

## From the Audit Committee **Leadership Network**

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## Comply, Audit, Disclose! New thinking about the role of the audit committee

### Introduction

The Audit Committee Leadership Network held its sixth meeting in New York on September 22, 2004. The theme for the discussion was “Comply, Audit, Disclose! New thinking about the role of the audit committee.” It covered three issues that are significant for members:

- **Non-financial compliance** – beyond checking the box?
- **Internal audit** – what future post Section 404?
- **Disclosure** – is there value in external and internal transparency?

Members also identified other issues they are currently concerned with and that they are likely to return to in future meetings. These issues include:

- Implementation of Section 404 (including complexity and cost, time available for remediation efforts, auditor and regulator definitions of significant deficiency and material weakness, and policy toward disclosure of significant deficiencies)
- Enterprise risk management and the role of the audit committee, including how to define risk
- Pre-approval of audit fees
- Amount of time available for audit committee business
- Nature of audit committee reporting to the full board

The members of the network participating in the meeting, who sit on the boards of about 25 large-, mid-, and small-cap public companies between them, were:

- Mr. Jim Adams, Audit Committee Chair, Texas Instruments
- Mr. Dan Akerson, Audit Committee Chair, American Express
- Mr. Bob Burt, Audit Committee Chair, Pfizer
- Mr. John Clendenin, Audit Committee Chair, The Home Depot
- Dr. Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- Mr. John Ferraro, Vice Chairman, Ernst & Young
- Mr. Gene Fife, Audit Committee Chair, Caterpillar
- Mr. Tom Flannery, Americas Director, AABS Quality, Ernst & Young
- Mr. Roland Hernandez, Audit Committee Chair, Wal-Mart
- Mr. Tom Kierans, Audit Committee Chair, Manulife Financial

*ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record but comments made during the meetings are not attributed to individuals or corporations.

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### Executive Summary

A strong theme that emerged from the Audit Committee Leadership Network's September 2004 discussions was that the audit committee has become increasingly overloaded. One member felt senior management was *"becoming frustrated that the board is not spending more time on the business, as opposed to compliance."*

Members discussed two potential remedies. First, off-load some responsibilities to other standing committees of the board. Second, define the audit committee's role as ensuring that management has the right processes in place for compliance, audit, and transparency – and is implementing them – rather than undertaking the work itself. The specific issues found to be most important to members are highlighted below, with more detailed discussion on the following pages.

- **Non-financial compliance – beyond checking the box?** (Pages 3-6)

Members agreed that the audit committee, and not another board committee, should oversee non-financial compliance. They argue that the audit committee's role is to ensure that management has put the processes and accountabilities in place and is enforcing them: the audit committee should not manage non-financial compliance itself. It is senior management that should enforce zero tolerance of wrongdoing and create a clear linkage between compliance and management compensation.

The audit committee must spend its time on the non-financial compliance issues that carry the greatest risk for the company. Members describe a prioritization process based on the 80/20 rule, which states that 80% of risk can typically be found in 20% of the business or processes. However, they believe management should have a rigorous process for dealing with the detail of non-financial compliance.

- **Internal audit – what future post Section 404?** (Pages 6-7)

Members stated that the internal audit function may be reaching an inflection point in the next 18 months, as the initial work on Section 404 is completed. Audit committees are starting to raise questions about the long-term direction of the function. Some members intend to meet with their internal chief audit executive (CAE) to review mission, program, and resources. Most members also agreed that the audit chair should be more involved in reviewing the CAE's performance.

- **Disclosure – is there value in external and internal transparency?** (Pages 7-10)

Members see little value in transparency for its own sake. They favor disclosing whatever would best help investors make decisions. The challenge is how best to balance useful and important disclosures against disclosures that could aid competitors or cause potential market overreaction.

Members have a mixed reaction to the most recent guidance the Securities and Exchange Commission (SEC) has offered on management discussion and analysis (MD&A) disclosure: FR-72. Some feel it is unlikely to be controversial, as the MD&A rarely contains any information that has not already been shared with investors and analysts.

From the Audit Committee **Leadership Network**

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### Non-financial compliance – beyond checking the box?

Non-financial compliance encompasses different subjects depending on the size and scale of the enterprise, the sector in which it operates, and the activities it undertakes. These subjects can include compliance with government laws and regulations (often environmental regulations and health and safety legislation), contracts, or the corporation's own policies and procedures.

The involvement of the board and board committees in overseeing corporate compliance has been framed by the duty of oversight set out in the Delaware Chancery Court's 1996 *Caremark* decision. This decision held that the full board is protected by the business judgment rule as long as board members take reasonable steps to assure themselves that the corporation has in place a system of financial and legal compliance controls designed to provide accurate financial reports and prevent serious violations of law.

