PRICEWATERHOUSECOOPERS

The Internal Audit Newsletter

Volume 4 March 2005

In this issue:

To find out more about our Internal Audit Services, please contact pwc.internal.audit@us.pwc.com.

2005 Audit Committee Update

This 48-page PDF document -– encompassing a wide range of Audit Committee topics — was compiled by P. Gregory Garrison, America's Leader, Assurance and Business Advisory Services, and Catherine L. Bromilow, Partner, Corporate Governance Group, PricewaterhouseCoopers.

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

"Companies," the summary continues, "have been working to address what is arguably the Sarbanes-Oxley Act's biggest impact — 404 compliance…" (But) "… numerous other issues also warrant audit committee attention.

"So, in addition to supporting the role of audit committee oversight of the new 404 reporting, this publication highlights some of the other significant governance developments and their implications, to help committees cope with ongoing regulatory, legislative, and other changes in the business environment."

What are some of these changes for 2005?

The Audit Committee changes for 2005 include:

- Shareholders are demanding a greater voice in the selection of directors;
- Amendments to the Sentencing Guidelines require greater board-level involvement in programs to prevent and detect criminal conduct;
- There's a modified director independence definition from the NYSE to consider;
- The SEC is publishing its comment letters and companies' responses, and requiring more real-time disclosures in 8-Ks;
- The most sweeping tax reform bill in more than 15 years is in effect, with major financial reporting implications and limited windows to take advantage of certain provisions;
- Globally, companies are facing the challenge of adopting international accounting standards in 2005, with their auditors preparing to apply international auditing standards not long thereafter.

Download the entire 2005 Audit Committee Update (468 Kbyte PDF).

For More Information…

PricewaterhouseCoopers would be pleased to help you with these objectives in any way we can, bringing the full benefit of our vast experience and resources. In this spirit, we currently are researching how leading audit committee practices have evolved in the post-Enron era. Look for the results to be published in the third edition of *Audit Committee Effectiveness – What Works Best*, due during the summer of 2005.

To find out more, please contact pwc.internal.audit@us.pwc.com.

How Computer Assisted Audit Tools (CAATs) Can Be Used In A Fiduciary Audit Environment

By Valerie Nielsen, Senior Manager, Internal Audit Services practice and Winifred Whelan, Director, Data Management practice, PricewaterhouseCoopers LLP

The fiduciary audit space is becoming ever more complex with the need to expand audit coverage with finite resources. Internal auditors are challenged to enhance their monitoring and reporting of the effectiveness of the organisation's fiduciary internal control activities, while maintaining resource levels.

In this environment, Computer Assisted Audit Tools (CAATs) can be a powerful way for internal auditors to enhance both the efficiency and effectiveness of their audit process. In fact, with the increased scale of the automated systems supporting fiduciary businesses, the lack of CAAT capabilities may be indicative of an internal audit process that is not up to date with their organisation's business units.

What is a CAAT?

A CAAT is the use of a software application or an extract of data to search for and identify trends, exceptions errors, or indications of potential fraud by comparing and analysing files according to criteria established by the auditor. These applications may be purchased packages, such as ACL or embedded report writers that are available with a related business application. This automated testing capability replaces traditional manual searches, tests or samples. From the output generated from the CAAT, an auditor can review or test an entire population, at a level of coverage that would not be possible under manual testing methods.

CAATS enable auditors to perform many, varied testing routines such as recalculating and verifying balances, identifying control issues, testing for compliance with standards, aging and analysing accounts receivables/payables or any other time sensitive transactions, testing for duplicate payments, and gaps in invoice numbers, etc. CAATs can increase the effectiveness of an auditor's work by impacting the depth of the auditor's analysis and understanding because data tells the story! CAATs enable auditors to quantify the financial impact of errors, or internal control issues. Line management will respond more positively to problems and opportunities that are quantified.

What CAATs can help you identify

More specific to fiduciary audit activities, CAATs can help you identify:

- Accounts not set up properly for statement production, fee collection, tax preparation, etc.;
- System inefficiencies such as uninvested cash not resolved in a timely manner or overdrafts not aged properly;
- Inappropriate or erroneous fee discounts; and
- Impact of poor data quality in regards to accuracy RC-T and 13F reporting and incomplete CRM reporting

Implementing a strategy to incorporate or significantly expand CAAT usage into a fiduciary audit plan, starts with establishing a strategy for who should develop and generate fiduciary CAAT reports within the Internal Audit Department. There are three approaches for deploying CAAT resources: 1) fully dedicated team of CAAT programmers 2) CAAT competency embedded across the fiduciary audit teams and 3) deploying a limited number of CAAT competent auditors on the audit team who would develop and use CAATs on an ad hoc basis.

