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Best Practices In Audit Committee Oversight Of Internal Audit

Summary

The audit committee of the board has been a focal point of governance reform in recent years, with heightened attention paid to the integrity of financial reporting, internal controls, and compliance and risk management processes (often the audit committee doubles as the board's risk committee)¹. Audit committee meetings are more frequent, last longer and are more professionally run than in the past, and by all accounts the audit committee has asserted more control over relationships with both external and internal auditors.

Within this context, Moody's views the audit committee's oversight of internal audit as critical to the sound running of an institution. In evaluating the quality of committee oversight of this function, among other areas, we have interviewed more than 400 audit committee chairmen of large U.S. and Canadian companies over the past three years, along with many internal audit professionals. This special comment describes how Moody's views best practices for the role of audit committees in overseeing internal audit.² This comment is part of a series of Moody's reports that describe the benchmarks against which Moody's evaluates the quality of corporate governance within rated issuers as part of determining the effect of governance on those firms' debt ratings (see appendix for other reports).

In Moody's view, the audit committee has five central functions with respect to internal audit oversight:

1. Ensure the audit plan is sufficiently broad in scope and executed in a timely manner
2. Ensure audit reports are actionable and implemented
3. Enable an audit team that is independent, empowered and sufficiently staffed and resourced
4. Promote effective committee functioning, and staff the committee with sufficient expertise
5. Promote an open, transparent relationship with the audit and other control professionals

1. By board, Moody's typically refers to the board of directors. In those jurisdictions with a dual board structure, we refer to the supervisory board.

2. In companies where an audit committee has not been established, we believe a group of independent directors should undertake the roles outlined in this special comment.



#1. ENSURE THE AUDIT PLAN IS SUFFICIENTLY BROAD IN SCOPE AND EXECUTED IN A TIMELY MANNER

In Moody's view, internal audit serves as a critical element of each firm's risk and control framework, working alongside other control functions. It provides an independent and regular validation of the firm's control processes. In order to be most effective in this function, the audit committee should focus on some key issues related to the audit plan:

- *Effective segmentation of the organization.* The audit committee should ensure audit professionals segment the firm into well-defined, reasonably sized, auditable units (often collectively called the "audit universe"). In several cases, Moody's has noticed that auditors defined auditable units so broadly, and with such lack of precision, that it was difficult to determine and prioritize the inherent risks in those units. Even a small business unit will likely have a range of risks, some of which are higher priority than others. By defining a business unit with greater precision, high risk areas are more likely to be identified and audited on a more frequent basis than other parts of that unit. The audit committee should also ensure the audit universe includes, as auditable units, key change processes, such as new systems implementation or merger integration activities.
- *Risk-based audit plan.* The audit plan should be devised with a holistic view as to the nature and significance of risks facing the business, rather than focus solely on financial reporting risks (which are the main focus of the external auditor). The risk assessment should evaluate current and prospective risks, particularly where new risks are emerging due to a change in the firm's strategy or product mix. Moody's believes audit committees should take a broad view of risks, to include, but not be limited to: reputational, operational, financial, legal, information technology and compliance risks. More specifically, from a bondholder perspective, we believe the risks that should drive the audit plan are those that are central to determining the future creditworthiness of the company, many of which are specific to each firm. Once the array of risks is identified, by an auditable entity, the audit team should use a formal process to rank the risks and plan its work accordingly. The audit committee must ensure the audit function does not limit its risk assessment by reference to its own skill-sets—that is, areas of risk should not be excluded from the plan just because internal audit does not have the required set of skills. An effective way to prioritize processes for audit purposes is to look at a matrix of probability of occurrence versus severity of loss for each of the processes and develop a risk-based audit plan according to this classification.
- *Independent view of risks.* The audit committee should ensure that the internal audit group uses intelligence gathered by other functions within the organization, such as risk management or compliance, in identifying and prioritizing risks. However, in devising its audit plan, internal audit should have an independent view on risks, recognizing that its view may differ legitimately (and sometimes markedly) from other functions' perspectives. Similarly, in shaping and approving the audit plan, the audit committee should have an independent and informed view of the key risks and priorities for internal audit. It should also evaluate whether any strong executives outside of the audit function or strong business areas, played a major role in shaping the plan and if so, in what way.
- *Timely and comprehensive coverage.* Many firms have been re-evaluating their audit cycle with a view to determining the timing of audits across a spectrum of risks (often simple rankings are used, such as high, medium and low risk). The audit committee should ensure that the timeliness of the audits, by risk category, is appropriate, and ensure a process is in place to revisit the cycle on at least an annual basis. In Moody's view, for large firms, a full audit cycle of three years generally seems appropriate; that is, the whole organization should be audited in an appropriate manner within three years. High risk areas should be audited at least annually. There will be times where there is some slippage due to the annual re-assessment of the firm's risk profile. However, Moody's takes the view that no auditable unit should go un-audited for longer than four years, because even those areas that are seemingly low risk can create problems (for example, many U.S. companies treated the administration of stock option grants as a low risk process, yet we have seen many U.S. companies fall afoul in this area³). Significant changes in the audit plan should be pre-approved by the audit committee, with clear explanations on how the deferred or cancelled audits will be re-prioritized. The committee should be updated routinely on tactical changes to the audit plan, such as including updates on such changes in routine written communications from the internal audit team.

