

The CEO perspective on the audit committee

About this document

The Audit Committee Leadership Network is a group of audit committee chairs from leading 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.

InSights is produced by Tapestry Networks to provide assessments of key issues of concern to audit committees. Initially, *InSights* will be distributed to network members who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

Why the CEO perspective?

Eighteen months after the signing of the Sarbanes-Oxley Act, members of the Audit Committee Leadership Network felt it timely to explore the evolving relationship between corporate senior management, as embodied by the CEO, and the audit committee. Members are looking for insight into how CEOs think about their own role and the role of the audit committee in ensuring good corporate governance, reinforcing the “tone at the top,” and developing an enterprise-wide view of risk.

Tapestry Networks conducted discussions with six CEOs from corporations represented by members of the Audit Committee Leadership Network:

- Glen Barton, Retired Chairman and CEO¹, Caterpillar
- Kenneth I. Chenault, Chairman and CEO, American Express
- Dominic D’Alessandro, President and CEO, Manulife Financial
- Thomas J. Engibous, Chairman, President, and CEO, Texas Instruments
- Joe Galli, CEO, Newell Rubbermaid
- Henry A. McKinnell, Jr., Ph.D., Chairman and CEO, Pfizer

This issue of *InSights* will help CEOs and audit committee chairs determine, among other issues:

- How CEOs can help the audit committee dig deeper into operational issues without crossing the “bright line” into management
- How the audit committee can partner with the CEO to set the “tone at the top” of the corporation
- How the CEO and the audit committee can improve the management and oversight of enterprise-wide risks, and use Sarbanes-Oxley Section 404 to enable value-enhancing initiatives

¹ Glen Barton elected to retire as Chairman and CEO on January 31, 2004, after 5 years in the role and 43 years with Caterpillar.

Executive Summary

- **CEOs need strong relationships with their audit committee based on “trust, but verify”; they welcome the committee’s digging deeper into operational issues** (Pages 2-3)

CEOs believe that Sarbanes-Oxley has not altered their already strong relationship with the audit committee. However, it has created significant incremental demands for audit committee time in the form of “check the box” compliance activities. CEOs believe trust is essential for their relationship with the audit committee to work. However, they broadly welcome the committee’s digging deeper into operational issues. Several CEOs have enhanced the audit committee’s education about the business to facilitate this.

- **CEOs must drive the “tone at the top” of the corporation, and some see the audit committee as a potential partner** (Pages 4-5)

CEOs are clear that it is their role to drive the tone at the top. They see that task as a matter of articulating the values of the corporation and ensuring management and employees have an appropriate sense of accountability. There is less agreement about the audit committee’s role. Some CEOs see the audit committee as an essential partner in setting the tone at the top. Others believe the audit committee either has no specific role to play, or is simply too constrained by lack of time to play a meaningful part.

- **CEOs manage enterprise-wide risk through strategic planning, see Section 404 as enabling reengineering, and want audit committees to broaden their definition of risk** (Pages 5-7)

CEOs feel their role in managing enterprise-wide risk is crucial; they link risk management to their corporation’s strategic planning process. Most welcome Sarbanes-Oxley Section 404 as an “enabling vehicle” for improving risk management, and several have explicitly tied internal controls work to value-creating process reengineering efforts, including Six Sigma programs. CEOs share a broad definition of risk and feel that financial risk (the usual domain of the audit committee) is just one subset of the risks that audit committees ought to address.

CEOs need strong relationships with their audit committee based on “trust, but verify”; they welcome the committee’s digging deeper into operational issues

Well-governed companies have little to fear, or perhaps even to learn, from Sarbanes-Oxley. That is the consensus among six CEOs interviewed by Tapestry Networks eighteen months after the law was signed by President Bush. As one CEO put it, *“In some companies [Sarbanes-Oxley] may have been overdue. In our case, we are simply confirming that we are in compliance, and [it is] not adding a lot of value.”*

CEOs are also clear that Sarbanes-Oxley has not altered their already strong relationship with their audit committee. One, describing his relationship with his audit chair as a mutually reinforcing partnership, told us, *“[He] pushes the company ... to do the right things and play by the rules.”*

Trust, but verify

In September 2003, members of the Audit Committee Leadership Network described their relationship with their CEOs in terms of President Reagan’s dictum, “trust, but verify.”² Speaking with CEOs in February 2004, we again heard that trust is the most important quality in the relationship between the CEO and the chair of the audit committee. One CEO told us that he would find it impossible to serve as a non-executive director if he didn’t have complete faith in the management team’s integrity. However, trust alone is not enough. CEOs recognize that an important role for the audit committee is to act *“as a tool to ensure that what we are doing is what we should be doing, from the management side.”*

Indeed, from the CEO perspective, one unhelpful outcome of Sarbanes-Oxley has been an increase in time-consuming, compliance-oriented “check the box” activities for the audit committee and the CFO. This activity *“detracts from behavioral improvements which are more important than anything else. There is less time to focus on issues where we need to work together.”*

