

# BoardMatters Quarterly

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## Changes on the horizon

As audit committees and companies contemplate how to deal with a number of new accounting issues and a rapidly changing business environment, this issue of *BoardMatters Quarterly* explores some of the most significant developments, including questions about the role of the auditor and changes to accounting standards.

Additionally, many companies are evaluating their use of “conflict minerals” and the new disclosures required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Others are facing pressure to keep up with the move to cloud computing while being mindful of the risks. This issue addresses these topics and also reviews leading practices for evaluating and enhancing audit committee performance.

We hope you find *BoardMatters Quarterly* insightful and will share it with others. If you have feedback or ideas for future issues, please contact Sara Brandfon at [sara.brandfon@ey.com](mailto:sara.brandfon@ey.com).





# The constant in global financial reporting: change

## *Potential changes to the US auditing environment*

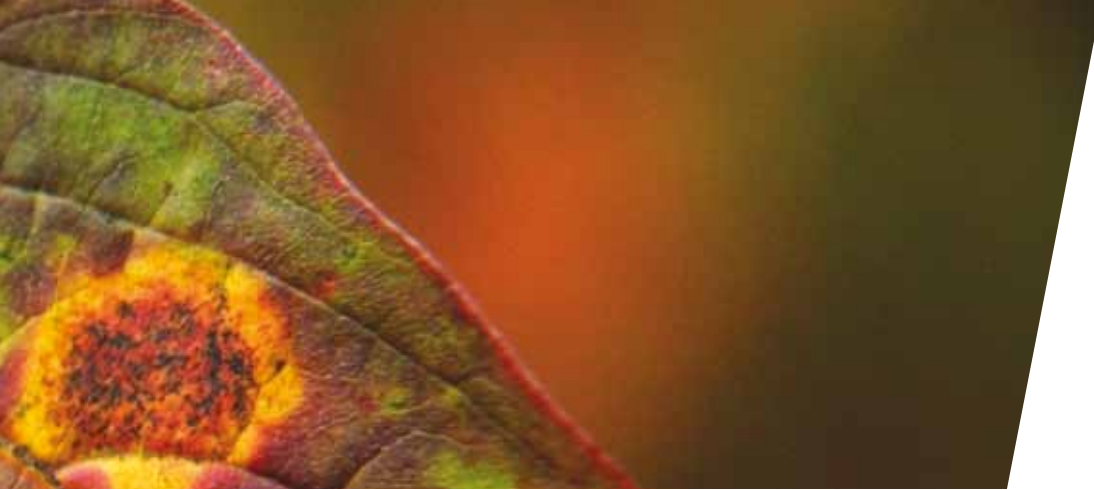
The Public Company Accounting Oversight Board (PCAOB) Chairman, James R. Doty, has indicated in a series of recent speeches that the PCAOB is increasing its focus on auditor oversight. In June and August 2011, the PCAOB issued concept releases on the auditor's reporting model and auditor independence, respectively. As indicated in a recent speech by Mr. Doty, the concept releases are intended "to foster broad debate and research about ways to enhance both the relevance and credibility of audits, and to provide the investing public a better understanding of what an audit is through enhanced transparency."<sup>1</sup>

Both of these concept releases seek comment on potential changes that could directly affect the audit committee's oversight of the auditor and a company's financial reporting. Therefore, boards and audit committees are encouraged to carefully study the issues raised and the potential changes contemplated in the releases, and then consider providing input to the PCAOB.

According to the concept release on the auditor's reporting model, investors want information beyond that reflected in the current pass-fail auditor's report. While the PCAOB has stressed that it intends to retain the current pass-fail opinion, it presents various alternatives that it says could increase the transparency and relevance of the auditor's report, including an Auditor's Discussion and Analysis, expanded use of emphasis paragraphs, having the auditor report on information outside of the financial statements and clarifying certain language in the auditor's report. For example, the Auditor's Discussion and Analysis could supplement the current auditor's report with documentation that may address:

- ▶ Areas of risk in the entity's financial reporting and the auditor's response to those risks
- ▶ The quality of the entity's accounting policies and practices
- ▶ The auditor's views on significant judgments and estimates made in preparing the financial statements
- ▶ Difficult or contentious issues
- ▶ Auditor independence matters

<sup>1</sup> James R. Doty, speech to the SEC and Financial Reporting Institute 30th Annual Conference, Pasadena, CA, 2 June 2011.



