

Audit committees: converging roles, diverging practices?

Introduction

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

The European Audit Committee Leadership Network held its third meeting in Brussels on 22 June 2005. Members explored the theme for the meeting: “Audit committees: converging roles, diverging practices?” while considering the following two topics:

- **Shared responsibility: the relationship between boards and their audit committees**
- **Enterprise risk management and the audit committee**

The members of the network participating in the meeting sit on the boards of about 40 large, mid and small cap public companies. They were:

- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Sir Anthony Greener, Audit Committee Chair, BT
- Mr Jan Hommen, Audit Committee Chair, Royal Ahold
- Mr Daniel Lebègue, Audit Committee Chair, Alcatel
- Mr Tom McGrath, Global Managing Partner, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business, Ernst & Young
- Mr Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Sir Ian Prosser, Audit Committee Chair, BP
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi Universal
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Dr Ronaldo Schmitz, Audit Committee Chair, GlaxoSmithKline
- Dr Manfred Schneider, Audit Committee Chair, Allianz

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 meetings are not attributed to individuals or corporations.

Executive summary

Most members of the European Audit Committee Leadership Network believe the EU Member States are beginning to resemble each other in the corporate governance codes, rules and regulations they adopt. A previous edition of *ViewPoints* reported one member who commented: “Convergence is already underway in Europe. Ninety percent of the content and standards in the individual codes is the same. Benchmarking [between companies] will lead to further convergence”.¹ Where audit committees are concerned, roles may be converging but their practices remain divergent.

Shared responsibility: the relationship between boards and their audit committees

The increased use of board committees that has been identified across Europe is particularly significant in the case of the audit committee, yet very little has been written about the interaction of board committees and the board itself. Audit committee chairs are also concerned about the lack of clarity in roles and boundaries between committees and the full board. Members discussed four potential solutions. These solutions are highlighted below, with more detailed discussion on the following pages:

- **Reporting to the board** (*Page 4*)

There is an emerging consensus around how the audit committee chair reports back to the board. Network members said they have one allocated item on the board agenda: the report on the audit committee’s own meeting. They can also add discrete items to the board agenda for more in-depth discussions. Audit chairs take about 15 minutes (and certainly no more than 30 minutes) for their reports. Members noted that they rarely receive questions on their report from directors who are not on the audit committee.

- **Distributing minutes and other written materials** (*Page 5*)

Most board members are provided with comprehensive minutes of the audit committee meeting and some audit committee chairs rely on these minutes to keep their colleagues informed about audit committee issues. However, there is a wide range of practice – from some companies that distribute all audit committee papers to board members, to other companies that do not even distribute audit committee minutes.

- **Open attendance at audit committee meetings** (*Page 6*)

In most companies represented by network members, board committees allow any non-executive director to attend. Members disagree on the benefits of inviting the chairman of the board and/or CEO to audit committee meetings. Some members believe having the CEO present helps to get line management to take ownership of audit committee issues, such as the importance of embedding internal controls. Other members are convinced they will have a more candid dialogue with business unit leaders presenting to the committee if the CEO is not present.

- **Educating other board directors about audit committee issues** (*Page 6*)

Members take varied perspectives on the need to educate their fellow board directors, who are not on the audit committee, on the complex financial and accounting issues dealt with by the

¹ European Audit Committee Leadership Network, *ViewPoints*, “The future of the audit committee in Europe”, 17 May 2005, page 4. Available for download at: http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May05_View.pdf

committee. Noting that as many as half of a typical board may not have understood the finer points of IFRS conversion, for example, members offered different solutions from funding continuous board education for all directors, through providing specific audit committee-related education, to expecting board members to take care of their own education needs.

Enterprise risk management and the audit committee

Risk management is an interesting case in point for shared responsibility. The precise roles of the board and of the audit committee for overseeing the risk management process – and for discussing specific risk items – are evolving even before the EU 8th Directive on Statutory Audit (which is likely to come into effect on 1 January 2006) starts to influence the practices of audit committees.

Members discussed three aspects of the audit committee's role in risk management. These are highlighted below, with more detailed discussion on the following pages:

- **Identifying and prioritising risk** (*Page 7*)

In developing an effective approach to enterprise-wide risk management, most companies in Europe use their own framework. Network member's companies are no different, either using the COSO framework (Committee of Sponsoring Organizations of the Treadway Commission) or specific national or industry frameworks and sometimes combinations of them. Companies that adopt enterprise-wide risk management methodologies also link risk management processes to their strategic planning and budgeting processes. Some members are sceptical about how effective their company's risk identification process is and cited the fact that recent oil price increases had not been identified in advance.

