

## Review of audit committee charters

### About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from North America's 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 concise assessments of key issues of concern to audit committees. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view on these important issues.

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 also be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network.

### Why review audit committee charters?

On September 24, 2003, the Audit Committee Leadership Network met in New York. Among the discussion topics, questions were raised about the direction, content, and increasing length of audit committee charters. The audit committee chairs who were present requested a comparison of their charters to determine the similarities and differences among them, and how the charters might evolve.

### How was the review conducted?

The review compared the audit committee charters of nine network members, all of whose companies are listed on the New York Stock Exchange (NYSE). The companies were American Express, Caterpillar, The Coca-Cola Company, The Dow Chemical Company, FedEx, Newell Rubbermaid, Pfizer, Texas Instruments, and Viacom. We also reviewed the National Association of Corporate Directors' Sample Document, pertinent provisions of the Sarbanes-Oxley Act, and the SEC-approved NYSE listing requirements.

Data was compiled to highlight trends and variations, taking into account that there is no comprehensive checklist of items to be found in an audit committee charter. The review can be no more than a snapshot in time. We expect the charters to continue to evolve since most require annual review.



## Executive summary

- **Rules-based approaches dominate** *(Page 2)*

All but one of the charters we reviewed took a rules-based, rather than principles-based, approach. Will the detail in the latest NYSE listing standards make a principles-based approach impossible in the future?

- **Ten core topics are covered by rules-based audit committee charters** *(Pages 3-4)*

The rules-based charters had very similar content broadly grouped around 10 topic headings: Purpose, Authority and Responsibilities, Membership, Financial Statements and Disclosures, Independent Auditor, Internal Auditor, Internal Controls, Compliance/Risk, Meetings, and Organization. More detail is provided on each of the ten topics.

- **Provisions are driven by the new regulatory environment** *(Pages 4-5)*

Sarbanes-Oxley and the new NYSE listing requirements have introduced new roles and responsibilities for audit committees that are beginning to be reflected in audit committee charters. These roles and responsibilities include development of whistleblower policy, review of codes of conduct, pre-approvals, and risk assessment and management.

- **Some emerging best practices?** *(Pages 5-6)*

There are a number of idiosyncratic items that may prove of wider interest to audit committee members, including provisions concerning the number of public company audit committees that a member can serve on, more detail about the relationship between the audit committee and the external auditor, and provisions concerning disclosures by the CEO and CFO.

## Rules-based approaches dominate

At the highest level, an audit committee has to decide whether its charter should take a principles-or-rules-based approach.

- A principles-based charter focuses on overarching objectives for the committee. Detailed responsibilities and tasks are recorded in a separate “checklist,” which does not need to be made publicly available. Some audit committees have been advised by general counsel to provide only high-level principles in their charter to avoid any unnecessary liabilities and subsequent shareholder suits.
- A rules-based charter is more prescriptive, and includes all the detailed responsibilities and tasks of the committee.

In the charters we reviewed, eight of the nine corporations are taking a rules-based approach. The recent SEC approval of the NYSE listing standards may have left audit committees with even less latitude. Even a simple list of required responsibilities and communications will now result in a very detailed charter.



## Ten core topics are covered by rules-based audit committee charters

Although the structure and language of the charters differed, the basic topics covered in each included:

- Purpose
- Authority and Responsibilities
- Membership
- Financial Statements and Disclosures
- Independent Auditor
- Internal Auditor
- Internal Controls
- Compliance/Risk
- Meetings
- Organization

Standards encompassed in the rules-based charters included the following items:

- **Purpose:** The audit committee has responsibility for oversight of the integrity of financial statements, the financial reporting process, and the performance of both the independent and internal auditors. It also ensures the qualifications and independence of the independent auditors. Almost all the rules-based charters also included oversight of the company’s compliance with legal and regulatory requirements.
- **Authority and Responsibilities:** The committee reports regularly to the board and prepares or reviews the audit committee report required by the SEC as part of the annual proxy statement. The committee has the authority to retain outside counsel or other advisers as it deems appropriate to assist in the fulfillment of its functions.
- **Membership:** Members are appointed by the board and must meet the independence and qualification requirements of the NYSE and/or the SEC. The charters are generally explicit regarding the three-director minimum now required by the NYSE listing standards.
- **Financial Statements and Disclosures:** The committee reviews quarterly and annual financial statements and disclosures prior to SEC filing. The committee discusses the results of the annual audit and reviews earnings releases as well as financial information and guidance provided to analysts and rating agencies – discussing these with both management and the external auditor.

With regard to press releases, some of the charters allow for a general discussion of what types of information should be disclosed and what types of presentations should be made, while others require a review of each press release prior to its being issued. A few require both types of discussion. The NYSE listing standards allow for a general discussion, rather than a review of each specific release.