In its August concept release on auditor independence and audit firm rotation, the PCAOB notes that provisions of the Sarbanes-Oxley Act of 2002 have improved audit quality. But the PCAOB also believes that there continue to be instances of auditors failing to approach the audit with the required level of independence, objectivity and professional skepticism. As a result, the concept release seeks comments on possible ways to enhance auditor independence, objectivity and professional skepticism, including mandatory audit firm rotation and other alternatives.

Proponents of mandatory audit firm rotation argue that setting a limit on the term of an audit firm's relationship with a company would potentially allow the auditor to better withstand pressures from management. Opponents say mandatory audit firm rotation could lower audit quality by eliminating the auditor's institutional knowledge of the company and its industry. The PCAOB recognizes in the concept release that mandatory audit firm rotation would represent a significant change in practice and could impose significant costs and disruptions. The release identifies a number of issues, in addition to those noted above, that would have to be considered.

Comments on the June and August concept releases are due by 30 September and 14 December 2011, respectively. The PCAOB hosted a roundtable on the auditors reporting model on 15 September 2011. It will host another roundtable on auditor independence in March 2012.

### ***Europe also discusses changes to the audit environment ... and auditors***

In October 2010, the European Commission (EC) released its green paper, *Audit Policy: Lessons from the Crisis*. A green paper is an early stage in the European legislative process and is essentially a request for consultation on possible proposals. The green paper raises many questions about the audit profession, similar to those raised by the PCAOB in its recent releases.

These questions have important implications, not just for the audit profession but also for management, audit committees and investors in Europe and around the world. Some of the ideas discussed in the green paper, even if they were confined to the European Union (EU), would nevertheless have a global effect because many businesses have operations in Europe that would be affected if the proposals were implemented.

While all of the issues addressed in the green paper deserve careful consideration, a few are of particular concern for audit committees due to their potential to impair, not enhance, audit quality. These issues include whether there is an unnecessary concentration in the four major audit firms that decreases audit quality, the possible prohibition of non-audit services, mandatory audit firm rotation and joint audits. Several of these measures could significantly change the role of audit committees in overseeing the appointment of and working relationship with a company's external auditor.

### ***Taking time with convergence***

Turning to the ongoing changes in global accounting standards, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) decided to formally expose their proposals on revenue recognition and leases for comment for a second time because they have made significant changes to the models since the original Exposure Drafts. Final standards could be issued in the second half of 2012. Although the Boards have not yet decided on an effective date, it does not appear that the new guidance would be effective before 1 January 2015, given that the new guidance will likely require retrospective application to the earliest periods presented.

### ***SEC discusses IFRS with investors, smaller registrants and regulators***

At a US Securities and Exchange Commission (SEC) roundtable on 7 July 2011, investors, representatives of smaller public companies and regulators discussed the possible incorporation of International Financial Reporting Standards (IFRS) into the US financial reporting system. The SEC staff is gathering feedback from constituents as part of its 2010 Work Plan to help the commissioners decide whether or not to incorporate IFRS into the financial reporting system for US issuers, and if so, how and when.

The investors participating at the roundtable generally supported the pursuit of a single set of high-quality, globally accepted accounting standards, with some expressing direct support for the phased-in approach that the SEC described in its May 2011 paper (i.e., completing the convergence projects on the Boards' agendas and then gradually incorporating IFRS guidance into US GAAP over a five- to seven-year period). Other participants preferred an approach that would provide for full adoption of IFRS. There was mixed support for providing US issuers with an option to fully adopt IFRS.

Participants representing smaller public companies expressed less support than investors for moving toward IFRS in the US. While most appeared to understand the theoretical merits of such a move, many said the costs outweighed the benefits for smaller companies.

The SEC made no decisions at the roundtable and is expected to decide later this year if, when and how to incorporate IFRS into the US financial reporting system.

