FALL 2005

Volume I
Issue 2

PUBLIC COMPANY PERSPECTIVES

TAUBER & BALSER

The Changing Role of the Audit Committee

Historically, the Audit Committee has served as overseer, monitor and advisor to company management and outside auditors when conducting audits and preparing financial statements. However, due to highly publicized corporate scandals, Audit Committees have been appointed – via legislation and stock exchange rules – a more significant role, which includes the following responsibilities:

- Ensuring accountability of management as well as internal and external auditors
- Clarifying the roles of all groups involved in the financial reporting and internal controls process
- Gaining input from internal auditors, external auditors and, when needed, outside experts
- Safeguarding the objectivity of the financial reporting and internal controls process

Prior to Sarbanes-Oxley, management had a direct relationship with outside auditors. Now, the Audit Committee is directly responsible for appointment, compensation, retention and oversight of independent auditors, who report directly to the Audit Committee.

With new responsibilities in hand, Audit Committees must be proactive in challenging management and auditors.

"Audit Committees need to shed the 'Don't Rock the Boat' mindset and be willing to push the auditors and the company to address inconsistencies and issues that arise," says **Mark Murovitz, CPA**, Tauber & Balser, P.C.'s managing principal.

Focus Areas for Audit Committees

Risk Reduction. Audit Committees must always be on the lookout for ways to reduce risk, proactively scrutinizing financial records for any misstatements, especially related to new transactions, at the end of accounting periods and the propriety of significant revenue recognition policies. Evaluating risk cannot be a "cookie-cutter" process – each Committee member needs to understand areas of increased risk associated with the industry they are dealing with, and be able to ascertain the nuances of each scenario that arises.

Audit Committees need to shed the "Don't Rock the Boat" mindset and be willing to push the auditors and the company to address inconsistencies and issues that arise.

Resist "Group Think." The term *group think* was coined in 1972 by Irving Janis, to describe a process by which a group can make bad decisions. When group think is at play, individual members of the group tend to conform their opinions to what they believe to be the consensus of the group, which ultimately results in the group agreeing upon an action that each member might independently consider to be unwise. It is crucial that Audit Committees take steps to minimize the effects of group think by

AUDIT COMMITTEES continued on page 4

Tax Tip: Valuation Allowance for Deferred Tax Assets

Future realization of a deferred tax asset cannot be accurately predicted. Therefore, sound judgment must be used to assess the need for a valuation allowance, and all evidence – positive and negative – must be considered. When negative evidence exists, more positive evidence is necessary.

"More Likely Than Not" Test

A valuation allowance is recognized if, based on the weight of available evidence, it is *more likely than not* that some portion or all of the deferred tax asset will not be realized.

Evidence of the deductibility of future amounts depends on the future events of the organization. These events must generate future taxable income of a sufficient amount and nature (ordinary income, capital gains). SFAS 109 lists four possible sources of taxable income to allow for the recognition of a future deductible amount:

1. Future reversals of existing taxable temporary differences. Taxable temporary differences in the same time period give primary evidence of taxable income in a time period.
2. Taxable income in prior carryback year(s) if carryback is permitted under the tax law. Tax law may allow for such a long carryback/carryforward period that the recognition of a future deductible amount may be more likely to occur.
3. Tax-planning strategies that would, if necessary, be implemented to:
   - Accelerate taxable amounts to utilize expiring carryforwards
   - Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
   - Switch from tax-exempt to taxable investments
4. Future taxable income exclusive of reversing temporary differences and carryforwards. These items are evidence of income in a future period.

SFAS 109 limits tax-planning strategies to those necessary to recognize deductible amounts and operating loss or tax credit carryforwards. These strategies must be prudent and feasible – not something a company would ordinarily do, but would do to keep amounts from expiring unused.

SERVICE SPOTLIGHT

Forensic Accounting: Conducting Internal Investigations

The highly publicized problems of Enron, Arthur Anderson, WorldCom and others have increased the scrutiny of all public companies' potential for liability in the realm of employee misconduct. This increasing liability puts greater emphasis on conducting internal investigations.

Types of Fraud Subject to Internal Investigations...

- Related Party Transactions
- Financial Statement Fraud
- Regulatory Compliance

Count on Tauber & Balser, P.C.'s Experienced Internal Investigations Team to...

