

## Audit committee emerging roles and responsibilities

### About this document

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

*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. *ViewPoints* is a synthesis of key issues arising from a facilitated discussion among members of the Audit Committee Leadership Network. It reflects the questions and perspectives of individuals who are charged with helping bring about the new governance environment. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

Initially, *ViewPoints* 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 *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 better it will be for us all.

The Audit Committee Leadership Network held its first face-to-face meeting on September 24, 2003. The discussion focused on the changing roles and responsibilities of chairs and members of audit committees, given the changing expectations of key constituencies: regulators, management, investors, external auditors, and the internal audit function.

The members of the network present at the meeting, representing in all more than 25 large and small public company boards, 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, Quality, Ernst & Young
- Mr. Fred Salerno, Audit Committee Chair, Viacom

*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 attributable to individuals.

## Executive summary

The discussion at the first face-to-face meeting of the Audit Committee Leadership Network on September 24, 2003, focused on the sea change in corporate governance – changing regulations, changing expectations, and changing relationships – and the impact of those changes on the roles and responsibilities of the audit committee. The changes were explored through the relationships of the audit committee with regulators, management, investors, external auditors, and the internal audit function.

Out of the discussion, five key issues emerged as particularly important to network members at this time. Network members are taking different approaches to dealing with these issues, and this diversity is reflected in *ViewPoints*. The five issues are listed below. More detailed discussions of each issue can be found on the following pages. It is our hope that these questions and viewpoints will spark further discussions of value to audit committees, their auditors and, ultimately, to investors.

- **What is the role of the audit committee in setting the “tone at the top?”** *(Page 3)*

SEC Chairman William Donaldson has challenged corporations to shift the “tone at the top.” Network members are adopting a “trust, but verify” approach. Some consider CEO compensation to be a major influence on the “tone at the top,” and within the scope of the audit committee to address.

- **What triggers justify crossing the “bright line” into operational matters?** *(Page 4)*

Reflecting the new tone at the top, members feel empowered to drill down into any area of the corporation they choose. Collectively, members identified thirteen financial, behavioral, or organizational triggers that warrant crossing into corporate operations.

- **What approach to implementing Section 404 is in the best interests of investors?** *(Page 5)*

Members agree that closing holes in internal controls will reduce risk and create value, but they disagree over how much detail is needed for verification and how to maximize the benefit associated with the cost. Responses fall within a continuum from cost containment to value enhancement.

- **How can the relationship with external auditors be strengthened?** *(Pages 6-7)*

The relationship between the audit committee and external auditors is being strengthened to create more trust. Barriers to overcome include auditors’ relationships with management, committees’ lack of time and proximity, and the lack of transparency associated with recent increases in audit fees.

- **What changes are needed in the roles and capabilities of internal audit?** *(Page 7)*

Many corporations are using internal audit to spearhead their Section 404 compliance efforts. This raises the question of whether the right people with the right skills are in place to fulfill that role. Another challenge is having the internal auditor report to the audit committee when his or her career is effectively managed by the CFO.

## What is the role of the audit committee in setting the “tone at the top?”

SEC Chairman William Donaldson has declared that fulfillment of the intent of Sarbanes-Oxley – restoring the investing public’s confidence in America’s corporations – will require a shift in the “tone at the top.”<sup>1</sup> Important questions for audit committees to consider are what tone they seek to set, what responsibility they have to influence the tone, and what actions they should take based on that responsibility.

The recent focus on the tone at the top comes from Chairman Donaldson’s public intention to change “attitude and practice throughout corporate America” by reducing corporations’ “obsession with quarter-to-quarter earnings.”<sup>2</sup> According to Donaldson, a moral tone at the top should permeate every level of the organization, guiding decisions and behaviors.

The discussion among network members suggests the tone among leading audit committees has shifted since Sarbanes-Oxley. Some directors see Sarbanes-Oxley as the catalyst to reform; others see it as a reaction to changes that were already taking place in the wake of the Enron scandal. Yet there is widespread agreement that boards and audit committees have been too trusting and have had inadequate processes for verification.

One member summed up the general view that, “*The culture of entitlement in corporate America is changing.*” The new tone at the top is best described by President Reagan’s dictum, “trust, but verify.”

The threat of litigation and punishment has empowered boards and audit committees to challenge CEOs on a whole range of issues, including compensation. Meeting a week after Richard Grasso’s resignation as chairman of the New York Stock Exchange, members felt this was an issue that had fueled much public mistrust and that plays a major role in influencing the tone at the top.

Members were concerned that even now many corporations have not received the message on CEO pay and continue to erode the distinction between managing and manipulating earnings. This behavior can often be seen at the end of the fiscal year when executive bonuses are triggered by EPS targets.

