

II. Oversight of Financial Reporting Processes, including Internal Controls

A. Review of Internal Audit Function: Staffing, Resources, Objectivity, Objectives, Scope of Audit Work and Effectiveness

Activity	Objectives	Key Questions	Timing Considerations
<p>Review with representatives of the internal audit function its audit plan and objectives, staffing and other considerations of relevance to its functioning effectively.</p>	<p>Ensure that the internal audit function is properly resourced so as to be able to provide sufficient and timely assurance services with respect to all aspects of the Company's risk management strategy and practices, management control frameworks, and information used for decision-making and reporting.</p>	<p><u>Staffing:</u></p> <p>What are the backgrounds of the internal audit staff members?</p> <p>Is the experience level of the internal audit staff adequate?</p> <p>Is the technical knowledge of the department members sufficient to ensure that duties are performed appropriately?</p> <p>Are there department members with sufficient IT auditing expertise to address the level of technology used by the Company?</p> <p>To what extent is outsourcing used in the internal audit function?</p> <p>What areas are outsourced?</p> <p>To whom are they outsourced?</p> <p><u>Resources:</u></p> <p>Is the internal audit department's size and structure adequate to meet its established objectives?</p> <p>Given the scope of the audit work plan, the individual audits to be performed and the rationale for such audits,</p>	<p>The discussion regarding the internal audit department's staffing, resources, objectivity and scope of planned audit work should occur relatively promptly after the filing of the Company's annual report for the prior fiscal year.</p> <p>On an on-going basis, the audit committee should review with the head of the internal audit function the status and results of the audit work and the internal audit function's effectiveness.</p>

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		<p>does the internal audit staff have the required resources, knowledge and skills needed to complete its work in a timely manner?</p> <p><u>Objectivity:</u></p> <p>Does the internal audit department and its staff appear to be objective as a matter of the head of the internal audit staff:</p> <p>(1) reporting directly to the audit committee?</p> <p>(2) having his or her compensation determined by the audit committee?</p> <p>Does the audit committee have involvement in the determination of the staffing of the Company's internal audit function?</p> <p>What procedures are performed to test and ensure the objectivity of each member of the internal audit staff and the function as a whole?</p> <p>Is there a direct working relationship between the head of internal audit and the internal audit function's staff and the audit committee?</p> <p>What are the internal audit staff's views regarding the Company's controls, the risk of fraud and compliance matters?</p> <p><u>Objectives:</u></p> <p>Is the internal audit staff's work plan based on a risk assessment model that identifies business risks, reflecting</p>	

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		<p>input from line managers?</p> <p>When was the most recent risk assessment completed?</p> <p>Did the risk assessment process give consideration to the Company's strategic and operational plans, goals, planned system changes, previous audit results, and external market conditions (industry, political, technological and economic)?</p> <p>Does the internal audit staff's audit work plan reflect the use of risk scenarios (e.g., fraud risk scenarios) in developing a macro-risk assessment?</p> <p>Does the plan prioritize audit projects, making clear that the areas of highest risk and significance are being addressed?</p> <p>Does the audit work plan identify the expected level of assurance to be provided and the criteria to be assessed?</p> <p>Has the proposed audit work of the internal audit staff been fully vetted with management such that there is agreement that implementation of the audit work plan will provide value-added service to management?</p> <p><u>Scope of Audit Work:</u></p> <p>Does the audit work plan evidence the coordination of the planned work and activities of the internal audit dept. and the external auditors?</p> <p>Does the internal audit staff's audit work plan encompass:</p> <p>(1) reviewing the adequacy and effectiveness of internal</p>	

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		<p>controls established to ensure compliance with corporate governance policies, plans, procedures and business objectives?</p> <p>(2) assessing the reliability and security of financial and management information, and the systems and operations that produce this information?</p> <p>(3) assessing the means of safeguarding assets and, where appropriate, verifying the existence of assets?</p> <p>(4) reviewing the systems established to ensure compliance with applicable laws and regulations?</p> <p>(5) reviewing the risk identification, assessment and management processes and procedures?</p> <p>(6) assessing the production cycle process to identify material and efficiency losses?</p> <p>(7) reviewing the sales forecast process to avoid ineffective production planning and excessive or obsolete inventory?</p> <p>(8) reviewing the adequacy of outsourcing and partnering arrangements and strategic alliances to ensure efficient and effective management of critical supply chain areas and to avoid unexpected business disruption?</p> <p>Does the audit work plan describe the process for follow-up on management commitments arising from earlier internal and external audit work?</p> <p><u>Effectiveness:</u></p>	