A dedicated CAAT programmers team offers advantages

The advantages of a fully dedicated team of CAAT programmers include the ability to develop and maintain deep, ongoing trust system expertise. This can lead to the development of complex reports and data extracts and a library of CAAT reports, which can be used by line auditors as frequently as needed. The CAAT team can also be viewed as technical systems experts who would support an integrated IT audit approach.

However, there are some disadvantages of a fully dedicated CAAT Team. Because dedicated resources are required, this could limit resources available for other IT and/or financial audits. Also, report requests may have to prioritise because of the limited resources. Finally, the use of the CAAT Team may lead to over-reliance on them for systems issues and other auditors may not develop or expand their system knowledge.

Advantages of embedded CAAT expertise and competency across an audit team are that auditors with the greatest business knowledge would be programming the CAAT reports. Some internal audit organisations who are dealing with highly automated environments are viewing CAAT competency as a core competency for all auditors.

Having CAAT expertise and competencies among several individuals across the Internal Audit Department can be advantageous as auditors with business knowledge would be programming the CAAT reports. Resources would be more flexible for deployment between IT and financial audits and reports can be created as testing circumstances warrant. This model also allows more staff with the interest in CAAT capabilities to develop those skills without forcing others who may not have that interest.

(see next page)

The disadvantages of embedded CAAT expertise in an audit team are that sufficient depth of IT knowledge may not be developed to create complex data extracts and programming. Audit staff may not have access to sufficient technical training to create more complex CAAT reports. Some auditors may not have the interest or aptitude to develop CAAT competencies.

As with the other models, there are some drawbacks to this model also. Although CAAT expertise is spread more broadly among several individuals, CAAT resources may still not be available to audit teams when required. Also, sufficient depth of IT knowledge may not be developed to create complex data extracts and programming, and it does not encourage an integrated IT audit approach.

Strategic questions to consider

With these three possible resource models, how would an Internal Audit Department determine which is the best CAAT Model? For the strategic use of CAATs, the Internal Audit Department should consider questions such as:

- What is the extent of needed CAAT coverage?
- How complex are the business systems in the areas to be audited?
- What is the volume of manual testing and what is the opportunity for enhanced efficiencies by automating it?
- Has the effectiveness for the existing audit coverage been questioned by management or regulators?
- Should competency in the development and use of CAATs be a core competency for auditors?

Once the resource model for the CAAT implementation has been selected, the determination should be made of what specific software tools should be acquired to create and generate CAATs? The ACL software application is widely used in the internal audit space because of its relatively easy programming and its capabilities to assess large amount of data. An alternative is to download a text file into Microsoft Excel or Access, download an existing end user report into Microsoft Excel or Access or use a software application's report writer capabilities to create reports. The choice of IT tools depends on the planned use of CAATs, complexity of the systems being audited and cost considerations.

Creating an inventory of software applications and mainframe systems

The Internal Audit Department should create an inventory of software applications and mainframe systems used by fiduciary businesses. Systems should be ranked or risk assessed to determine which are most significant to the audit plan. Plan should then be developed to identify and access critical data for use in CAAT development. Examples of system applications in a fiduciary business environment are the Trust Accounting system (ex. SEI, Sungard, etc.), trade execution and performance measurement systems, corporate trust (bond indentures and stock transfer), tickler systems, personal transaction reporting systems and workflow systems.

The internal auditor should also consider systems issues such as the need to identify when new system releases have been implemented and their impact on CAAT programming, system change controls, data feeds to/from systems and the adequacy of system documentation.

At the individual audit level, CAATs can be used to generate various data analyses. For example, Internal Auditors should design data analyses to test controls identified during the risk assessment. Prior to fieldwork, define the populations of items to be tested during the audit. Additional CAAT reports may be developed during field work to validate and quantify findings as they are identified.