- **Managing risk** (*Page 8*)

Although all network members are adamant that the management of risk is management's responsibility, there are wide differences in the role of the audit committee. Most audit committees tend to oversee the process of risk management, while the full board discusses individual risk factors. However, in some companies it is the audit committee that discusses risk factors – the emphasis may be on financial risks or all types of risk, prioritising the most material ones. Several audit committees have also taken on the role of reinforcing accountability for risk mitigation by inviting line management to report on progress in audit committee meetings.

- **Disclosing risk** (*Page 11*)

There is continuing debate across Europe about whether it is better to disclose risk factors, or risk management processes, or both. Members who are SEC registrants are generally critical of the SEC's required 20-F (which includes disclosure of a list of risk factors by foreign private issuers) feeling that it has become an anodyne list of business risks developed in order to avoid litigation, rather than to aid shareholder understanding of the business.

Shared responsibility: the relationship between boards and their audit committees

The trend towards convergence on standards of corporate governance in Europe is reflected in the development of board committees. A study on behalf of the European Commission noted in 2002: “The [corporate governance] codes reflect a trend towards reliance on board committees to help organise the work of the supervisory body, particularly in areas where the interests of management and the interests of the company may come into conflict as in areas such as audit...”²

In the network’s second meeting in April 2005, members discussed how some European countries have only introduced legislation and recommendations to establish audit committees within the last few years. This growth is tracked in the latest Heidrick & Struggles survey on corporate governance in Europe which showed: “The audit committee is now found in 94% of companies surveyed (which is an 18% increase over two years and a 68% increase over six years)”³

However, very little has been written on the interaction of board committees and the board itself. One member described how, in the past: *“The audit committee was considered a technical committee and board members were very happy [those issues] were being taken care of. That has changed. New board members have a different sense of responsibility and take acute interest”*.

There is also concern about the lack of clarity in roles and boundaries between committees and the board. One member commented: *“The starting point is to define the role of the audit committee. For instance, we are quite clear that risk is a matter for the board, not the audit committee”*.

The increasing influence of the audit committee detected by members in their April 2005 meeting⁴ led one audit chair to recommend: *“Anyone joining a public company board should insist on joining the audit committee. It is the hub of the non-executive director’s information requirements”*. Even so, another member quipped: *“Members of the board are not interested in joining the audit committee. It is a lot of work and lousy pay”*.

Members discussed four potential solutions to the problem of shared responsibility across the board for the work of the audit committee:

- Reporting to the board
- Distributing minutes and other written materials
- Open attendance at audit committee meetings
- Educating other board directors about audit committee issues

Reporting to the board

Within the network, there is an emerging consensus around how the audit committee chair reports back to the board. One member noted: *“The audit committee chair is really listened to by the board – this [attention] is a commodity you use carefully and make good use of the time”*.

² Weil, Gotshal & Manges on behalf of the European Commission Internal Market Directorate General, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States*, January 2002, page 62.

³ Heidrick & Struggles, *Corporate Governance in Europe: What’s the Outlook?*, 2005 study, page 11.

⁴ European Audit Committee Leadership Network, *ViewPoints*, “The future of the audit committee in Europe”, 17 May 2005, page 3. Available for download at: http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May05_View.pdf

There are two main types of report:

- **General audit committee report.** All network members said they have one allocated item on the board agenda: the report on the audit committee's own meeting. This agenda item is typically open-ended, with several members indicating they can take as much time as they want. Audit chairs take about 15 minutes (and certainly no more than 30 minutes) for their reports.

Typically, the audit chair decides what to present to the board and one member said: *"I have two responsibilities: to bring up recent happenings of a certain importance and to raise things when I believe [other directors] should take part in the conversation"*. Another member commented: *"There is a danger in 'one size fits all'. You have to adjust [your report] to the circumstances of the company and what is needed this year. It could change next year"*.

Members said they rarely receive questions on the audit committee report from directors who are not on the audit committee. One member commented: *"In large boards of multinational companies, you can't expect every member to be interested in every issue. For routine reports, I know who are my specialists and who is peripheral but there are items on which I make sure they are all 'awake'"*.

- **Dedicated items on the board agenda.** Audit chairs may work with the board chairman to add a specific item to the board agenda. These items could include a particular fraud investigation, an update on IFRS or Section 404 implementation status and compliance, or emerging accounting issues, such as stock option accounting. These items often allow for more questions and discussion. One member said: *"It goes to the heart of the audit committee's existence"*.

Some members also serve on boards where they are not on the audit committee and see the audit committee report through different eyes. One member lamented the lack of opportunity for information sharing with the board: *"I want to probe on a couple of things but in a four hour board meeting that has five hours of business [it is difficult]. Do you see the audit committee chair outside the meeting or ask questions in the meeting? Communicating back to the board is not as easy as we say. Are we satisfying individual members' desire to probe more deeply?"*

Distributing minutes and other written materials

Some members rely on the minutes of audit committee meetings to inform their colleagues about audit committee issues. One member said: *"Write good minutes of the audit committee meetings and people can read them and ask questions"*.