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		<p>Does the internal audit staff attend organizational forums held by senior management at which the impact of risks are discussed (e.g., monthly financial review/planning meetings; product development, marketing and advertising impact meetings; project implementation group meetings)?</p> <p>Is the internal audit dept. capturing, managing and sharing its audit evidence and the analyzed data with management?</p> <p>What fraud risks are being monitored by the internal audit staff on a periodic or regular basis?</p> <p>What specific procedures does the internal audit staff perform to address management override of internal controls?</p> <p>Did the internal audit dept. participate in the identification of the key processes supporting the Company's financial reporting and in the training of process owners to identify, document and test the financial controls?</p> <p>What types of reports are issued by the internal audit dept.? To whom?</p> <p>Are the reports issued on a timely basis?</p> <p>Do the reports include sufficient detail to allow for effective action by management or the audit committee?</p> <p>Does management respond in an appropriate and timely fashion to significant recommendations and comments from the internal audit staff?</p> <p>Does the internal audit conduct a "risk watch" service to</p>	

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		<p>monitor emerging issues that might impact the Company (e.g., by reading business and industry periodicals and other data sources to track issues, assessing how those issues may be relevant to the Company, and relating the information to senior management so that action may be taken)?</p> <p>Does the internal audit staff have a periodic “peer review” performed? If so, what were the results of the latest review?</p> <p>To what extent does the internal audit staff keep itself informed about, and involved in, professional activities?</p> <p>Does the department have a continuing education program?</p> <p>What could be done in the future to enhance the internal audit department’s effectiveness and efficiency?</p>	

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B. Internal Control Over Financial Reporting

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<p>Discuss among the members of the audit committee what are perceived to be the most significant or likely risks of inaccurate or fraudulent financial reporting.</p> <p>Also discuss this topic with senior management, business unit heads who report to senior management, the internal audit staff and the outside auditors.</p>	<p>The audit committee should focus on engaging in a top-down assessment of the risks associated with the Company's financial reporting, as part of its assessment of the Company's internal control over financial reporting.</p> <p>As part of this process, the audit committee should consider:</p> <p>(1) the risk factor disclosures included in the Company's periodic reports;</p> <p>(2) the key earnings drivers, including non-financial data, cited in the MD&A disclosure; and</p> <p>(3) the key performance indicators included in internal management reports.</p> <p>The audit committee should discuss amongst themselves (and with the internal audit function personnel) how the Company may be susceptible to fraud, what might motivate management to engage in fraud, how management would do so (including</p>	<p><u>Questions for the Audit Committee Members:</u></p> <p>Are there economic or industry conditions that pose risks to the Company's financial performance, such as:</p> <p>(1) a high degree of competition or market saturation, accompanied by declining margins?</p> <p>(2) rapid changes in technology, which are resulting in product obsolescence?</p> <p>(3) changes in prevailing interest rates?</p> <p>(4) a decline in customer demand?</p> <p>Is the Company experiencing operating losses? Negative cash flows from operations?</p> <p>Is the Company's management dominated by a single person or small group without compensating internal controls?</p> <p>Is the personal financial situation of any member of the Company's management linked to the Company's financial performance as a result of:</p>	<p>The audit committee should undertake the top-down assessment of the Company's internal controls on an annual and on-going basis, with the initial discussions with senior management, business unit heads, the internal audit staff and the outside auditors occurring shortly after the Company's filing of its annual report for the most recently completed fiscal year.</p> <p>The audit committee should engage in equally comprehensive discussions with all constituencies in conjunction with its review of the financial information in the Company's annual</p>