CAATs can also be designed to perform audit tests such as whether system fields have the appropriate value/calculation for an entire population of accounts, securities or transactions. Scenario based situations can be tested for to identify possible fraud and control failures and to identify unusual transactions. These automated tests significantly increase audit coverage and provide greater assurance from the audit results.

Beyond individual audits, CAATs can be used to validate management system reports to ensure operational decision making and financial reporting is reliable, to test the use/control of system business rules, consolidation of data controls, quality of data feeds, and reconciliation of reports to source systems. CAATs can also be used during system conversion projects to test the accuracy of management reports prior to "going live" and to test the completeness of actual conversion files and datasets.

Other uses for CAATs

What are other uses for CAATs in a fiduciary audit environment? CAATs can be developed and generated on a regular basis to provide Continuous Auditing or monitoring of key controls or performance indicators. This provides more flexibility in allocating audit resources to higher risk audits and allowing Internal Audit to be responsive to changes in the control environment. For Sarbanes-Oxley 404 testing, CAATs can provide audit coverage of journal entries, changes to account balances, dollar threshold approval authority for transactions, or to identify control failures. This monitoring and focusing of audit activities maximises the effectiveness of fiduciary audits.

Internal Audit Departments are being challenged by audit committees, line management and regulators to expand audit scopes to test complex control activities that rely on automated system routines with manual intervention. The most effective way to meet this challenge is to implement the use CAATS to perform testing. CAATs allow auditors to access an entire population of data rather using the results of samples to evaluate test results. This provides credible results to line management by quantifying a control concern at a point in time rather 2 of 25 errors and then assuming the same results exist across the entire population. CAATs have multiple functions because they can be leveraged for continuous auditing techniques and Sarbanes-Oxley testing. The financial and time investment by Internal Audit to develop CAATs will be rewarded with increased audit efficiency and effectiveness.

For More Information

Contact Valerie Nielsen, Senior Manager, PricewaterhouseCoopers' Internal Audit Services, 312.298.3524.

Or Winifred Whelan,Director, PricewaterhouseCoopers' Data Management, 312.298.3398.

A 10-Step Antifraud Action Plan

The changing corporate environment has created greater expectations and expanding opportunities for internal auditors in mitigating fraud and reputation risk.

By Jonny Frank, JD, LLM, Partner, Fraud Risks and Controls Practice, and Jim LaTorre, CPA, Partner, Internal Audit Services, PricewaterhouseCoopers

The following is a summary of a recent PricewaterhouseCoopers (PwC) white paper, *The Emerging Role of Internal Audit in Mitigating Fraud and Reputation Risks*. It was originally published in the FSA Times, First Quarter 2005, published by The Institute of Internal Auditors Inc., www.theiia.org

A number of significant regulatory and standard-setting actions are pressuring organisations and their auditors — both internal and external — to step up efforts to combat corporate fraud and misconduct. This new regulatory structure does more than encourage companies to consider fraud prevention as part of internal controls. The U.S. Sarbanes-Oxley Act of 2002, for example, requires management to evaluate and test its internal controls over financial reporting, including its antifraud programs, annually. The company's independent auditor must then attest to management's annual certification.

Within this regimen, one can easily foresee a scenario where executives who have certified internal controls could be asked to answer for fraudulent activities, misconduct, and losses discovered subsequent to their certification. Management can anticipate defending the authenticity of their certifications in the shadow of antifraud controls subsequently proven to be ineffective.

For internal auditing, this environment poses both opportunities and challenges. Internal auditors who develop antifraud action plans will find ample ways to provide added value to their organisations overall, as well as to executives required to sign on the dotted line.

A 10-Step Antifraud Plan

Given today's environment, prudent internal audit groups will seek to capitalise on antifraud-related opportunities and minimise downside risks. To achieve such a best-of-both-worlds positioning, internal auditors need to develop a strategic plan to address their role in the organisation's antifraud effort. In developing an antifraud action plan, the following steps should be addressed.

1) Anticipate Questions and Manage Expectations;
2) Assess existing antifraud programs and controls;
3) Secure management and audit committee sponsorship;
4) Assemble fraud expertise within internal auditing;
5) Organise a fraud and reputation risk assessment;
6) Link antifraud control activities;
7) Evaluate and test the design and operating effectiveness of controls;
8) Refine the audit plan to address residual risk and incorporate fraud auditing;
9) Establish a standard process for responding to fraud allegations or suspicions; and
10) Remediate and prevent recurrence.