### ***What audit committees can do now***

While the discussions in the US and Europe on audit matters are preliminary, audit committees should stay informed to understand the proposals and their potential effect on the audit committee's role in the financial reporting process. As with changing accounting standards, planning early gives audit committees and companies the opportunity to provide input to shape the changes and be better prepared for the uncertainties that lie ahead. ✓

### **Questions for the board and audit committee to consider**

- ▶ How would the auditor reporting alternatives in the PCAOB's concept release affect the information that the audit committee currently receives from the auditors?
- ▶ What are the audit committee's procedures to monitor auditor independence and audit quality in the current environment?
- ▶ What are the audit committee's and full board's views on mandatory firm rotation as discussed in the PCAOB concept release? Will the audit committee provide comments to the PCAOB?
- ▶ Given the delay in the revenue recognition and leases projects, when will the audit committee and company management address the effects of applying the revised proposals?
- ▶ What are management's views of the IFRS transition approach outlined by the SEC staff compared to a mandatory, date-certain adoption or an optional adoption of IFRS?

# Conflict minerals – SEC rule could affect thousands of companies

Under its proposed rule, the US SEC estimates that more than 5,500 companies would need to provide certain disclosures about their use of “conflict minerals” from the Democratic Republic of the Congo and adjoining countries (DRC countries<sup>1</sup>). Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act aims to dry up the source of money for certain mines. These mines are believed to abuse workers’ human rights, and money earned on the sale of the minerals is believed to be financing regional conflicts that have been characterized by widespread incidents of extreme violence.

The proposed rule would apply to SEC registrants that manufacture or contract to manufacture products that use conflict minerals, which are currently defined as cassiterite, columbite-tantalite, gold and wolframite.<sup>2</sup> These minerals are commonly found in electronic circuits, wires and electronic products. Industries likely to be most affected by the proposal include electronics, communications, aerospace, automotive, jewelry and industrial products.

## *What are the disclosure requirements?*

The SEC proposed a three-step disclosure process.

1. First, an issuer would need to determine if any of the four conflict minerals are necessary to the functionality of any of its manufactured products or to a product’s production process. If not, an issuer would not be required to take any action.
2. If, however, the minerals are determined to be necessary, the company would have to make a conflict minerals disclosure in its annual report and on its website on its use of conflict minerals and whether the conflict minerals originated in any of the DRC countries. The disclosure would have to be based on a “reasonable country of origin inquiry.”
3. If an issuer determines that its minerals are from the DRC countries or cannot determine their origin, the SEC proposal would require the company to furnish a conflict minerals report as an exhibit to its annual report and post it to its website.

<sup>1</sup>. The DRC countries are defined as including the DRC, the Central African Republic, Zambia, Angola, the Congo Republic, Tanzania, Burundi, Rwanda, Uganda and Sudan and (or) South Sudan.

<sup>2</sup>. Cassiterite is the metal ore commonly used to produce tin, columbite-tantalite is the metal ore from which tantalum is extracted and wolframite is the metal ore used to produce tungsten.



### ***The conflict minerals report***

The conflict minerals report would include a description of the measures taken to exercise due diligence on the source and chain of custody of any conflict minerals. Issuers would be required to describe:

- ▶ Any products that are not “DRC conflict free”
- ▶ The facilities used to process such conflict minerals
- ▶ The country of origin of those conflict minerals
- ▶ The efforts to determine the mine or location of origin of the conflict minerals with the greatest possible specificity

The issuer also would need to certify that it obtained an independent audit of the report and furnish the audit report.

### ***Timing and next steps***

There are many questions related to the conflict minerals report and its audit requirements that still need to be clarified in the final SEC rule, which is expected to be issued between September and December 2011. Annual reports for years beginning thereafter will be subject to the disclosure requirements. For calendar-year filers, it is currently anticipated that the disclosures will be required in annual reports for the year ended 31 December 2012.

There is still much to be determined, but public companies that manufacture or contract to manufacture products (including private label retailers) should evaluate the law’s applicability and the cost of compliance, and then develop a strategy to meet the requirements of the new law. The strategy could include implementing supply chain due diligence and track and trace procedures, changing procurement sources or potentially switching to other materials.