Digging deeper into operational issues

In September 2003, members of the network said they felt empowered to drill down into any area of the corporation they chose, and that their board colleagues would support them.³ In their discussions with us, the CEOs concur. One CEO told us he welcomes the *“more proactive, anticipatory approach rather than the old style of ‘after the fact.’”*

These CEOs have also initiated new practices to educate the audit committee about the “business of the business” – to enable it to dig more deeply. Examples include:

- a seminar series to help committee members understand the whole business and each of its constituent parts, the drivers of each business, the nature of transactions, each business’s market context, the risks each faces, and the role of technology in shaping the business
- increased exposure of operational management to the audit committee, again as an aid to understanding, but also to reinforce accountability within the corporation

However, another CEO is more circumspect: *“It’s certainly true that the audit committee is drilling down further into operational issues, but they must not get into management.”*

Attending audit committee meetings

CEO attendance at audit committee meetings also varies from company to company. Four of the six CEOs we spoke to attend all the audit committee’s meetings. One CEO commented, *“I can’t imagine not attending audit committee [meetings] as CEO. It communicates the importance of the function.”*

However, two of the CEOs we interviewed attend only for specific items, when either they or the audit chair thinks it is appropriate. They were no less respectful of the role of the audit committee.

² Reported in Audit Committee Leadership Network, *ViewPoints*, “Audit committee emerging roles and responsibilities,” October 15, 2003

³ *ibid*

CEOs must drive the “tone at the top” of the corporation, and some see the audit committee as a potential partner

The chairmen of the SEC and the PCAOB have both warned that restoring the investing public’s confidence in SEC registrant corporations will require a shift to a more moral “tone at the top” that also permeates every level, guiding decisions and behaviors. CEOs are clear: It is their role to drive the tone at the top.

Focus on culture and behavior

CEOs believe there is a continuous need to balance their focus on culture and leadership behavior with their responsibilities for compliance processes and policies. All the CEOs we spoke to stressed how important behavior is for good governance. In several cases, they expressed concern that legislation and regulation have put too much focus on checking the box at the expense of real behavioral change. However, CEOs operating in regulated industries are using the need for compliance with regulations to shape corporate culture and influence leadership behavior.

Importance of corporate values

The CEOs we spoke to see their role as articulating the often long-standing values of the corporation, then providing examples of how the values are used in the company and the importance of integrity and ethics. The key, they state, is to ensure management and employees feel accountable for upholding the highest standards of conduct.

Several of the CEOs have created holistic approaches to integrate corporate values into their leadership development and training programs, as well as into the performance review process. Most of the CEOs are obtaining feedback on management’s adherence to those values and ethics through surveys of employees. One corporation determines a large proportion of senior management incentive compensation based on employee survey data on management behavior and its impact on compliance.

Other CEOs have developed a compliance-oriented culture through the use of codes of conduct supported by annual certification for employees and specific training for management.

Role of the audit committee

The role of the audit committee in setting the tone at the top is less clear.

- At one end of the spectrum, the audit committee is seen as the CEO’s partner in setting the tone. One CEO told us: *“I rely on the audit committee to ensure there is no unethical behavior in the system. Their role is to be a guard dog to ensure no one is drifting. That is why it is good to have a very strong leader of the audit committee.”* Another said, *“The audit chair plays a role in bringing a different point of view from management ... In talking to business leaders and internal auditors, they help set the tone.”*
- Wary of encouraging the audit committee to cross the “bright line” into management, another CEO stated, *“There is no role for the audit committee except where we had violations. They need to satisfy*

themselves that we have the right tone at the top. My role is to determine that where there are lapses, we ensure we are reinforcing the culture.”

- Other CEOs believe the audit committee is simply too constrained by lack of time to play a meaningful part. One CEO told us, *“I’m not sure that the audit committee has an opportunity to set the tone ... Most of their time is spent listening. The board can’t set the tone for the company. It has to be people’s actions on a daily basis.”*

Dealing with lapses

CEOs know that no approach is perfect and that there will be occasional lapses in behavior. The challenge is how to deal with those lapses. Several of the CEOs use lapses as an opportunity to reinforce the culture. One CEO reports to the audit committee and shows them how the lapse has been dealt with and how the corporation will ensure that it doesn’t happen again. Another told us, *“When we see deviant behavior, we deal with it ... [Employees] know there is a zero-tolerance policy in the CEO and CFO offices.”* He explained that managers who miss their numbers are helped to deal with the situation, and to understand why the numbers were missed so they are never under any pressure to bend the rules.