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	<p>through overriding controls), and how the Company's assets could be misappropriated.</p>	<p>(1) significant financial interests in the Company?</p> <p>(2) significant portions of compensation (e.g., bonus, stock options, earn-out arrangements) being contingent on the Company's achieving targets for share price, operating results, financial position or cash flow?</p> <p>(3) personal guarantees of the Company's debt obligations?</p> <p><u>Questions for Senior Management:</u></p> <p>Does the Company's management prepare a Company-wide or business area risk assessment report? If so, how frequently is this assessment updated? Does the assessment include management's specific risk mitigation plans? [The audit committee should be provided with any risk assessment report.]</p> <p>Is management under pressure to meet the expectations of financial analysts that follow the Company's shares as a function of projections or other financial information included in Company press releases or other public communications (e.g., group or one-on-one analyst briefings, business area seminars)?</p> <p>Are there financial covenants in the Company's financing agreements that the Company has only a marginal ability to meet?</p> <p>Is the Company seeking to obtain additional debt or equity financing to fund major R&D or other capital expenditures?</p>	<p>report.</p> <p>At other times during the year, the audit committee's focus should be on:</p> <p>(1) changes in the Company's internal control over financial reporting, and</p> <p>(2) identified significant deficiencies and/or material weaknesses in such control.</p>

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		<p>What is the process by which the design and operation of the Company's internal controls are assessed for purposes of preparing the management assessment report included in the Company's annual report and the CEO and CFO certifications? [The audit committee should be provided with any report generated as part of the assessment process.]</p> <p>How frequently are the Company's code of business conduct and ethics, related policies and procedures updated?</p> <p><u>Questions for Business Unit Heads:</u></p> <p>How much pressure does the Company's senior management put on heads of business areas, divisions or subsidiaries to meet financial performance targets? Are there arrangements in place that will result in these personnel suffering adverse consequences (e.g., loss of incentive compensation) if they fail to meet or exceed budgeted or forecasted results?</p> <p>What are key business unit heads' perceptions of the level of pressure from senior management to meet performance targets?</p> <p>Have any of the key business unit heads been asked by senior management to engage in questionable activities to meet performance targets?</p> <p><u>Questions for the Internal Audit Staff/Outside Auditors:</u></p> <p>Does the nature of the industry or the Company's</p>	

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		<p>operations provide opportunities to engage in fraudulent financial reporting as a function of, for example:</p> <ul style="list-style-type: none"> (1) significant related-party transactions? (2) balance sheet or income statement accounts that are based on estimates that involve subjective judgments or uncertainties that are difficult to verify? (3) the Company's having sufficient market power to dictate terms or conditions to suppliers or customers that may result in other than arm's-length transactions? (4) significant, unusual or highly complex transactions, especially those close to the year or quarter end? (5) significant operations located or conducted outside of the Company's home jurisdiction? (6) significant changes in the Company's or a subsidiary's accounting systems? (8) major structural changes, such as acquisitions or divestitures or down-sizings, that might have affected the effectiveness of internal controls? (9) uncertain tax provisions? <p>Does the Company have a complex or unstable organizational structure involving unusual legal entities or managerial lines of authority?</p> <p>Has the Company taken a proactive approach to reducing</p>	

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		<p>fraud opportunities? What preventative and detective internal controls exist to identify, measure and mitigate such risks?</p> <p>What fraud risks have the Company's outside auditors focused on in their audit procedures?</p> <p>What were the results of the outside auditors' inquiries of management about fraud? Is there cause for concern on the part of the outside auditors as a result of such inquiries?</p> <p>What were the results of the outside auditors' audit procedures to address the risk of management override of internal controls?</p> <p>Is the relationship between management and the outside auditors characterized by:</p> <p>(1) frequent disputes on accounting, auditing or reporting matters?</p> <p>(2) demands on the outside auditors, such as unreasonable time constraints regarding completion of the audit or the issuance of the audit report, that the outside auditors are disturbed by?</p> <p>(3) formal or informal restrictions on the outside auditors that limit access to people or information?</p> <p>(4) attempts on the part of management to influence the scope of the audit work or the selection or continuance of audit personnel assigned to the engagement?</p>	

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		<p>What is the process by which material contract terms and conditions (e.g., provisions that would affect revenue recognition, such as rights of return, cancellation and refund provisions, etc.) are checked and verified against the accounting for the related transactions?</p>	