Companies should begin now to assess the potential level of effort the rule would require, the potential reputational risks involved in the new disclosure process and the options available to ensure compliance. ✓

### **Questions for the board and audit committee to consider**

- ▶ Does the company manufacture or use conflict minerals? If so, in what products?
- ▶ What has management evaluated to make this determination? Has it looked at all raw materials? Has it made inquiries of subcomponent’s manufacturers?
- ▶ If the company is subject to Dodd-Frank Section 1502, has management developed a strategy for compliance? Does the strategy take into account the public relations and reputational issues involved with conflict minerals and the potential cost of totally conflict-free manufacturing? Has management communicated its strategy to the audit committee?
- ▶ Does the audit committee understand what still needs to be finalized so the company is ready to meet the reporting requirements of Section 1502?

# Securing the cloud

## Alleviating the fear of cloud computing

Cloud computing is growing rapidly, but for large organizations, information security concerns continue to slow the pace of adoption.



Relinquishing control of the security of IT infrastructure and data seems risky for most large organizations. In fact, in a recent survey of North American and European businesses, 50% of respondents said their chief reason for avoiding cloud computing was security concerns.<sup>1</sup> In particular, boards and organizations fear:

- ▶ Increased risk to data as it travels over the internet
- ▶ Cloud service provider (CSP) business models that share infrastructure among many clients

- ▶ The inherent opacity of the cloud, which makes it difficult to determine where data is located or how it is protected
- ▶ Personally identifiable information stored in the cloud that could be breached

Yet in the same survey, Forrester Research projects that within five years cloud security will become one of the primary drivers for adopting cloud computing.<sup>2</sup>

<sup>1</sup>. "Cloud Security to Reap \$1.5 Billion by 2015," *CMP TechWeb*, 22 October 2010, via Dow Jones Factiva, © 2010 United Business Media LLC.

<sup>2</sup>. *Ibid.*

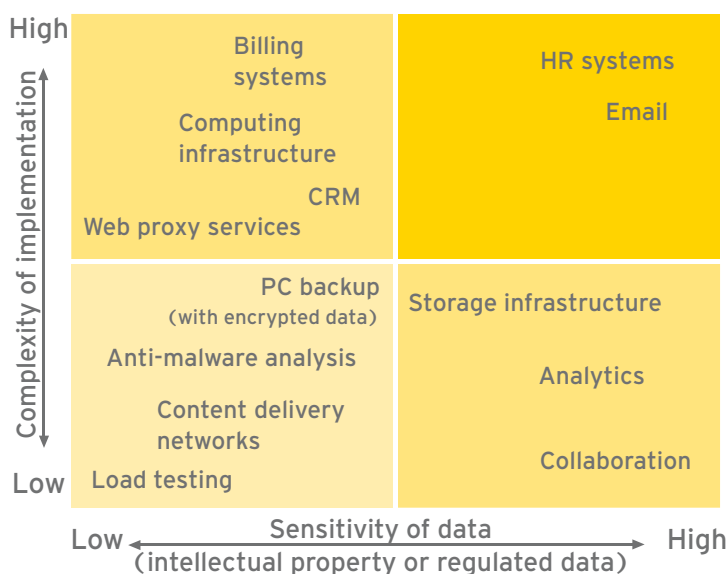
## Feeling secure in the cloud

Organizations thinking about a move to the cloud should consider the following approach:

### 1. Get comfortable with the cloud before moving the most sensitive data

To test the risk of moving data to the cloud, organizations should consider moving less risky services first (see examples in Figure 1). These applications may have little or no regulatory oversight and are relatively easy to implement. Other business processes, such as HR systems or email, both of which involve personal data, should probably move last.

**Figure 1: Considering cloud migration opportunities**



### 2. Be prepared to respond to incidents in the cloud

Responding rapidly to security incidents is difficult enough when organizations are using their own infrastructure. When data moves to the cloud, these incidents can create additional process challenges. Boards and organizations need to understand how their data is being stored and who has access to the data, as well as the appropriate levels of response to data requests.

### 3. Understand a CSP's security position

Because CSPs do not always provide transparent access to the technical details of their security practices, understanding the provider's security position can be somewhat difficult. Instead of focusing on technical implementation details, organizations may want to consider asking process and control questions, such as:

- ▶ Will the CSP provide timely notification if there is a security breach?
- ▶ What is the CSP's policy when a law enforcement agency subpoenas the organization's data directly, without going through the organization's general counsel office?