3. See Moody's *Stock Option-Timing: Scrutiny and Risks Increase*, July 2006 (98494) and *Moody's Stock Options "Backdating,"* June 2006 (97760).

#2. ENSURE AUDIT REPORTS ARE ACTIONABLE AND IMPLEMENTED

The audit function's effectiveness depends heavily on its ability to spot problems or improvement opportunities during its audit work and to facilitate speedy remedial action after the audits are complete. Audit committees should focus on certain aspects of the audit report production and follow-up process:

- *Timeliness of reports.* The audit committee should ensure that audit reports are generated and circulated in a timely fashion after the audit is complete. Any significant delays in the reports-particularly when delays relate to the intransigence of the executives in charge of the audited unit in agreeing to the report-should be communicated to the audit committee chairman in a timely fashion, and to the committee as a whole if the delays continue.
- *Ranking of reports.* We view it as best practice that audit professionals adopt a simple, yet sensible, grading or ranking of their reports, to help users distinguish problematic audit reports from other audit reports. The audit committee should be able to distinguish the various kinds of reports generated from the audit team: (1) highly critical reports where significant remedial actions are recommended; (2) reports that cite deficiencies that need to be corrected, but where the lapses are not significant; (3) reports that are, effectively, a clean bill of health, even though some improvement opportunities are identified. It is important that the audit committee stays abreast of the trends across these various categories of reports. While we would not expect a well-functioning company to generate excessively harsh reports on a routine basis, we believe the committee should question the effectiveness of audit function if it effectively only produces reports that fall into the 'improvement opportunities,' or in other words, the adequate category.

Does the adoption of an audit report ranking system alienate the audit professionals?

Some audit professionals have argued to Moody's that a crude ranking of the audit reports – particularly one that includes the harshest of categories – can alienate the audit team from the rest of the organization and undermine collegiality. While Moody's recognizes this concern, we believe that it is important that weak audit reports be identified clearly so that remedial actions are taken swiftly. The audit committee, supported by senior management, should take a lead role in ensuring that the approach taken to grading reports does not constrain the effectiveness of the audit function within the organization (see the comments below on ensuring the audit function's independence and empowerment).

- *Effective, timely follow-up to reports.* The audit committee should be updated routinely on the progress in executing the audit plan and implementing audit report recommendations. The committee should pay particular attention to: (1) the speedy implementation of remedial actions recommended in highly critical reports; and, (2) delays in agreed implementation plans. Best practice calls for the executives in charge of units that receive highly critical reports or of units significantly delayed in implementing recommendations to present directly to the audit committee on the reasons for the problems and the proposed corrective actions. Significant problems or delays should factor into those executives' compensation, in our view. An important element of the follow-up process is the effective tracking of audit reports and action plans, and where appropriate the integration of this tracking process with tracking processes in other functions (that is, the audit committee should be able to see where a particular unit has a number of action plans in place related to control improvements, not just those attributable to the audit team). The audit committee should determine how and in what manner audit reports and problems should be communicated to its members.

