the independent auditor is not auditing its own work, design and implementation services should only be provided on systems where it is reasonable to conclude that the results of the auditor's services will not be subject to its own audit/attestation procedures.)
5. Non-recurring, one-off internal audits (generally in areas where specialised or unique skill sets are required) of discrete items or other programmes that are not in substance outsourcing.
6. User acceptance testing services subsequent to management's initial testing, or where the independent auditor needs to perform testing for audit procedures.
7. Advice and consultation regarding an audit client's design and implementation where the SEC guiding principles are not violated (e.g., advising a project management team regarding standard industry practices, common control procedures or suggested fixes to a problem would be permissible).
8. Evaluation of the internal controls of a financial system as it is being designed, implemented or operated and making a recommendation for improving the internal controls that are part of the system. However, implementing such a recommendation would not be permissible.
9. Recommendations on internal control matters as they relate to the design and implementation by another service provider.
10. Advice and consultation (generally in the form of assessment, testing and recommendation) regarding the client's operations.
11. Recommendations regarding improvements in risk management controls.
12. Compliance testing of the audit client's established controls/processes, as long as such testing is not a substitution for the audit client's own monitoring functions (i.e., functioning in the role of management).
13. Assessment of the audit client's controls, systems and processes and recommendations to management to correct weaknesses, enhance controls, etc. This includes documenting current controls and performing a gap analysis of potential control deficiencies.
14. Valuations for non-financial reporting purposes, including transfer pricing studies, cost segregation studies and other tax-only valuations.
15. Review of a valuation prepared by management or third parties.
16. Assistance to help an audit client understand methods, models, assumptions and inputs used in computing amounts, and general advice regarding actuarial methods and assumptions.
17. Actuarial work for non-financial reporting services.
18. Internal investigations – that is, the conduct of internal investigations and fact-finding specifically approved by the audit committee in connection with alleged improprieties performed on behalf of management or internal audit.
19. Provision of factual testimony on positions taken or conclusions reached during the performance of any service.

Appendix C: Audit Partner Rotation in the United States

Type of Audit Partner	Rotation Requirement – U.S.
Lead audit partner	<p>Rotate after 5 years; time-out of 5 years.</p> <p>Effective for the first fiscal year beginning after 6 May 2003 (first fiscal year of service for a calendar year client would be 2004).</p> <p>Service includes time previously served as the lead or concurring partner[†].</p>
Concurring review partner	<p>Rotate after 5 years; time-out of 5 years.</p> <p>Effective for the second fiscal year beginning after 6 May 2003 (second fiscal year of service for a calendar year client would be 2005).</p> <p>Service includes time previously served as the lead or concurring partner[†].</p>
Other audit partners who are part of the audit engagement team if they provide 10 or more hours of audit services to the issuer or parent or serve as the lead audit partner on a subsidiary whose assets or revenues constitute 20% or more of the issuer's consolidated assets or revenues.	<p>Rotate after 7 years; time-out of 2 years.</p> <p>Effective as of the beginning of the first fiscal year after 6 May 2003 (first fiscal year of service for a calendar year client would be 2004).</p> <p>Service does not include time served on the audit engagement team prior to 6 May 2003.</p>

[†] Accounting firms may institute stricter policies.

Appendix D: Registration Requirements of the PCAOB

Organisational Components and Policies	Registration Responsibility
Firm identity	<ul style="list-style-type: none"> • Legal name • Primary contact and signatories • Form of organisation • Office locations • Licenses
List public company audit clients	<ul style="list-style-type: none"> • List issuers for which applicant prepared audit reports during the preceding and current calendar year. • List issuers for which applicant expects to prepare audit reports during the calendar year. • List issuers for which applicant played a substantial role in audit or expects to play a substantial role.
Statement of quality control policies	<ul style="list-style-type: none"> • Describe policies used to monitor compliance with independence requirements.
List certain proceedings involving the applicant	<ul style="list-style-type: none"> • List certain criminal, civil and administrative proceedings. • List pending private civil actions. • Provide discretionary statement regarding proceedings involving the audit practice.
List filings disclosing accounting disagreements with public company audit clients	<ul style="list-style-type: none"> • List existence of disagreements with issuers, including name, date and a copy of the filing.
Roster of associated accountants	<ul style="list-style-type: none"> • List accountants associated with applicants. • Provide profile of firm personnel, including: <ul style="list-style-type: none"> – Total number of accountants – Total number of CPAs, or accountants with comparable licenses from non-U.S. jurisdictions – Total personnel employed by the applicant
Consents of applicant	<ul style="list-style-type: none"> • Provide consent to cooperate with the Boards and statement of acceptance or registration condition.