In addition, as a direct consequence of Sarbanes-Oxley, amendments to the Federal Sentencing Guidelines for Organizations are scheduled to come into effect on November 1, 2004. Although the Federal Sentencing Commission has no authority to prescribe a course of conduct, these amendments "now emphasize that significant board involvement in corporate compliance and ethics programs is required to mitigate potential criminal penalties."<sup>1</sup>

It is the New York Stock Exchange (NYSE) listing standards that effectively delegate the duty of oversight to the audit committee. The standards introduced for implementation during 2004 require the audit committee's charter to specify the committee's purpose, which must include a provision to "assist board oversight of ... the company's compliance with legal and regulatory requirements."

#### The buck stops with the audit committee

The question of what role the audit committee should play in non-financial compliance was dominated by concern over the increasing load the committee is asked to bear. One member pointed out, "*The audit committee is overburdened to the point of diminishing or negative returns. Anything nasty goes to the audit committee ... This is a [trend] that is unhealthy.*"

There was concern that shareholder litigation, the legal community, and regulators alike are causing a dimming of the bright line between operational management and corporate governance. "*Frivolous litigation [is] stimulating boards that are [already] doing a good job to intrude on management. [Management has] responsibility; the board has oversight. There is a line.*"

Despite a desire to off-load some of the audit committee's responsibilities, most members agree that the audit committee should take responsibility for overseeing non-financial compliance. They noted that non-compliance can have a material financial impact and could also involve criminal activity, and that "*the audit committee can't hand that off.*" Another member agreed: "*If you look at the major financial hits taken [by the company], by and large they are not financial in origin.*"

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<sup>1</sup> Weil, Gotshal & Manges LLP, letter to clients and friends, July 14, 2004.

## From the Audit Committee **Leadership Network**

Another member suggested the workload would be more manageable if the committee “*cycles the issues in [over the year] and tackles some germane issues at the [full] board itself.*” Another audit chair recommends that these “germane” issues can be dealt with by ad hoc committees that assemble the right board resources and dissolve themselves after they have tackled the issues. One example is the establishment of an asbestos liability committee.

Members felt that non-financial compliance comes close to crossing the bright line between corporate governance and management of the business. This means it is important for the audit committee to define its role (and by implication the role of management) very clearly across three key areas:

1. Reinforcing a compliance culture
2. Prioritizing the issues
3. Supporting management and the chief compliance officer

The role of the audit committee and management in each of these areas is explored in more detail below.

### **1. Reinforcing a compliance culture**

Most experts in compliance management agree that developing a corporate culture of compliance is the first step. “The director’s role in the oversight of a corporate compliance program is vital to its long-term success. The board and senior management must set the right tone at the top, sending the message that ethics and compliance are critical factors in conducting business.”<sup>2</sup>

However, the role of the audit committee in setting the tone at the top is not so clear. Members agree that setting the tone at the top and reinforcing a compliance-oriented corporate culture is the role of senior management. Members recommend compliance activities be tied to business objectives wherever possible in order to embed them in the company’s culture. The CEO is particularly important in establishing expectations directly with each senior leader and then holding them personally accountable. Members discussed important practices for reinforcing a compliance-oriented culture:

- The CEO takes a zero tolerance approach to compliance. One audit chair commented, “*If someone does something unethical, they have got to go. If you allow one person to get by, that radiates through the organization and undermines procedures.*”
- Senior leaders’ compensation is linked to successful compliance. As one audit chair member put it, “*Actions are more important than words. Compensation gets to the core of an issue and impacts behavior.*” One member reported that in his company, the CEO had linked the annual bonus to monthly status reports on compliance. “*This led to a remarkable attitudinal change.*” Members discussed two different approaches to compensation:
  - Negative – docking managers’ compensation for any breaches of compliance
  - Positive – qualitatively evaluating managers’ performance on an agreed set of compliance issues (perhaps using 360-degree feedback)

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<sup>2</sup> Sherrie G. McAvoy, “Building a Culture of Compliance: A Business Imperative for Directors,” *Director’s Monthly*, May 1998.