- **Independent Auditor:** The committee has the authority and responsibility to hire or replace the independent auditors and is directly responsible for their appointment, compensation, and oversight. The committee assesses the independent auditor’s independence annually. Most of the charters went further, describing the requirement to obtain and review a report from the independent auditors at least annually describing:
  - The firm’s internal quality control procedures
  - Any material issues raised by the most recent internal quality control review or peer review of the firm, or by any inquiry or investigation by governmental or professional authorities within the

preceding five years regarding the audits carried out by the independent auditor together with any steps taken to deal with any such issues

- All relationships between the independent auditor and the company (to assess independence)

- **Internal Auditor:** The committee discusses the internal audit scope and plans with the internal auditor.
- **Internal Controls:** The committee reviews and discusses the company's internal controls, an area that has been highlighted by the requirements of Sarbanes-Oxley Section 404.
- **Compliance/Risk:** The committee discusses the company's major risk exposures. The type of exposures listed include financial, legal, and regulatory. The discussion may be targeted at one or more of the following parties: general counsel, independent counsel, independent auditors, internal auditors, or management.
- **Meetings:** Almost all the rules-based charters establish a minimum frequency for meetings. For those companies that stated a minimum, most opted for four, with the highest setting a minimum of eight meetings. The committee meets separately on a periodic basis with management, the independent auditor, and the internal auditor, in separate executive sessions.
- **Organization:** Most of the rules-based charters explicitly address the limitations of the audit committee's role and responsibilities. While the language used varies, the charters state that it is not the duty of the audit committee to plan or conduct audits, or to determine that the company's financial statements are complete, accurate, and in accordance with GAAP.

### Provisions are driven by the new regulatory environment

The passing of the Sarbanes-Oxley Act has led to a number of other provisions appearing in many of the charters, including:

- **Establishing a whistleblower policy** with procedures for the receipt, retention, and treatment of complaints received regarding accounting, internal accounting controls, or auditing matters and processes for the confidential, anonymous submission of those complaints by employees with concerns regarding questionable accounting or auditing matters (Sarbanes-Oxley Section 301).
- **Requiring a discussion of the company's code of conduct or ethics.** However, charters varied in the degree to which they involved the audit committee, with some taking no responsibility, others merely requiring the discussion, still others requiring a review of existing policies to monitor compliance, and some actually establishing compliance procedures (Sarbanes-Oxley Section 406).
- **Pre-approving all audit services and permitted non-audit services** to be performed by the independent auditor (including fees and terms). One-third of the charters allow pre-approval to be delegated to a subcommittee (Sarbanes-Oxley Section 201/202).
- **Setting hiring policies** for employees and former employees of the independent auditors (Sarbanes-Oxley Section 206).

- **Indicating financial reporting oversight** responsibility for reviewing and discussing a report from the independent auditor prior to filing an audit report with the SEC. The report should cover:
  - All critical accounting policies and practices used
  - All material alternative treatments of financial information within GAAP that were discussed with management
  - Any other written communications between the independent auditor and management that are material (Sarbanes–Oxley Section 204)

The NYSE listing requirements influenced new provisions in most of the charters, including:

- Considering the effect of **regulatory and accounting initiatives**, as well as off-balance sheet structures, on the financial statements.
- Discussing with management and the independent auditor significant **financial reporting issues and judgments** made in connection with the preparation of the financial statements, including any significant changes in the company’s selection or application of accounting principles, any major issues regarding the adequacy of the company’s internal controls, and any special audit steps adopted in light of material control deficiencies.
- Discussing **risk assessment and risk management** policies. Some of the charters focused on actual exposures rather than policies. The NYSE rules indicate that the committee must discuss guidelines and policies to govern the process by which the company handles its exposure to risk. The rules also confirm that the audit committee is not required to be the sole body responsible for risk assessment and management.

### Some emerging best practices?

The review of the nine charters shone a spotlight on a few distinctive items that may prove of wider interest to audit committee members:

- **Limiting the number of audit committees on which a person may serve.** Charters with such limits have set the total at three public companies. The final NYSE rules state that if a person simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number, then the board must determine in each case that such simultaneous service does not impair the person’s ability to serve effectively and must disclose such determination in the company’s proxy.
- **Adding further responsibilities that impact the relationship with the independent auditor**
  - Requiring a discussion with the independent auditor of any accounting or auditing issues on which the auditor consulted its national office
  - Annually evaluating the senior members of the independent auditor’s team. The final NYSE rules suggest that an evaluation of the lead partner should be included in the annual evaluation of the auditor’s qualifications, performance, and independence
  - Ensuring regular rotation of the independent auditor’s partners as required by law

# InSights

FOR AUDIT COMMITTEE MEMBERS



- **Reviewing disclosures that the Company’s CEO and CFO made to the audit committee** in connection with their certification of the Form 10-K and Form 10-Q about:
  - Any significant deficiencies in the design or operation of internal controls or material weaknesses therein and
  - Any fraud involving management or other employees who have a significant role in the company’s internal controls

*The views expressed in this document represent those of the Audit Committee Leadership Network. They do not reflect the view nor constitute the advice of network members, 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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