- Investigate allegations that come from employees, suppliers, customers, government agencies or other third parties
- Work hand-in-hand with outside counsel to investigate allegations raised
- Provide investigation results to management and the board so that an informed decision can be made
- Use forensic methodologies that adhere to stringent professional standards and procedures to investigate, analyze, interpret, summarize and present complex financial evidence

To learn more about Tauber & Balser, P.C.'s Internal Investigation Services, contact:

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COSO Proposes New Guidance for Small-Business Controls

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has released for public comment an exposure draft of its much-anticipated *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting*.

This guidance, which serves as a supplement to COSO's *Internal Control – Integrated Framework,* originally published in 1992, focuses on the unique needs of smaller public companies in regard to compliance with Sarbanes-Oxley (SOX) section 404.

Internal Control Help for Smaller Public Companies

"This guidance will provide relief for small companies that have been trying to use the COSO framework," says **J. Marc Welch, CPA**, a principal of Tauber & Balser, P.C.'s audit department.

The 189-page draft of COSO's new guidance outlines 26 fundamental principles associated with the five key components of internal control: control environment, risk assessment, control activities, information and communication; and monitoring. The report defines each principle and describes its attributes, lists a variety of approaches smaller companies can use to incorporate the principles and includes real-world examples of how smaller companies have effectively applied the principles.

The project task force consisted of approximately twenty members with experience in small business. They brought experience with both small public companies and SOX 404 from within their respective organizations. The task force focused on providing examples that demonstrate how the principle-based *Framework* can be applied to small public businesses.

The new guidance does not change or replace the existing COSO internal control framework – it is intended to clarify how smaller businesses can implement internal control in a more cost-effective way.

"While the control principles addressed in the new document may be applicable to both large and small companies," said COSO chairman Larry Rittenberg, "it was important for us to demonstrate how smaller public companies can implement effective internal control in a different manner than do their larger counterparts. For example, management's hands-on approach in smaller businesses may create opportunities for controls to be less formal without decreasing their quality. Further, the scale of those controls may differ and the opportunity to shift many of the controls from a fixed cost to a variable cost structure may be available to smaller companies."

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The guidance asserts that internal control over financial reporting may be accomplished by choosing approaches to applying the COSO principles that best fit each company's circumstances in the most effective and efficient manner. According to the guidance, smaller public companies may strengthen internal controls by broadening the pool of audit committee members, using controls built into accounting software, leveraging management monitoring, and outsourcing some activities. This new guidance provides a tool for management to use in determining the appropriate level of internal controls over financial reporting for smaller businesses. The document is intended for use by board members, senior management, other personnel and external auditors.

The comment period for COSO's exposure draft ends on December 31, 2005. To download the draft and submit comments, go to www.ic.coso.org. Final guidance is expected in the first quarter of 2006.

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AUDIT COMMITTEES continued from page 1

encouraging the expression of opinions and ideas, and creating a process for looking at all sides of any scenario.

Set up a Sound Charter. Your Audit Committee charter should outline the guidelines for the Audit Committee, and should be reviewed annually at a minimum. The American Institute of Certified Public Accountants (AICPA) recommends that a carefully constructed Audit Committee charter will:

- Delineate responsibilities of the board and those of the Audit Committee;
- Cover important areas such as structure, process and membership;
- Incorporate new legal and exchange requirements;
- Assert the Committee's authority to hire and fire internal auditors and external advisors to the Audit Committee;
- Be regularly refreshed, usually on an annual basis; and
- Be disclosed to shareholders to promote transparency.

The AICPA has a very useful *Audit Committee Toolkit*, which can be downloaded at: www.aicpa.org/audcommctr/toolkitscorp/01.htm.

Control Costs. There needs to be a cost-benefit mechanism in place to weigh the cost of putting any internal controls in place vs. the benefit of that control. The Committee should always look to reduce the risk to the lowest level for reasonable cost.

Ensure Independence. All members of the Audit Committee must be independent, as required by the Sarbanes-Oxley Act. "Independence" means that the member cannot accept any consulting, advisory or other compensation from the company (except for director's fees); or be an "affiliated person of the issuer" or any of its subsidiaries. The New York Stock Exchange and NASDAQ have also proposed stricter independence standards for Audit Committee members.

To learn more about setting up an Audit Committee please contact **Mark Murovitz, CPA**, at (404) 261-7200 or mmurovitz@tbcpa.com.

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