#3. ENABLE AN AUDIT TEAM THAT IS INDEPENDENT, EMPOWERED AND SUFFICIENTLY STAFFED AND RESOURCED

A large majority of companies reviewed by Moody's on corporate governance have increased the manpower and resources available to the internal audit function over the past several years. These enhancements have taken place in light of an increased regulatory focus on audit and internal controls, most noticeably due to Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404"). Moody's generally views upgrades to the internal audit function capabilities as positive, from a bondholder perspective. In approving such enhancements, however, we believe audit committees should focus on some key issues to ensure the additional costs translate into a more effective control environment:

- *Independence of internal audit.* An important feature of the governance reforms of recent years has been enhancements to the degree to which the internal audit function (and, also the external auditors) is independent of management. We believe audit professionals feel more accountable to the audit committee and, as a result, more independent within the organization. Best practices that support greater independence include (see below for comments on independence and the staffing model):
 - Significant committee role in setting and approving the audit function's staffing and budget (with appropriate input from the management team).
 - Periodic benchmarking of the audit function (its staffing, as well as its functioning) with peers and industry best practices. The external auditors often have insights as to improvement opportunities within internal audit, although the committee should also look to other sources to effectively benchmark internal audit. For heavily regulated entities, such as banks, audit committees should seek perspectives on the audit function from their regulators during their periodic interactions.
 - Significant committee role-particularly the chairman-in the audit head's annual evaluation. The committee should review and approve compensation decisions for the head of internal audit and ensure that compensation incentives for audit professionals are not tied to corporate performance. Committee members should play a central role in recruiting a new, or firing an ineffective, head of internal audit.
 - Clarity on internal audit's role in operational risk and pre-implementation control-development matters. There have been some signs in recent years that the internal audit function has been drawn away from its validation/control role towards one more akin to an internal consultant, for example, in identifying operational or cost efficiencies. Moody's believes that this trend creates some cause for concern, particularly if the function loses its focus on its core controls mission and undermines its independence. The audit committee should monitor the function's activities and ensure its independence is not impaired. There are legitimate areas when the audit function should be linked into operational risk or pre-implementation areas:
 - *Operational risk.* A recent trend in many institutions, particularly financial institutions, has been the implementation of an operational risk management framework that depends upon collaboration between the audit function and the operational risk team. This makes sense, as the identification of operational risks can inform the audit process and the feedback from audits is often used in remediation plans. Although Moody's does not see any serious conflicts of interest in such a set-up, it is important for the audit team to focus on its validation tasks and not become implementers of operational risk solutions, which should remain the task of business unit executives alongside the operational risk specialists.
 - *Pre-implementation design.* Internal audit may be asked to provide guidance to line management on those areas where controls should be implemented in the development of new products or new processes. So long as the advice relates where the controls are required, rather than designing of the actual controls, audit's role in this area does not impair its independence, in our view.
- The audit head should report functionally to the audit committee and administratively to either the CEO or a direct report of the CEO. Most often this internal reporting line is to the CFO, but a number of organizations prefer reporting elsewhere, particularly to the legal head (Table One identifies the benefits and challenges of the common approaches).

Table 1: Nature of Internal Audit Head's Administrative Reporting Line

Reporting line to:	Benefits	Challenges
<i>CEO</i>	<ul style="list-style-type: none"> • Unhindered access to CEO; routine attendance at senior management meetings • Signals CEO/top management commitment to quality audit • May be particularly helpful following control or governance problems 	<ul style="list-style-type: none"> • Accountability to audit committee may be constrained
<i>CFO</i>	<ul style="list-style-type: none"> • Provides sponsorship and visibility within the function most focused on financials and the financial reporting process 	<ul style="list-style-type: none"> • Could constrain independence of audit function in auditing the finance and accounting function
<i>Head of legal</i>	<ul style="list-style-type: none"> • Provides some independence from the finance function, which is often the major area that needs to be audited • Facilitates greater coordination with legal – and often compliance – staff 	<ul style="list-style-type: none"> • Chief legal officer may not be conversant in audit work and needs
<i>Head of risk management</i>	<ul style="list-style-type: none"> • Provides some independence from the finance function, which is often the major area that needs to be audited • Facilitates greater coordination with the risk professionals 	<ul style="list-style-type: none"> • Can make the risk organization too burdensome and insufficiently focused • Audit budgets may be squeezed when the risk function requires significant upgrading, e.g. to cope with operational risks • Potential conflicts of interest in the area of operational risks if auditors are seen as implementers of operational risk solutions.
<i>Another functional head, e.g. head of strategy</i>	<ul style="list-style-type: none"> • Provides some independence from the finance and control functions, which are the major areas that need to be audited 	<ul style="list-style-type: none"> • Functional head may not be conversant in audit work and needs • May make coordination with other control or finance functions more difficult