So what responsibilities does the audit committee have for setting CEO compensation? What should an audit committee do when the compensation committee proposes something that the audit committee believes is contrary to shareholders’ interests? One member commented, “*We must be willing to question the compensation committee report to the board – otherwise we will get more excesses.*”

Many audit chairs believe the audit committee must become more active. They see the audit committee as the committee of last resort for managing risk, including reputation risks. Other chairs are more cautious. They fear if the committee charters are not clear enough, the audit committee will start to get into areas not defined in its charter and that such action will establish a precedent and a liability. Either way, the audit committee should be explicit about its role and responsibility for helping to set the tone at the top of the corporation.

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<sup>1</sup> “Remarks to the National Press Club” by Chairman William H. Donaldson, U.S. Securities and Exchange Commission, Washington, D.C., July 30, 2003.

<sup>2</sup> *ibid*



## What triggers justify crossing the “bright line” into operational matters?

Historically, there has been a “bright line” between audit committees and management – a clear boundary between the oversight role of the audit committee and the operational role of management. Sarbanes-Oxley has changed this relationship.

Reflecting the new tone at the top of “trust, but verify,” members of the network feel empowered to drill down into any area of the corporation they choose, and to have their board colleagues support them. *“We need to be bold enough to ask the dumb questions [of management].”* Some members work by instinct, applying a *“smell test”* to difficult issues. All take a skeptical view of data interpretation until compelling explanations are provided.

The nature of the conversation with senior management and external auditors about the scope of the audit has changed. Many audit committees now drill down more deeply into risk areas and want to understand the scope of procedures being performed in the audit on different lines of business or subsidiaries.

In the collective experience of the network, any one of thirteen triggers might cause the audit committee to cross the bright line and undertake a deeper dive into the operations of the business.

### Thirteen triggers for crossing the “bright line”

#### Financial triggers

- Changes in estimates
- Changes in accounting policies
- Reserves taken or released every month
- Material change relative to historical trend analysis on key financials including balance sheet changes (e.g., inventories and accounts receivable)
- Any disconnect between cash and profitability in the cash flow statement
- An unusually low effective tax rate
- Entrance into any transaction proposed by a banker

#### Behavioral triggers

- Allegations of improper behavior or any litigation, including reports from internal audit, general counsel, and the internal ombudsman
- Turnover in general management in any part of the business or in finance
- A presentation to the audit committee that is too quick, too slick, or too defensive
- *“Any time I am surprised. Surprise is usually the tip of the iceberg”*

#### Organizational triggers

- Poor management attitude towards the internal audit function
- Unique risk areas in specific businesses (e.g., product safety, obsolescence)

## What approach to implementing Section 404 is in the best interests of investors?

In the new world of Sarbanes-Oxley, audit committees are far more accountable to investors than they were in the past. Many see the role of the audit committee as having changed from one of an impartial overseer of financial reporting to one of an omnibus guardian of investor interests. Section 404 requirements for greater transparency and tighter internal controls are at the heart of this change.

Members agree that Section 404 should be considered from the perspective of investors and the ability to create and protect shareholder value. They also agree that closing holes in the internal controls will reduce risk and thereby create value. Where they disagree is over how much detail is needed for verification and when cost exceeds benefit. 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).

- **The cost containment approach**

Some audit chairs expect to do the minimum necessary to comply with the legal requirements and control costs of Section 404. They are unclear on how work on Section 404 will translate into value for shareholders, and consider it an opportunity for audit firms to extract further fees from their clients. One member described the approach of his audit committee: *“We will ... fix the leaky pipes to reduce expenses or capture additional revenues. We can’t look at every item that could be wrong and could be fixed – that would be very expensive.”*

- **The value enhancement approach**

Other audit chairs plan to use the new regulations to undertake a wider review of risk, including reputation risk, and seek ways to create new value for the corporation. They see Section 404 as *“the best section of Sarbanes-Oxley. We were stunned to see all the processes and then to understand them – it was a real eye-opener.”* Activist committees are using the pressures of Section 404 to sponsor full internal process reviews, including non-financial controls, and to develop re-engineering projects. However, chairs of these committees also have concerns. *“What are the limits of reasonableness? Should we drug test every driver in our company? We are not sure on the limits of exposure on operational issues.”*

One question hovering over Section 404 is whether the audit committee will need to have another audit firm attest to the work. Some governance experts believe there is conflict of interest in auditors auditing their own work on Section 404 and have proposed a rule change requiring third-party attestation. However, members of the network are not using third parties and see no need for a change in the rules.

For audit committees looking to the future of Section 404, a useful antecedent may be the experience of the banking industry dealing with FDICIA 112 controls, introduced in the 1990s after several banking scandals.<sup>3</sup> Where Sarbanes-Oxley requires only financial controls, FDICIA controls covered three areas – operations, financials and compliance. FDICIA also led to annual attestation, but that process became fairly routine a few years after implementation.

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<sup>3</sup> Section 112 of the 1991 US Federal Deposit Insurance Corporation Improvement Act (FDICIA) deals with internal controls.

## How can the relationship with external auditors be strengthened?

Since the audit committee now has primary ownership of the audit relationship, many audit chairs feel the relationship between the committee and the auditor must be strengthened to create more trust and transparency. Both auditors and audit committees must work together to adjust to the new environment.