## From the Audit Committee Leadership Network

- Clear metrics are developed for compliance. Among the suggestions shared by members:
  - Use an enterprise risk management (ERM) approach to set the risk profile for the business and focus metrics on the priority items
  - Develop an ongoing compliance reporting process with criteria that will demonstrate improvement in achieving compliance targets on time and within budget

Members are also clear that the audit committee's role is to ensure that processes and accountabilities are in place and that management upholds them – not to undertake this work itself. However, the importance of linking senior manager compensation to compliance outcomes raises interesting questions about the interdependence of the audit committee and the compensation committee, an issue also raised by members last year in reference to CEO pay.<sup>3</sup>

### 2. Prioritizing the issues

Members advise that audit committee members devote their limited time together to the non-financial compliance issues that carry the greatest risk for the company. Many organizations are still struggling with prioritization. One member suggested the audit committee ask three questions:

- What are the relevant compliance topics the audit committee should oversee?
- What does the audit committee really need to know about those topics? For instance, are there appropriate policies and procedures to reveal any problems?
- How does the audit committee determine that the company has a rigorous approach to compliance?

Members described the way that priorities emerge from dialogue between management and the committee. One member said, *“Management has to do the prioritization. The audit committee has to test and challenge their thinking. Then we jointly own it.”* However, one member was cautious about how this is handled. *“Our most able executives do not have a legal background ... Part of the complexity for us is to educate the most senior managers.”*

Audit committees using an ERM approach tend to prioritize their oversight of non-financial compliance based on an assessment of which risks are most material to their business. The question of relevant compliance topics is often determined by the nature of the business. Members described applying a version of the 80/20 rule: 20% of business will contain 80% of the risk for the company. Even the 80/20 rule has exceptions, however, and one member talked about the need to ensure that the audit committee is immediately informed of any investigation of illegal behavior, anywhere in the business. In cases of illegal behavior, one member declared, *“... you can't use materiality as a measure [for prioritization].”*

However, most members believe management should not use the 80/20 rule and must have a rigorous process for dealing with the granular details of non-financial compliance. One member counseled that even the smallest items of risk can have a major impact on the company. He cited the example of a regulatory body that requires application and approval for the use of certain appliances on site. Such an issue would never be rated high on a review of business risk, but if the company has several hundred such appliances, then that minor risk of non-compliance becomes proportionally greater. This audit chair felt the audit committee itself needs to *“take a rigorous approach to structurally get at the details better ...*

<sup>3</sup> Audit Committee Leadership Network, *ViewPoints*, “Emerging Roles and Responsibilities,” October 15, 2003.

## From the Audit Committee **Leadership Network**

*The board needs to hold people accountable.” Conversely, another member suggested that “it is not a good use of resources. Some things will fall through: So be it.”*

### **3. Supporting management and the chief compliance officer**

An article in the *New York Law Journal* earlier in the year stated that “... the audit committee should be briefed, initially and periodically, on the totality of the company’s compliance systems and procedures, so that the committee members understand and can periodically evaluate the adequacy of the resources being devoted to compliance.” The board is also advised to appoint the senior compliance officer, and the authors suggest that the audit committee may need to meet separately in executive session with the chief compliance officer (or other executive with such responsibilities).<sup>4</sup>

Most members felt this approach blurred the roles of management and the board and they would prefer senior management or the general counsel to appoint the chief compliance officer. One member said, “*Management is responsible for compliance, not the board, which should oversee it.*” They agree that the chief compliance officer should have private access to the audit committee.

Members were also anxious to ensure that the appointment of a chief compliance officer did not undermine the idea that compliance is everyone’s job. One member noted, “*There is a danger in moving too much under the compliance officer. You could be giving managers a free pass and undermining management procedures.*”

### **Internal audit – what future post Section 404?**

Although the Sarbanes-Oxley Act put the audit committee’s reporting relationship with external auditors on a new footing, there was no equivalent change in the committee’s relationship with the internal audit function. One CAE told us the relationship with the audit committee has changed, but said, “*we’ve seen that evolution over time, and it’s not a knee-jerk reaction to Sarbanes.*” Another CAE said internal audit is working with the audit committee in much the same way as always: “*I do not feel like the audit committee is managing our work more closely.*”<sup>5</sup>

#### **Reviewing mission and purpose**

ACLN members now believe the internal audit function has reached an interesting inflection point. As one member put it, “*We are not reviewing their mission and objectives [this year] because of [Section] 404, but in a year or two we need to revisit the fundamentals in light of 404. 404 is a comprehensive assessment embedded into the culture of a company. I don’t think it can be the ‘same old, same old,’ but I’m not sure what should change.*” Another member said that he intended to spend time now with his CAE to review the relationship and check “*that we are operating the way I think we are.*”

Members did not agree about whether a fundamental review of the internal audit function should be carried out by the audit committee or by management:

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<sup>4</sup> Bart Schwartz and Jonathan Freedman, “Audit Committee Oversight of Company Compliance,” *New York Law Journal* 231, no. 14 (2004), <http://www.deweyballantine.com/docs/publications/1838.pdf>.