- *Empowerment of the audit function.* The audit committee plays a critical role, together with top management, in communicating the importance of internal audit across the organization. Too often internal audit is not well placed to provide a credible check on management, either due to an asymmetry of knowledge (business unit professionals inevitably know more about the business than audit) or due to the power exerted within the organization by particular business units or business unit managers. Committee members should ensure that they communicate the importance of audit in their communications with employees and that management does the same on a routine basis.
- *Balanced staffing model.* Broadly speaking, we have found that there are two stereotypical staffing models within internal audit: one based on long-tenured audit career professionals and the other based on rotating talented executives from across the organization into the audit function for two or three year rotations. In our view, best practice calls for an ad hoc mix of these models that is adopted to each firm's needs because neither one of the two pure models meets all of the demands placed upon today's audit function. Audit committees should be wary of audit teams that depend too heavily on one of these models. Career professionals have developed the necessary skills and expertise over the years to ensure consistent, professional reports; however, without new additions to the team (preferably, additions without an audit background), consistency can translate into mediocrity as new thinking from outside the audit profession is not considered. Similarly, rotating generalist executives into the function provides them with an opportunity to see different parts of the organization, to apply new thinking and to promote a control culture across the organization as they move back into the rest of the organization. But a high dependence on rotating executives can undermine consistency and limit the degree to which professional audit skills and developing best practices are applied to the audit work. Also, with the rotational model, the audit committee should ensure that the reliance on executives rotating in and out of the audit function does not materially affect the function's independence (after all, those executives are fully aware that they will return to the business lines after their rotation in audit is complete).

- *An effective working relationship between internal and external audit.* Audit committees are tasked with overseeing and directing both internal and external audit and ensuring that the two groups work together effectively. Central to effective coordination is ensuring: (1) the scope of each group is well defined, complementary and not overlapping; (2) the working relationship between the two groups is collegial, respectful, yet independent; and, (3) the two functions meet periodically to discuss key issues openly.
- *Selective use of co-sourcing arrangements.* The majority of companies we have reviewed as to the quality of their corporate governance have highlighted some level of dependence on third party firms for specialist audit skills, be they technical (e.g. information technology), geographic (e.g. overseas operations) or sector-specific (e.g. financial services operations within a corporate). Moody's believes co-sourcing arrangements can be effective and cost-efficient. However, audit committees should question the use of such arrangements when the specialist skills are integral to the firm's audit approach (for example, IT audits are commonplace in financial services firms so it may be more appropriate to have some of those skills in-house and available all the time—that said, for the most technical of IT audits, some co-sourcing may be inevitable). Committee members should ensure they understand how external professionals are integrated into the in-house team. When the co-sourcing budget increases sharply or has been on an upward trend over time, the committee should probe the audit head on the reasons and debate openly the effect on the overall staffing model. (See 'Governance problems with outsourcing internal audit.')

Governance problems with outsourcing internal audit

A significant minority of U.S and Canadian companies outsource internal audit to a third party firm (by which we mean all, or nearly all, of the audit professionals are third party employees). Those companies typically cite several advantages of such an approach: (1) the professionals are more independent as they are not beholden to management for their compensation; (2) it can be difficult to design a robust career path for audit professionals, particularly in smaller companies or those with a limited finance function, which makes it hard to attract and retain high quality audit staff; (3) by using third party firms, the company has access to an array of technical, up-to-date expertise. In cases where a company has experienced significant control or governance failures, it is sometimes prudent, at least in the short-to-medium-term, to outsource the function to ensure its effectiveness in aiding the remediation of those failures.