The Corporate Watchdog

In today's world, business fraud and reputation risk have achieved priority status among corporate concerns, and management and audit committees are looking to internal audit groups to play a stronger role in corporate antifraud efforts. In response, internal auditing needs to evaluate what management's concerns are about fraud, and when it comes to antifraud efforts, determine what senior management's expectations are of the internal audit function.

When it comes to mitigating fraud and risks to reputation, internal auditing can play an all-important role in an organisation's antifraud efforts, which can more than pay for themselves. What better way for internal auditing to create organisational value?

To read the entire 10-Step Antifraud Plan article: download the PDF.

Download the 48-page Antifraud White Paper: The Emerging Role of Internal Audit in Mitigating Fraud and Reputation Risks.

Introducing Pricewaterhouse-Coopers Internal Audit Advisory Services QARPlus

The business climate is evolving. There are greater demands for better governance, better accountability and more transparency.

More than ever, more organisations depend on the quality of internal audit.

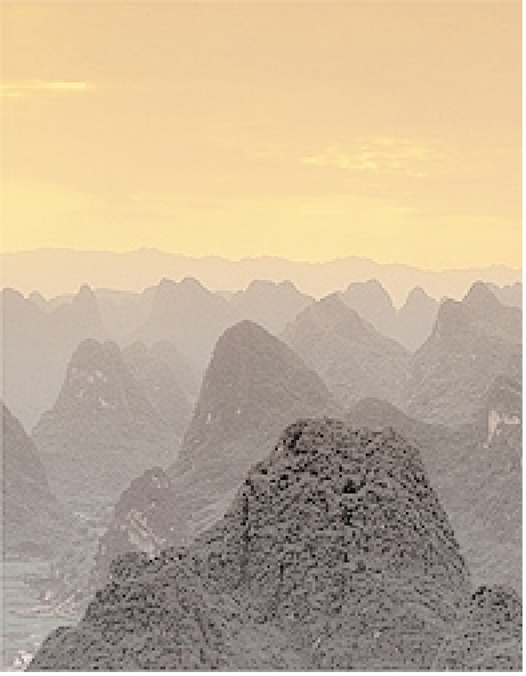
To this end, we recently introduced PricewaterhouseCoopers Internal Audit Advisory Services/QARPlus — www.pwc.com/quality — and our commitment to quality improvement that goes beyond just compliance.

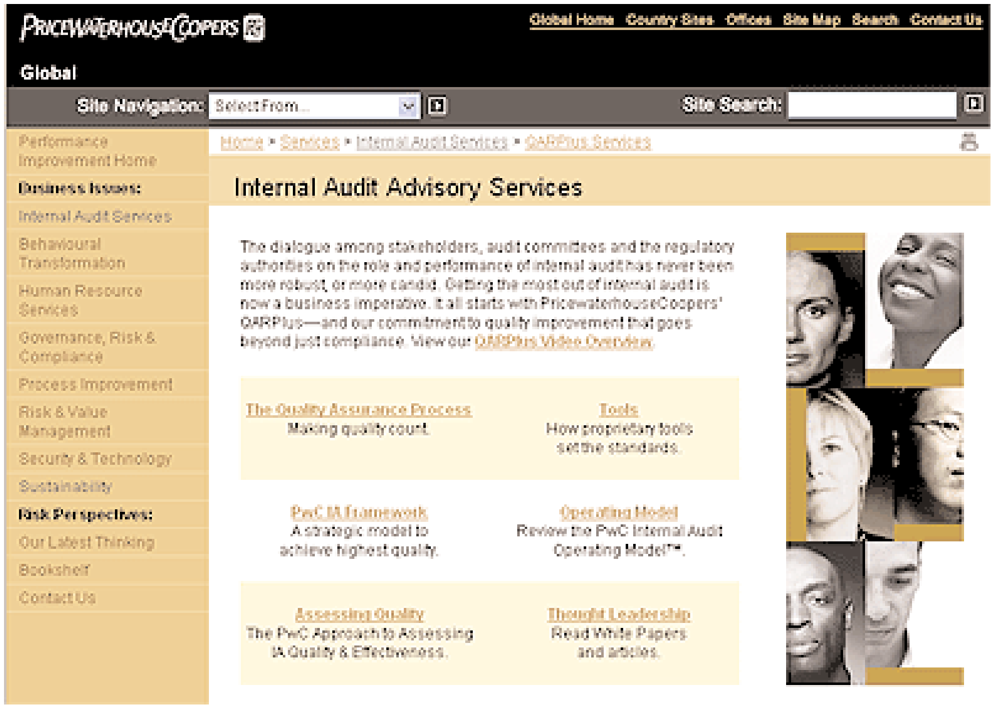
What This Web Site Contains

PwC's Internal Audit Services practice has deeply credentialed people with extensive experience in assisting audit committees, chief audit executives and management in ensuring internal audit quality and effectiveness.