One barrier to the new relationship is the historical mindset held by management and external auditors, many of whom have not yet adjusted to their new role. *“[The external auditors] think they report to management. We try and strike fear into their hearts and manage to get their attention for short periods.”*

One way to overcome this barrier is for audit chairs to be actively involved in the selection process. *“The auditor(s) know that they report to me and the audit committee because we interviewed and selected the partner. It was very clear who was driving the process.”*

Candid dialogue between audit committees and external auditors is critical to offset the lack of time and proximity. Audit chairs report investing more time in open and frank communication with external auditors: *“I speak to the lead partner every week and that has added a new dimension to the relationship.”* Executive sessions have also become more open than before, *“partly because of partner attitudes, partly because of Sarbanes and the change in the relationship.”*

Some audit chairs go a step further, seeking direct participation in meetings between management and the external auditor. *“We look at the Significant Unresolved Differences each quarter. This is a small list by the time it gets to the audit committee. A longer list goes to management and gets narrowed down. As a chair, I want to see the long list, so I go to the [auditor’s] meeting with management. This prompts issues that the audit committee might want to explore.”*

While the level of candor has increased in some areas, audit chairs do not feel it has extended to auditors’ fees. There are significant pricing issues. In the last two years, the number of global audit firms has fallen to four, while auditors’ training costs, legal fees and insurance expenses have all risen. Sarbanes-Oxley has also led to larger audit scope. As noted by one member, *“This is an oligopoly now and we are at their mercy. There is no leverage any more on fees.”*

Against this backdrop, audit committees are struggling with how to determine what is fair pricing. There are two broad approaches being adopted by network members: introducing greater transparency and bidding out audit work periodically. Some members are using both approaches.

- **Introducing greater transparency**

Some network members requested greater transparency in how pricing is determined and suggested developing a set of principles with the audit firm. *“Working on the principles first helped with a potentially divisive situation. [Principles] included the expected profit [margin] on base business, pre-approval processes, and profit margins on other services.”*

Audit chairs also sought earlier involvement in the fee negotiation process to avoid the risk of having to reject an entire plan if it was presented as a fait accompli. *“It is difficult to review the plan. The auditor on site works with the controller on site [in each country and line of business]. It is a budget built from the ground up to the CFO.”*

- **Bidding out audit work**

Some network members are considering the threat of rotation – putting audit work out to bid periodically – as a way of keeping the incumbent sharp and cost-effective. However, those who had been through a firm rotation noted potential difficulties in transition. *“Our transition costs were relatively small but the [cost of the] learning curve is difficult to estimate. The audit firm took a bath for the first couple of years. Letting them know there is a threat out there is good.”*

One argument made against rotation is the need to change all the other arrangements the corporation has made with the other three audit firms in such areas as tax advice, outsourcing, and IT. As one member commented, *“They are all doing significant work for us.”*

### **What changes are needed in the roles and capabilities of internal audit?**

The shift of responsibility for external auditors to the audit committee raises an important question regarding internal audit. In the past, internal audit functions have focused on fairly mechanical, routine operations. The advent of more activist audit committees reporting on risks within the corporation means the work of internal auditors may need to be reoriented.

For instance, should internal auditors have a defined role and competency for internal controls work in addition to internal audits? Many corporations are using internal audit to spearhead their Section 404 work in order to reduce their external audit fees. This raises the question of whether the right people with the right skills are in place in the function to fulfill that role.

The relationship with the internal auditor is also one of the most difficult for audit committees to manage. Sarbanes–Oxley put the reporting relationship with external auditors on a new footing, but it did not spell out an equivalent change for the internal auditor. The challenge is how to get the internal auditor to report to the audit committee when his or her career is effectively managed by the CFO.

*“The internal auditor reported to me when I was a CFO but had direct access to the audit committee chair. The auditor’s career was based mostly on what I thought of [the person]. It is naive to think that the audit committee chair, who sees the auditor 8 to 12 times a year, can be the major evaluator of his or her performance, although the chair should have significant input.”*

However, some audit chairs are using the emerging model for the new relationship with the external auditor to manage their relationship with the internal auditor. *“I work with the CFO to prepare a written evaluation and pay recommendation for the internal audit head. [The head] is interviewed by me and by the audit committee before selection and is the primary management person in charge of the conduct of the audit committee meeting.”*

Members viewed internal audit as a very good launching pad for a career path in the financial organization or in operations, describing the role as *“a window into the whole company.”* Although 20% of Fortune 250 companies outsource their internal audit function (as of August 2003), it was unsurprising, given network members’ views, that none of the corporations represented by them have done so.

Indeed, for the larger corporations, the way in which the internal audit function and its staff are treated by senior management may be used by audit committee members to assess the tone at the top.

AUDIT COMMITTEE LEADERSHIP NETWORK  
IN NORTH AMERICA

# ViewPoints



*The views expressed in this document represent those of the Audit Committee Leadership Network, a select group of audit committee chairs from North America's leading 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 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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