There is a wide range of practice within network companies when it comes to distributing written materials:

- Most board members are provided with the minutes of the audit committee. One company prides itself on producing the minutes overnight for the next day's board meeting. Several companies ensure that all directors are kept informed about audit committee items by providing copies of all the written materials prepared for the audit committee.
- In at least one company, no audit committee minutes or related written materials are shared: *"We don't send the minutes to members of the board, only to the executive chairman. My report to the board is 15-20 minutes and nobody has asked for a copy of the minutes"*.

Open attendance at audit committee meetings

In most companies represented by network members, every board committee has open attendance and several members described this as key to increasing their non-executive colleagues' comfort with complex audit committee issues. In some cases: *"Very few people attend the audit committee"*. In other cases: *"Many attend audit committee meetings and that leads to delicate interaction with the chairman of the board"*.

Members disagree on the benefits of inviting the chairman of the board and/or the CEO to audit committee meetings. Some members feel that *"the audit committee would be poorer"* if the CEO were not present. Those members believe that having the CEO in attendance helps to get line management ownership of audit committee issues, such as the importance of internal controls: *"The CEO needs feedback on the things we want him to do"*.

Other members are concerned that if the board chairman and/or the CEO are present, the meeting could become more like a board meeting and prefer to work closely with them after the audit committee meeting so they can prepare for the board meeting. These audit chairs also think that if subsidiary leaders are presenting to the audit committee, which has considerable merits in enabling the committee to check that the tone at the top is represented in the next layer down and to assess leadership strength in-depth: *"You will get a fresher view if the CEO is not there"*.

Educating other board directors about audit committee issues

Members take varied perspectives on the need to educate their fellow board directors who are not on the audit committee on the complex financial and accounting issues dealt with by the audit committee. Noting that as much as half the board may not have understood the finer points of IFRS conversion, for example, members offered a range of solutions:

- **Board requires that directors undertake continuous education.** One member noted: *"Training sessions are very useful for each of us to gain knowledge and see what is new in accounting standards and risk management. We need to train again and learn again"*.
- **Specific audit committee-related education is provided.** One member described how: *"We do twice-yearly updates on IFRS to the whole board with a separate discussion away from a board meeting. Pretty much everyone turns up"*. Another company provides a one-day update on new accounting principles for all board members and a summary paper goes out to those who could not attend. Another example of best practice is the selection of a financial expert for the board and audit committee: *"An embedded financial expert can challenge financial management on [matters like] IFRS and that is a big advantage"*. Other members report that technical education is provided across a whole range of topics to enable directors to understand the business of the company.

In boards with co-determination⁵, trade unions often provide education for the board's trade union and employee representatives. One member commented: *"It is not our task to bring them up to date. They know their responsibilities and should take action if necessary"*.

⁵ Co-determination is the practice whereby trade union or worker representatives are given seats on a company's board of directors.

- **New directors take responsibility for their own education.** One audit chair said: *“My approach to life is that if people are selected for a board, they are grown-ups and can help themselves. I only help people who ask for help”.*
- **No training is required.** One member said: *“[Having enough understanding to contribute] applies to all decisions at board level. You are there to make the final decision at the end of an orderly process. As long as the audit processes are working, the board can follow the audit committee’s lead”.* Another member joked: *“My advice is if you join a board, make sure your colleagues have better knowledge and understanding of financial matters than you”.*

Enterprise risk management and the audit committee

A number of factors have combined to bring the topic of risk management to the fore: complex global operations, high-profile risk management failures and increased regulatory attention. In order to fulfil their duties to shareholders, board directors must have a comprehensive understanding of their companies’ business risks. Yet risk management in Europe is still evolving. In some countries and companies, risk management is little more than a perfunctory board discussion of insurance and exposures. In other companies, risk management has become a complex internal function of the company with its own staff, resources and processes.

The drive to improve risk management in Europe may receive a boost from the proposed EU 8th Directive on Statutory Audit, which is due to come into effect on 1 January 2006. The directive states that the audit committee should monitor the effectiveness of the company’s internal control, internal audit (where applicable) and risk management systems.⁶

Members discussed three aspects of the audit committee’s role in risk management:

- Identifying and prioritising risk
- Managing risk
- Disclosing risk

Identifying and prioritising risk

In developing an effective approach to enterprise-wide risk management, most companies in Europe use their own framework. A survey by Ernst & Young for the Federation of European Risk Management Associations (FERMA) in 2004 stated: “The vast majority of respondents (78%) have defined their own risk management policy”. The survey went on to point out that “risk management standards (FERMA) and internal audit frameworks (COSO⁷) are not yet widely known”.⁸

Network members also use different frameworks. One company uses a combination of COSO plus risk evaluations of the annual business plan. Another company in the UK uses a framework combining the

⁶ Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC, Commission of the European Communities, Brussels, 16 March 2004.