Moody's believes these reasons are legitimate, particularly in the wake of significant control failures. However, based on interviews with audit committee chairmen, we believe that full or near-full outsourcing brings with it specific governance challenges for the audit committee. These problems include:

- *Limited communication.* The committee may have (or feel that they have) less access to the audit professionals. In many interviews with committee chairmen of companies with outsourced functions, we have found that the level of interaction between those directors and the audit partners is more limited than within the context of an in-house audit function.
- *Less standing.* It can be more difficult for the auditors to gain sufficient standing in the company. External professionals who are not on payroll may find it more difficult to gain standing within the company, particularly when the audit team changes significantly.
- *More limited ability to influence audit team appointments.* While audit committees that are unsatisfied with the quality of the outsourced internal audit team can request that the outside firm make personnel changes, the degree to which the committee controls such changes is far more limited than in the context of an in-house audit team. For example, the committee can maintain full control over the appointment of the head of the in-house audit team, whereas it can only approve or reject the choices served up by the outside audit firm as to the lead internal audit partner.
- *Where budget constraints are in place, audit coverage can be limited.* Outsourced internal audit is significantly more expensive on a per-hour basis than undertaking the function in-house. As such, in a firm that has a fully outsourced approach and which has placed significant constraints on the audit budget, materially less audit work will be undertaken each year—and consequently a longer time period will be required to work through the audit universe.

We believe practices can be adopted to mitigate these problems. The most significant step is the appointment of a full-time, in-house head of internal audit, to whom the outside firm is accountable. Nonetheless, overall Moody's has been somewhat critical of a full (or near full) outsourcing model for prolonged periods. For financial institutions, particularly, we believe several of the arguments for outsourcing are overstated; for example, financial institutions typically have more opportunity to devise attractive career paths for internal audit than corporates, given the array of potential roles in the finance or other control functions. Over the long-term, we believe the inherent governance challenges in the outsourcing approach outweigh the benefits⁴.

4. The U.S. Institute of Internal Auditors recommends that internal audit activity never be fully outsourced, but should be managed from within the organization.

- *Agreed upon role for internal audit in SOX 404.* U.S. companies have taken various approaches to the audit function's role in the SOX 404 process. At one end of the spectrum, the audit function has taken a leadership role in identifying and testing the key internal controls; at the other end, the audit function has been effectively removed from the process, other than reviewing the overall SOX process and testing management's control approach. Both approaches are legitimate (indeed, the latter approach is essential so as to provide the audit committee with an internal, independent validation of the SOX 404 process). The audit committee, however, must ensure the audit function:
 - It is not so involved in SOX 404 that it has limited its ability to execute the agreed upon audit plan (we have heard from many audit committee chairmen that "traditional" audits have taken a back seat to SOX 404).
 - Has sufficient connections with the SOX project team—where it is separate from audit—so the audit team gains early visibility into potential control problems. (Movement of personnel between the SOX team and those undertaking operational audits may also prove beneficial for career development and skills-transfer.)
 - Does not play a role in designing controls and does not become part of the control process itself.

#4. PROMOTE EFFECTIVE COMMITTEE FUNCTIONING, AND STAFF THE COMMITTEE WITH SUFFICIENT EXPERTISE

Demands on the audit committee have increased significantly in recent years. Several years ago, these committees typically met quarterly for perhaps an hour. Today, the typical audit committee meets eight times a year, for three or four hours at a time. There are several key practices that ensure the committees use their time effectively (communication with audit professionals is dealt with separately below).