<sup>5</sup> Audit Committee Leadership Network, *InSights*, “The Internal Auditor’s Perspective,” July 6, 2004.

## From the Audit Committee Leadership Network

- Review by management? One member stated, “you can’t just change the responsibilities of internal audit without impacting other parts of the organization. Management should determine where work is done; the audit committee should determine that it is done.”
- Review by audit committee? Another member said, “Internal audit is different from every other part of management [that the audit committee oversees], because it is the extended arm of audit.”

Either way, members agree the audit committee needs to have a view on the future role of the internal audit function and to discuss this with management. One member said he had changed his mind about the role of internal audit: “As a [senior executive], I used to believe that internal audit should do business improvement work. Now with 404, I think they should focus on internal controls.”

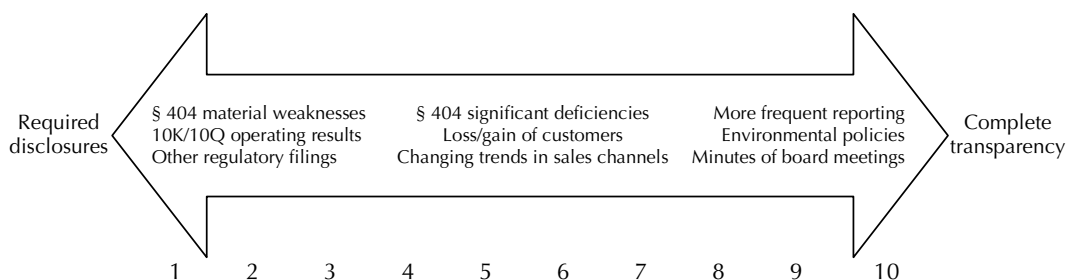
Members are also reviewing how the internal audit function undertakes Section 404 compliance activities. In some cases in which the work has been done in business units, there are questions about whether it should be centralized within the internal audit function in future years.

### Reviewing performance

Members also want to be more involved in reviewing the performance of the CAE. Some use their position as audit chair to take the lead: “I want to sign the performance appraisal with [senior management] ... [to] let all the parties know that the audit committee is involved.” Others want the whole audit committee involved in salary and bonus discussions, as well as in setting the CAE’s performance objectives for the year ahead.

### Disclosure – is there value in external and internal transparency?

Transparency suggests that a company go beyond mandated disclosures. For instance, while companies are required to disclose material weaknesses uncovered in the Section 404 compliance process, they may choose whether or not to disclose significant deficiencies.<sup>6</sup> Figure 1 illustrates a continuum from dealing with nothing but required disclosures through to complete transparency. Members describe their companies operating between four and six on a scale of 1 to 10 and reject the idea of complete transparency. However, members feel that in any case, they “release everything, every quarter, in excruciating detail.”



**Figure 1. Companies have significant latitude in determining disclosure practices**

<sup>6</sup> For more information refer to Question 11 of the U.S. Securities and Exchange Commission’s *Management’s Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions*, <http://www.sec.gov/info/accountants/controlfaq0604.htm>

## From the Audit Committee Leadership Network

### External transparency

Members question the value of transparency for its own sake. Their goal is to disclose whatever would best help investors make their decisions. One member recommended that audit chairs sit in on company conference calls with the analyst community in order to understand what analysts are interested in knowing. Another member commented, *“Of course we should disclose a material event or one that helps investors, but as an investor myself I don’t want to see the sausage being made.”* Members are concerned about potential market overreaction to small and relatively unimportant disclosures. They are also concerned that certain disclosures might aid competitors.

### FR-72 – increasing transparency?

Last December, the SEC provided guidance related to corporate MD&A, stating: “The Commission has long sought through its rules, enforcement actions and interpretive processes to elicit MD&A that not only meets technical disclosure requirements but generally is informative and transparent.” The SEC views transparency as fundamental to the spirit of its mission, even when that fact is not explicitly spelled out in regulation.<sup>7</sup>

The SEC’s current requirements around MD&A are over 20 years old. In order to evaluate their suitability, the SEC reviewed the MD&A of Fortune 500 companies from annual reports filed in 2002. Concluding that the MD&A of too many companies had become unnecessarily lengthy and confusing, the SEC determined in December 2003 that additional guidance was required in four areas:

- Overall presentation of MD&A
- Focus and content of MD&A
- Disclosure regarding liquidity and capital resources
- Disclosure regarding critical accounting estimates

This guidance, known as FR-72, does not modify any existing disclosure requirement, nor does it create any new legal requirement. Rather, it is intended to assist companies in preparing MD&A disclosures that are easier to follow and understand. However, the SEC has said that future MD&A reviews by the Division of Corporate Finance will consider whether companies are following the guidance.