### Moving ahead with good governance and security standards

Many security issues remain open to interpretation in cloud computing, making governance a critical component. But as the influence of security and reporting standards flow through the industry, and as CSPs and users gain more experience, security concerns will stop inhibiting cloud adoption – and may even accelerate it. ✓

### Questions for the audit committee to consider

- ▶ Is the organization well positioned to manage governance activities in a CSP environment?
- ▶ What is the organization's risk tolerance related to electronic data?
- ▶ Which compliance and security requirements must the organization and the CSP meet?
- ▶ What independently verifiable assurances of security and privacy does the CSP offer?
- ▶ Does management understand the CSP's stance on security – who will have access to the organization's data, where the data will be stored, what its backup procedures are and what notification the provider will give in the event of a security breach?

# Enhancing audit committee performance through ongoing candid feedback

As audit committees respond to pressures to expand their agendas to tackle new subjects (such as IT risk), they also face increased scrutiny from regulators such as the PCAOB and from some investors who have expressed significant concern recently about the role and quality of the audit.

Leading audit chairs recognize that the time is right to look for ways to enhance the audit committee's performance and help reassure stakeholders. How do leading audit committees evaluate and improve their performance?

Traditionally, the year-end board evaluation process is the primary means by which audit committees gauge their effectiveness and determine how to make improvements. Yet surprisingly few audit chairs view the annual self-assessment questionnaires used by many companies as an effective way to improve committee performance, especially if used without the benefit of timely feedback.

One audit chair said, "In general, the committee assessments have become too rote ... everyone just checks the boxes." Another added, "[The questionnaires] come out at the end of the year as part of a huge package - the CEO assessment, peer assessments, etc. The more time you spend on these, the more you just want to check the boxes as opposed to turning it into a valuable discussion tool."

Audit chairs who have noted positive outcomes from performance evaluations recommend employing a mix of approaches:

- ▶ **Clearly define what is meant by "success"**  
In a dynamic environment, agreeing on what constitutes a high-performing audit committee is a challenge. Some audit chairs define success as a "smooth audit" without any reporting surprises throughout the year. Others suggest success is "if we have the information we need to tackle the right issues." Audit chairs agree that setting objectives for performance is critical. Many use the audit committee charter as a guide for doing so. It is also important that objectives are tracked throughout the year.
- ▶ **Seek ongoing feedback from management and external auditors**  
Audit committee members routinely report that the most effective means to increase audit committee effectiveness is to seek feedback through regularly scheduled executive sessions between the audit chair and members of management and, separately, with the external auditors. These sessions should allow issues to be addressed candidly and then acted upon quickly.



One audit chair explained, “I get input on our agenda, like whether we are covering the right things; and together we identify where we need some kind of tutorial.” Other members reflected that this approach allows feedback to occur in the “flow of work,” which allows for more substantive discussions on issues.

► **Prioritize committee performance issues to discuss**

Rather than using lengthy, process-heavy questionnaires or third parties, many audit chairs use an informal process. One chair noted, “I circulate some questions to committee members and ask them to answer the questions but also to make comments. They can do it anonymously or for attribution. I look at the feedback and end up with two or three things that we need to talk about.”

► **Evaluate via lead director interviews**

Several audit chairs suggested the lead director on the board should hold individual discussions with members of the audit committee and the full board to gather feedback. A lead director

described an effective process: “I personally went around and interviewed directors about two things: first, issues we weren’t getting at as a board, and second, how can we make the board more efficient?”

► **Readjust the approach every few years**

An audit chair also noted the value of external experts when doing so: “We brought in someone with a fresh perspective who had a goal mentality and was familiar with best practices. This person can lead the assessment and provide a view on how to improve our committee performance.”

In a pressurized and continuously changing environment, ensuring the audit committee is maximizing its performance is a complex undertaking. Audit committees may want to reconsider their self-evaluation process. Rather than relying solely on year-end questionnaires, audit committees may be better served to initiate an ongoing approach for seeking candid feedback that is captured as work is performed, better enabling process or behavior changes to occur. ✓

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