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C. Review of Procedures for Handling Complaints regarding Accounting, Accounting Controls and Auditing Matters

Activity	Objectives	Key Questions	Timing Considerations
<p>Review, with representatives of the internal audit function, the procedures for handling complaints regarding accounting, accounting controls and auditing matters.</p> <p>Discuss any matters or issues identified with management and with the outside auditors.</p>	<p>Ensure that the Company's complaint handling procedures are working effectively and conform fully with applicable legal requirements.</p>	<p>What concerns are we, as members of the audit committee, informed about? Do they include all concerns regarding:</p> <p>(1) violations of applicable securities laws and regulations?</p> <p>(2) fraud or error in the preparation, evaluation, review or audit of the Company's financial statements?</p> <p>(3) the accuracy or completeness of the Company's financial reporting?</p> <p>(4) misconduct on the part of the Company's senior and financial management personnel?</p> <p>(5) deficiencies in or lack of compliance with the Company's disclosure controls and procedures or internal control over financial reporting?</p> <p>What is the time period between the initial reporting of a complaint and the audit committee's being made aware of it? How often is the audit committee updated as to the investigation of the complaint?</p> <p>Do the Company's employees know about the process for reporting concerns or complaints? How often are communications reinforced?</p>	

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		<p>Do the Company's procedures specify that complaints and concerns are to be reported, and initially screened by, more than one person within the Company?</p> <p>Has the Company established protocols for the timely distribution of each type of complaint, regardless of the mechanism used to report the complaint, to appropriate individuals within the Company and to the audit committee and board of directors, where appropriate?</p> <p>Are complaints of any kind involving senior management automatically and directly submitted to the audit committee without filtering by management or other Company personnel?</p> <p>How, specifically, is the Company ensuring the anonymity of employees initiating complaints?</p> <p>How is an originator of a complaint kept informed of the Company's follow-up action?</p> <p>Are the persons designated to interview the complaining party to get additional information knowledgeable as to accounting matters?</p> <p>Is the initial scope and timetable for an investigation of any complaint designed and documented to evidence that the objective is to obtain a complete understanding of the underlying facts and circumstances and take appropriate remedial action?</p> <p>What steps are taken to secure and preserve documents</p>	

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		<p>and information of relevance to an investigation of a complaint?</p> <p>Are the Company's outside auditors advised of issues raised in any complaint, the scope of the investigation, and the findings resulting from such investigation?</p> <p>Is there an assessment made of the possible need for public disclosure of the matters raised by a complaint, taking into consideration applicable rules of the exchange on which the Company's stock is listed and the materiality of the assertions made in the complaint? Who is involved in that assessment?</p> <p>How long are the documents and materials relating to an investigation of a complaint retained? [Note: suggest a minimum of five years.]</p> <p>Do the Company's communications regarding the complaint handling procedures address:</p> <p>(1) the measures taken to ensure anonymity?</p> <p>(2) how complaints are investigated?</p> <p>(3) how previously reported violations have been responded to and dealt with?</p> <p>(4) how much the Company values those who come forward to report concerns?</p> <p>(5) the Company's non-tolerance of any actions to compromise the anonymity of, or to retaliate against,</p>	

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		<p>anyone initiating a complaint?</p> <p>Does employee training cover topics related to:</p> <ul style="list-style-type: none"> (1) the Sarbanes-Oxley Act? (2) accounting irregularities? (3) insider trading? (4) improper loans to executives? (5) related party transactions? (6) conflicts of interest? (7) the handling of confidential information of the Company? <p>Does the training emphasize that the Sarbanes-Oxley Act makes it illegal for the Company to retaliate against an employee who reports accounting or auditing irregularities?</p> <p>Have the Company's investor relations personnel been briefed as to how to respond to questions from individuals outside the Company regarding the submission of concerns or complaints with respect to accounting or financial reporting matters?</p> <p>For suppliers, is information regarding the submission of concerns or complaints included in the vendor approval</p>	

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		<p>process, in purchase contracts and purchase orders?</p> <p>For customers, is information included in sales contracts, invoices and statements? In the customer service section of the Company's website?</p>	