This 10-page Internal Audit Advisory

(see next page)





Services/QARPlus Web site offers:

- **A Five Minute Video Overview** of PwC Internal Audit Advisory Services/QARPlus;
- **The Quality Assurance Process** that utilises a three-lens approach: to meet stakeholder needs, to benchmark your processes against best practices using our proprietary Profiler™ tool, and to determine compliance with the IIA International Standards and any applicable regulatory requirements determined by you;
- **Proprietary Tools That Set The Standards**, such as Profiler™, PricewaterhouseCoopers' unique, trusted benchmarking tool, and PwC's IIA Compliance Tool to review Internal Audit's compliance with the standards and identify potential areas for improvement;
- **The PwC Internal Audit Framework™** that provides a strategic model for internal auditors and their stakeholders to understand the relationships and linkages necessary to achieve a high quality and effective internal audit function;
- **The PwC Internal Audit Operating Model™** that depicts the choices from which organisations and stakeholders often choose in determining the value focus of internal audit and the corresponding supporting internal audit skill sets;
- **The PwC Approach to Assessing Internal Audit Quality and Effectiveness** that includes a four-phase plan of Project Planning, Value Driver Identification, Current State Assessment, and Solution Development;
- **Thought Leadership** with PwC Internal Audit White Papers and relevant articles; and
- **Internal Audit Advisory Contacts**, a list of PwC Partners, Managing Directors and Senior Managers who have significant experience with large global Internal Audit Departments.

Learn More

Internal Audit Global Best Practices: #2 in a Series

Overview

For many companies, internal auditors check employee compliance with internal controls, issuing reports listing the number and frequency of violations of policies and procedures.

Additionally, as investors, regulators, and public trading exchanges demand stricter accountability for accurate financial reporting, smart companies are assigning IA an expanded role in corporate governance, acting as independent and objective monitors who verify the ethical culture of the company and act as the eyes and ears of the board and audit committee.

> *Companies that apply best practices reap much more value from internal audit (IA) by leveraging the professionalism of the audit staff and the department's companywide scope to supplement compliance activities with services such as risk assessment, consulting, and process improvement.*

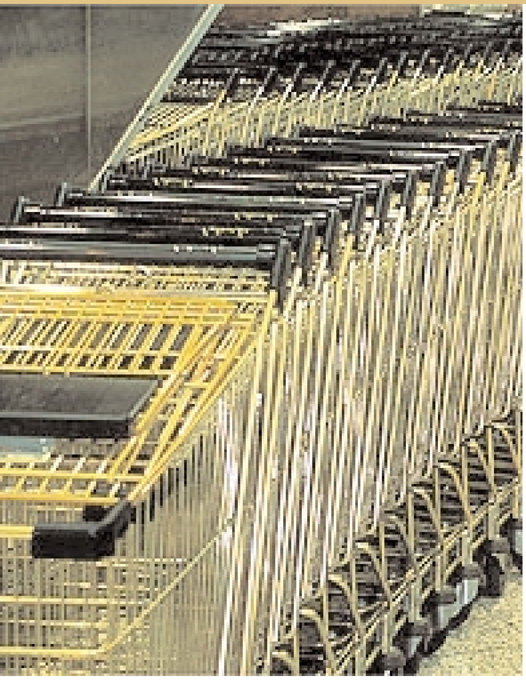
Best practices

Best practices in conducting internal audits stem from a diverse, experienced, and skilled audit staff who possess the professional training exemplified by certification of The Institute of Internal Auditors. Leading companies capitalise on the professionalism of IA staff by assigning management trainees a rotation in the department to offer first hand insight into company operations and develop skills in recognising and mitigating risk.