- *Right-skill the committee.* Almost without exception, boards that say they anticipate recruiting new members in the next two years have cited financial expertise as one of the top priorities in the director selection process. This reflects, in part, the requirement that boards designate at least one "financial expert" on their audit committee, or explain why they have chosen not to do so. Moody's view on what constitutes financial expertise differs somewhat from the Securities and Exchange Commission (SEC) guidance. SEC regulations allow boards to consider all outside directors who are currently supervising or have supervised financial staff, such as any CEO, to be financial experts. In our view, some CEOs have strong accounting or financial management experience but others do not. We see specific and direct experience in areas such as accounting, corporate finance or capital markets controls work as bringing a valuable perspective to the audit committee. Moody's believes audit committees should include more than one member with these kinds of expertise.
- *Ongoing training.* Communication without understanding is of limited value. Increasingly audit oversight requires an understanding of the technicalities of accounting standards, internal controls and compliance practices. Directors should receive ongoing updates on trends in these areas, periodically seeking input from outside advisors and professionals (not just from management, internal audit or the external auditors).
- *Committee independence.* Moody's believes, as do many regulators and investors, that the independence of the audit committee is paramount to its credibility. We believe audit committees should be composed entirely of directors that are clearly independent by a strict definition⁵.
- *Effective preparation.* Moody's believes that the audit committee chairman plays a critical role in the proper functioning of the audit committee. The chairman should meet routinely with the head of internal audit before each audit committee meeting to agree the meeting agenda and review—and when necessary request changes to—the materials that will be circulated to committee members. Best practice calls for a post-meeting briefing with the audit head to debrief on the key issues discussed. The audit committee chairman should hold regularly scheduled meetings (or calls) with the external auditors in between meetings to get their views on audit priorities, issues and problems.
- *Routine executive sessions.* Audit committees should routinely (at least quarterly) meet in private session with: (1) the head of internal audit; (2) the external auditor partner(s); (3) the CFO; (4) the chief compliance and legal professionals; (5) the head of risk management, particularly when the firm does not have dedicated risk committee; and (6) no others present, i.e. alone as a committee. An effective communication process should be established so the committee chairman can relay back to the appropriate managers or professionals any concerns identified in these sessions.

5. Moody's has its own criteria for evaluating director independence, which often go beyond standards adopted by local stock exchanges.

- *Coordination with other committees.* The audit committee chairman should ensure effective communication and coordinated agenda-setting with other committee chairs, as well as the board chairman. This is particularly important when other risk-focused committees have been established, for example, risk or credit committees. Best practice calls for (some) overlapping membership between the audit committee and other risk-focused committees and periodic joint meetings of these committees. Coordination between the audit and compensation committees also is critical; the compensation committee needs to understand what the audit committee considers to be the key areas of financial reporting risk, and the audit committee should have a thorough understanding of executive incentives and goals so that it is aware of management's motivations.

#5. PROMOTE AN OPEN, TRANSPARENT RELATIONSHIP WITH THE AUDIT AND OTHER CONTROL PROFESSIONALS

The support of the audit committee is key to creating an overall culture that promotes decision-making at all levels of the firm that is sensitized to audit matters and the control environment more broadly. This culture feeds from well established business and ethical principles emphasizing openness in communication. Key elements of promoting such a culture include:

- *Tone at the top.* Many directors speak of the "tone at the top" as a key ingredient of a strong, open culture. Moody's agrees. However, it is not very clear that directors have first-hand understanding of the tone across the firm, other than through their interactions with senior executives. In several major corporate governance failures of recent years, boards either did not understand the culture within the organization, including the attitude towards risk-taking, or ignored the culture and instead focused on short-term corporate performance. In our view, it is critically important that directors establish their own lines of communications with employees across the organization, unhindered by the CEO or other executives. These connections provide valuable context for the ongoing dialogue between the audit committee and management as to the firm's culture and approach to controls.
- *Communications with audit and other control professionals.* Audit committees should establish routine, robust and frank lines of communication with the key audit professionals and other executives in key control positions, such as compliance and risk management. Committee members should have direct access to audit professionals and, conversely, key audit professionals should have unhindered access to the audit committee chairman. Communications outside of the official committee meeting process between the audit committee members, particularly the chairman, and the head of internal audit should be direct and frequent.

Related Research

Rating Methodologies

[U.S. and Canadian Corporate Governance Assessment, July 2003 \(78666\)](#)

Special Comments

[Board Leadership: A Positive View on Non-executive Chairs and Lead Directors, August 2006 \(98557\)](#)

[Best Practices for a Board's Role in Risk Oversight , August 2006 \(98545\)](#)

[U.S. Executive Pay Structure and Metrics, June 2006 \(97887\)](#)

[The Downside of Incentive Pay for Directors, April 2006 \(97174\)](#)

[Lessons Learned in Moody's Experience in Evaluating Corporate Governance at Major North American Issuers, April 2006 \(97104\)](#)

[Assessing Corporate Governance As A Ratings Driver For North American Financial Institutions, April 2006 \(97279\)](#)

[Moody's Findings on Corporate Governance in the United States and Canada, October 2004 \(89113\)](#)

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