CEOs manage enterprise-wide risk through strategic planning, see Section 404 as enabling reengineering, and want audit committees to broaden their definition of risk

The NYSE listing rules do not require the audit committee to be the sole body responsible for risk assessment and management. However, they do indicate that audit committees must discuss guidelines and policies governing the process by which the company handles its exposure to risk.⁴ In the December issue of *ViewPoints*, we reported that members of the Audit Committee Leadership Network believe an enterprise-wide view of risk has to be driven by the CEO. One audit chair we quoted was adamant: *“You need a CEO who really believes in the process. Without that you are in trouble. I would not serve on a board where the CEO was not committed.”*⁵

The CEOs we interviewed feel their role is indeed critical. One had taken the major risks identified in his business and *“teed [them] up in personal objectives approved by the board.”* Another CEO told us, *“Senior management can’t sustain a high level of risk management unless it is a keen interest of the CEO.”* A third CEO felt his role had changed over time, from no involvement in risk management when he started, to today, when *“I spend more time thinking about risk than I could ever imagine.”*

Linking risk to the strategic planning process

As corporations struggle to develop an enterprise-wide view of risk, CEOs are linking risk management to the strategic planning process. Two examples:

- Corporation A has a three-year strategic plan, an annual budget process, and quarterly reviews of every part of the business. These reviews include identification and prioritization of risk. The idea is to

⁴ Final NYSE Corporate Governance Rules 303A.07(c)(iii)(D), <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>

⁵ Audit Committee Leadership Network, *ViewPoints*, “Enterprise risk management,” December 22, 2003

engage the organization in thinking about risk up front. *“The tension caused by having to report what you are doing is a good source of discipline.”*

- Corporation B has a twice-yearly retreat for senior management and key customers at which participants rip the company apart and put it back together again. The major risk they discuss? Forty percent of their revenue in two years’ time comes from products that do not exist yet.

Using Section 404 as an “enabling vehicle” for reengineering

The CEOs we interviewed mostly take a positive view of Section 404 of Sarbanes-Oxley and the link between risk management and internal controls. One told us, *“Section 404 is how you run a company. For a company to survive, you need to have impeccable internal controls.”*

Members of the Audit Committee Leadership Network are debating at what point the cost of Section 404 compliance will exceed any likely benefits. The October 2003 edition of *ViewPoints* stated, “Audit committees and management will need to choose an approach along a continuum from cost containment (the minimum standard needed to comply) to value enhancement (an enterprise-wide view of risk, with a focus on process improvement).”⁶

The CEOs we interviewed appear to have chosen to be closer to the value enhancement view. One told us: *“[Our audit committee] will not implement [Section 404] just for the sake of checking the box. They take a much more rigorous approach, looking beyond the financials.”* CEOs view Section 404 as an “enabling vehicle” for process reengineering, and two of them have already tied internal controls work to “broader systemic process reforms,” such as Six Sigma programs. Another suggested that his corporation would check the box on standard activities, but would also find ways to add value where it is already reengineering – for instance, with the procurement process.

At least one of the CEOs feels strongly that Section 404 does not go far enough: *“Sarbanes-Oxley is not the blueprint for world-class, impeccable internal controls. It is not about complying with rules from Washington, D.C. We use best practices from companies like Colgate-Palmolive, Dell, and GE.”*

Sharing a broader definition of risk

In December 2003 *ViewPoints* reported that members of the Audit Committee Leadership Network have different perspectives on what types of risk should be managed. For some members, reputation risk, for instance, is as important as financial risk. However, other members caution that the audit committee should not lose sight of its primary focus on financial risks.⁷

The perspective of the CEOs we talked with is that financial risk is just one subset of the risks faced by their organizations. One CEO pointed out, *“Brand is one of our most precious assets, so if the audit committee just took a fiduciary view on financial issues, they would be missing a large part of the picture.”*

⁶ Audit Committee Leadership Network, *ViewPoints*, “Audit committee emerging roles and responsibilities,” October 15, 2003

⁷ Audit Committee Leadership Network, *ViewPoints*, “Enterprise risk management,” December 22, 2003

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The CEOs talked about other risks, such as having “*major facilities in interesting parts of the world.*” They also mentioned market, operational, legal, and technological risks, as well as what one CEO called “*value proposition risk,*” which he defined as the risk involved in “*how we demonstrate to people who buy our products, and other stakeholders, that we add value.*”

Conclusion

Eighteen months after Sarbanes-Oxley challenged the framework of corporate governance for SEC registrant companies, the jury is still out. On the one hand, CEOs see an increase in “check the box” compliance activities that may detract from important discussions about corporate culture and leadership behavior. On the other hand, the legislation has caused companies to debate their approach to governance and provided some with an “enabling vehicle” for improved performance in areas such as risk management and the development of world-class internal controls.

In the perception of CEOs, what has not changed in well-managed corporations is the strong relationship between the CEO and the chair of the audit committee. Whether this view is shared by the audit chairs themselves is still part of an ongoing conversation in many corporations. As one audit committee chair commented in a recent meeting of the Audit Committee Leadership Network: “I am asking more questions that are annoying than I used to, or that I would welcome if I were the CEO.” However, this relationship lies at the heart of implementing Sarbanes-Oxley and restoring trust in financial markets. For that reason, both CEOs and audit committee chairs have every incentive to make it work.

The views expressed in this document represent those of the individual CEOs interviewed from leading SEC registrant companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the view nor constitute the advice of members of the Audit Committee Leadership Network, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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