One member reported that analysts frequently drew false conclusions about the company’s revenue stream based on incorrect assumptions about customers and their buying patterns. This member admitted a self-interested motivation in ensuring the accurate market valuation of his business, saying: *“It’s only smart business to be as transparent as you can so you don’t [inadvertently] mislead analysts.”*

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<sup>7</sup> U.S. Securities and Exchange Commission, *Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations*, Release Nos. 33-8350; 34-48960; FR-72, 2003, <http://www.sec.gov/rules/interp/33-8350.htm>.

## From the Audit Committee **Leadership Network**

### **Applying MD&A guidance**

Members discussed a recent article illustrating the concrete steps General Electric Company is taking to apply the SEC guidance to its MD&A.<sup>8</sup>

- Look at analyst presentations, which are usually quite succinct
- Review SEC comment letters, as the SEC often asks insightful questions
- Encourage cooperation of the finance group and lawyers early in the process
- Involve senior management early. GE sets aside a week during which management dives deep into financial statements, notes, and MD&A
- Form a disclosure committee with senior-level people who have knowledge of the various businesses and with people with accounting and legal expertise
- Solicit board input (including both the audit committee and the full board)
- Do an overview. This should not be a summary, but instead should focus on the themes to be conveyed in the MD&A

Members of the Audit Committee Leadership Network have a mixed reaction to FR-72. Most members think FR-72 is unlikely to be controversial as MD&A rarely contains any information that has not already been shared with investors and analysts. One member mentioned that, *“academic studies show the information value of the annual report is negligible. All [material] information has already been released ahead of the annual report and considered in the share price.”*

However, one audit chair said the two or three paragraphs containing forward-looking statements in his company’s MD&A did have value for investors and regularly impacted the share price of the company and its competitors. *“[That section] gets a lot of play, especially as it is vetted by every board member.”*

Members also talked about another SEC attempt to increase transparency, the June 2004 announcement that its comment letters and filers’ response letters related to disclosure filings made after August 1, 2004, will be made publicly available.<sup>9</sup> The SEC commented, “We believe it is appropriate to expand the transparency of the comment process so that this information is available to a broader audience, free of charge.” Members are concerned about certain confidential information included in the comment letter process becoming available to competitors.

### **Internal transparency**

Increasing transparency is not just about better and more accurate communications with external stakeholders. Internally, executives, managers, and board members need a clear and accurate picture of the relationship between disparate company activities and value creation. Unfortunately, many managers have only a vague understanding of how their company creates value. Members believe transparency requires the development of a clear, common language for evaluating performance both inside and outside the company.

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<sup>8</sup> “How GE Applies New Rules for MD&A Disclosures,” *Financial Analysis, Planning & Reporting*, April 1, 2004.

<sup>9</sup> U.S. Securities and Exchange Commission, “SEC Staff to Publicly Release Comment Letters and Responses,” June 24, 2004, <http://www.sec.gov/news/press/2004-89.htm>

## From the Audit Committee Leadership Network

One member talked about the importance of a strong finance organization as the driver of consistency in language and reporting through the company: “*Good internal transparency is driven by the leadership of the financial organization.*” Several members reported that they are involved in projects to improve reporting within their company and to the board of directors. One example is provided below:

**Financial Transparency Initiative.** One member described an extensive initiative designed to simplify and align internal reporting and information flow. “*When I first joined the board I could not find out how the company made its money by product or geography.*” Driven by the audit committee, this initiative involved a Six Sigma team digging into the core of how information was collected and reported over an 18-month period. “*I had no idea how deep or how difficult it would be, but management is delighted by it.*” As a result of the initiative, management is finally able to make decisions based on a single set of accurate, widely accepted financial and operating metrics and reports. “*Now I can drill down to any product or geography and see our investment and return. Now [the challenge is to determine] what do we disclose externally?*”

## Conclusion

Given members’ concern over audit committee overload as a result of Sarbanes-Oxley and their view that the audit committee cannot hand off its responsibilities for non-financial compliance, internal audit, or transparency issues, what does the future hold? Perhaps the only short-term answer, as members suggest, is to define the audit committee’s role as clearly as possible: ensuring that management has the right processes in place, is implementing them effectively, and will be held accountable for the results.

## About this document

The Audit Committee Leadership Network is a select group of audit committee chairs from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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