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End Notes

- 1 Corporate Responsibility, §301. Public Company Audit Committees. This legislation can be accessed at: http://financialservices.house.gov/media/pdf/H3763CR_HSE.PDF. See also the U.S. Securities and Exchange Commission, *Final Rule: Improper Influence on Conduct of Audits*, Release No. 34-47890; File No. S7-39-02, <http://www.sec.gov/rules/final/34-47890.htm>.
- 2 U.S. Securities and Exchange Commission, *Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence*, §210.2-07 "Communication with audit committees", Release Nos. 33-8183, 34-47265, 35-27642; File No. S7-49-02, <http://www.sec.gov/rules/final/33-8183.htm>.
- 3 Registered management investment companies have additional pre-approval and disclosure requirements, including pre-approval of non-audit engagements with the company's investment advisor and any entity under its control.
- 4 A "financial reporting oversight role" is a role in which an individual has direct responsibility for, or oversight of, those who prepare the registrant's financial statements and related information (e.g., management discussion and analysis), which will be included in a registrant's document filed with the Commission. Examples of such a role include a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, director of tax or any equivalent position.
- 5 SEC staff members have estimated a time expenditure of 383 hours per year for the average public filing company endeavouring to meet the requirements of this rule – with a far greater amount of time expected for the initial year and for large, complex organisations, such as those with overseas operations. This estimate excludes the additional time required by the independent auditor in performing the attestation. U.S. Securities and Exchange Commission, *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Release Nos. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03, IV. Paperwork Reduction Act, <http://www.sec.gov/rules/final/33-8238.htm>. U.S. Securities and Exchange Commission, Commission Open Meetings, Tuesday, 27 May 2003. Audio Archive, <http://www.sec.gov/news/openmeetings.shtml>.
- 6 For more information on internal control and the internal controls maturity framework, see the PricewaterhouseCoopers white paper, "The Sarbanes-Oxley Act of 2002: Strategies for New Internal Control Reporting Challenges". For information on the related topic of enterprise risk management, see the COSO Enterprise Risk Management Framework at <http://www.coso.org>.
- 7 U.S. Securities and Exchange Commission, *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, 17 CFR Part 210 Release Nos. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03, <http://www.sec.gov/rules/final/33-8238.htm>.
- 8 Proposed Statement on Standards for Attestation Engagements, "Reporting on an Entity's Internal Control over Financial Reporting", AICPA, 18 March 2003.
- 9 Ibid., Paragraph 15.
- 10 Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures (AICPA, Professional Standards*, vol. 1, AU sec. 110.02, "Responsibilities and Functions of the Independent Auditor").
- 11 COSO is the generally accepted framework for evaluating the effectiveness of internal control. COSO, however, does not specifically provide guidance regarding fraud management programmes.
- 12 FSG are employed during the sentencing of a corporation or individual convicted of a federal crime. The United States Sentencing Commission introduced seven criteria for "effective" management of ethics and compliance risk. These criteria have become the generally accepted benchmark for ethics and compliance programs. Fraud management is similar, although not identical, to ethics and compliance.
- 13 The appendix to SAS 99 includes this guidance, which was issued jointly by the American Institute of Certified Public Accountants, Association of Certified Fraud Examiners, Financial Executives International, Information Systems Audit and Control Association, The Institute of Internal Auditors, Institute of Management Accountants and Society for Human Resource Management.
- 14 U.S. Securities and Exchange Commission, *Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*, Release Nos. 33-8177, 34-47235; File No. S7-40-02, <http://www.sec.gov/rules/final/33-8177.htm>.
- 15 U.S. Securities and Exchange Commission, *Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports*, Release Nos. 33-8124, 34-46427; File No. S7-21-02, <http://www.sec.gov/rules/final/33-8124.htm>.

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