Additionally, smart companies provide their audit functions with the resources and authority to effectively fulfill the department's mandate, which is defined in the audit charter created by the board, audit committee, and senior management.

Best practices for internal audit include the following, which is the second in a series

(see next page)



of ten:

1) **Build an internal audit staff that supports the needs of the business.**
The first step in realising a value-adding internal audit function is to assemble a versatile, seasoned, and comprehensive talent pool to carry out the mission of the internal audit function, which is defined in the audit charter. Leading companies consider a core staff of seasoned, versatile internal auditors an investment that will add value, whether that value is achieved through risk assessment and tighter controls, enhanced efficiency through business consulting, as a corporate training ground for business unit management, or a combination of all of these.

2) **Structure the internal audit department on a fluid, flexible framework.**
Successful companies readily adjust to a continuous stream of internal and external forces that can impact their strategies and operations. Accordingly, companies that apply best practices structure their internal audit (IA) departments to adapt to changing priorities of the business.

3) **Create an enterprise-wide risk-based audit program.**
Companies that position their internal audit departments as strategically driven and value adding build their audit plans on a risk-based audit schedule. Risk-based audits use audit resources more efficiently, ensure that management and the board are sufficiently focused on key risks, and allow for a degree of flexibility that enables the company to adjust to shifting priorities.

4) **Broaden audit scope to address third-party and vendor risk.**
Successful companies recognise the strategic advantages of partnerships, including outsourcing, supplier agreements, joint ventures, and mergers and acquisitions, all of which present risks outside of the company's immediate control. Companies that apply best practices mitigate downstream risk and liability by proactively performing risk assessments and, when appropriate, audits of potential high-risk business partners. By examining prospective partnerships in advance, internal auditors apply a proactive risk prevention strategy that allows the company to avoid potential problems.

5) **Combat fraud by advocating high ethics throughout the organisation.**
All companies confront three specific types of fraud: asset misappropriation, such as theft of cash or assets; corruption, such as bribes and kickbacks; and fraudulent financial statements, such as providing false financial information to lenders, investors, and regulators.

6) **Collaborate with the information technology department to mitigate information systems risk proactively.**
Information technology (IT) is pushing each phase of business, increasing efficiency and productivity, allowing instantaneous communications, processing transactions in real-time, and facilitating global relationships with customers and vendors.

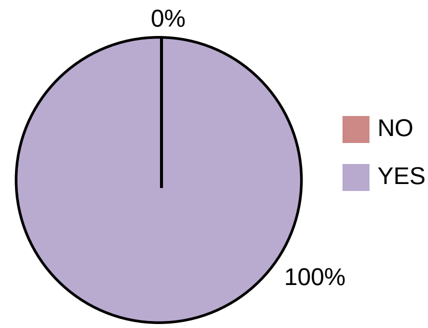
Read more, including Rationale, Action Steps, Tips and Tools, Measures of Success, and Practice Appraisal.

Find out more about Global Best Practices: **www.globalbestpractices.com**

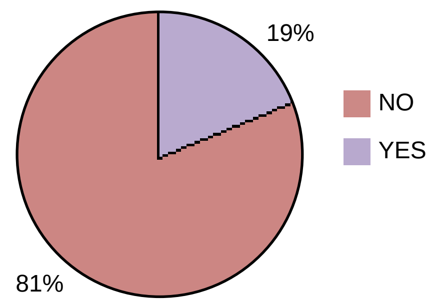
Summary of September 2004 Survey Results

The results have been tabulated for our most recent newsletter's Survey. There was a wide range of answers, as shown below.

Q 1. Has the Board of Directors taken action to strengthen and or formalise corporate governance structures and policies within the last 24 months?



Q 2. The scope of internal auditing in the IIA's definition of Internal Audit includes three components: Controls, Risk Management and Governance. Do you feel that your actual objectives, working practices and responsibilities include all three areas?



Q 3. If Yes, which of the following aspects of governance are addressed by the internal audit plan (Please indicate all that may apply):

37.5% of Respondents
Overall governance and Board of Director's structure and charters

25% of Respondents
Meeting agendas and minutes

62.5% of Respondents
Audit committee charter agenda and minutes

56.25% of Respondents
Audit committee membership and responsibilites

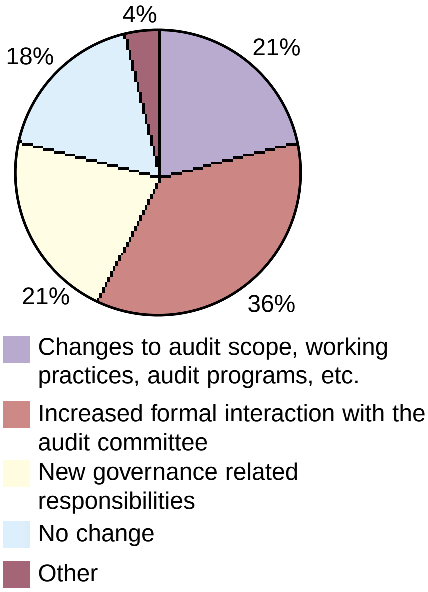
68.75% of Respondents
Compliance with governance related Sarbanes-Oxley requirements

50% of Respondents
Compliance with governance related SEC rules

(see next page)

6.25% of Respondents
Other

Q 4. The IIA's definition of internal auditing incorporates both assurance and consulting activities. In the next 18 months do you expect your balance between assurance and consulting to:



Q 5. What changes, if any, relative to internal audit's relationship with the audit committee and your specific responsibilities relative to governance (as apposed to risk management and internal controls) have taken place or are planned at your organisation? (Please check all that apply).

37.5% of Respondents
Changes to audit scope, working practices, audit programs, etc.
62.5% of Respondents
Increased formal interaction with the audit committee
37.5% of Respondents
New governance related responsibilites
31.5% of Respondents
No changes
6.25% of Respondents
Other

Conferences & Events

The IIA's General Audit Management Conference

March 21-23, 2005
Lake Buena Vista (Orlando), FL
For more than 25 years, The IIA's General Audit Management Conference has offered solutions to meet the unique challenges of chief audit executives, the audit committee, and board members. In 2005, GAM will be designed specifically to address issues facing chief audit executives in a post-Sarbanes-Oxley world. Take advantage of this opportunity to share best practices and lessons learned, as well as discover the most up-to-date methods for making your audit shop first-rate.

What Does the New ERM Framework Mean for Me and My Company?

Monday, March 21
10:30 - 11:40 a.m.
Glenn Brady, Partner,
PricewaterhouseCoopers

- Discuss the transformation of risk management from a soft, idiosyncratic activity to a disciplined, principles-based framework.
- Find out how this transformation is affecting companies and how they are responding.
- Explore the role of internal audit in this new context.

MIS 16th Annual Super Strategies Internal Audit Best Practices Conferences

April 27-29, 2005
JW Marriott Resort, Las Vegas
Get tactics for handling SOX challenges, maximising audit efficiency, and ensuring that standards are being met throughout the organisation at *SuperStrategies!*

Sarbanes-Oxley: Lessons Learned in 2004 and Strategies for 2005

Tuesday, April 26
9:00 a.m. – 4:00 p.m. Pre-Conference Workshop

- Lisa Choate, Director Internal Audit, Southwest Airlines Co.
- Michael Head, Managing Director Corporate Audit, Ameritrade
- Anthony O'Reilly, Partner, PricewaterhouseCoopers
- Dan Jackett, Partner, PricewaterhouseCoopers
- Gwenne Kooman, Senior Manager, PricewaterhouseCoopers

Overview: Sarbanes-Oxley documentation continues to demand attention and new action is needed from internal audit. During the past year, organisations have documented, developed compliance strategies, and handled implementation issues. However, the challenges keep coming as new issues arise and PCAOB regulations continue to evolve. In this workshop, you will hear how a group of leading audit professionals made adjustments based on what they learned in 2004, and developed strategies for 2005.

Rebalancing the Internal Audit Plan: The Emerging Challenge for Internal Audit

Wednesday, April 27,
10:30 a.m. – 12:00 Noon

- Richard Chambers, Director, PricewaterhouseCoopers
- Andrew Dahle, Partner, PricewaterhouseCoopers

Overview: In this session, you will explore the phenomenal impact of the Sarbanes-Oxley Act on internal audit throughout the corporate sector. You will discover the causes and consequences of abandoning risk-based auditing in order to meet the pressing demands of Section 404 project work and other SOX requirements. Discover short- and long-term strategies for addressing the imbalance in audit coverage that has accompanied new regulatory and statutory requirements.