⁷ Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management: Integrated Framework, Executive Summary*. Available for download at http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf

⁸ Key results and major trends prepared by Ernst & Young for the Federation of European Risk Management Associations, *Risk Management: An assessment of European practices in 2004*, FERMA 30th anniversary seminar, 5 October 2004, page 8. This presentation is available at the following web address: www.ferma-asso.org/Calendar%20of%20events/Seminar%202004/Survey/RM%20Survey2004%20FERMA%20EY%20AXA%20-%202005oct2004.pdf

Turnbull Report⁹ and a specific industry framework. (See the Appendix on page 12 for illustrations of the FERMA and COSO frameworks).

Regardless of the framework used, the first step for any company is to identify the enterprise-level risks to its business. Some members are sceptical about how effective their company's identification process is. One audit chair said: *"If you analyse the content of our risk report a year ago you will find no information on the oil price hike. We write risk management reports but the best risk management is an excellent board of directors"*.

Several of the companies represented in the network are pursuing a holistic approach in the form of enterprise risk management (ERM), a methodology that views risk in the context of business strategy rather than looking at individual hazards. ERM frameworks differ in their details but all take a portfolio approach to managing enterprise-wide risks, allocating priority status to critical risks within that portfolio. One member discussed how: *"The strategic plan devolves to an annual plan and then we evaluate the risks that could stop the plan being implemented. These risks are kept under review and new risks are brought to the board. The audit committee oversees process, the board evaluates risk"*.

Sources of enterprise-wide risk identified in discussions with members include internal and external financial and non financial risks, such as: acquisitions, climate change, credit, environmental, ethics, fraud, geopolitical, information technology, health and safety, litigation, market position, operations, piracy, reputation and social attitudes.

Once a company has developed a comprehensive understanding of its material business risks, it must classify those risks and determine their relative priority. Most frameworks prioritise risks according to three attributes: the probability of the risk occurring, the potential frequency with which it may occur and the likely severity of its impact on the corporation. In order to focus the board's attention on the most important risk areas, management will sometimes present a list of risks with a rating system – for instance, traffic light colours – to indicate the degree of risk. The board or the audit committee will then focus on red and yellow risks. One member said: *"Any red or yellow flag has to be approved by the independent directors in the committee. It is group management that decides on the colours"*.

While some boards review risk issues at multiple points throughout the year, others discuss risk in just one or two meetings each year. One member said: *"The board reviews risk at the time of accepting the annual budget and in the six-month review"*.

Managing risk

The complexity of today's environment is leading many enterprises to take a more systematic, integrated and holistic approach to managing risk. The emphasis on ERM frameworks is indicative of this trend. Regardless of whether or not the company adopts ERM, the board must answer a few key questions:

- What is the process for managing business risk?
- Who owns that process? How is success measured?
- How do you balance shareholders' need for value creation with their need for risk management?

⁹ The Institute of Chartered Accountants in England & Wales, *Internal Control, Guidance for directors on the Combined Code (The Turnbull Report)*, September 1999. The report is available at the following web address:
http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_6342&tb5=1&CFID=3904647&CFTOKEN=57577984

At a meeting in December 2003, members of the North American Audit Committee Leadership Network felt strongly that an enterprise-wide view of risk has to be both embraced and driven by the CEO. One US audit chair 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”.¹⁰

The E&Y survey for FERMA showed that, for most companies in Europe, it is executive management that drives risk management – although in 9% of cases the audit committee takes this role.¹¹ One member described how the audit committee “...together with internal audit reviewed all the businesses and determined the risk parameters with management and set targets. Then we do risk-based internal audits. Business plan presentations to the board include risk evaluations and committees are delegated to deal with them”.

Another member described a decentralised risk management process in his company: “In a good company with a good culture, risk management is embedded [in the business] and is a line management responsibility. The subsidiary CEO is accountable for having the right processes in place. The audit committee can monitor this and ensure that management is bringing risk management together to review [risk] enterprise-wide”. A third member pointed out the difficulties that arise out of a decentralised approach: “The problem in decentralised organisations is the consistency of definitions, materiality and aggregation. How do you trigger a red light? How do those risks then get aggregated and rise up the group chain?”.

Managing risk: the role of the audit committee

The International Organisation of Securities Commissions (IOSCO) set out principles for corporate governance, including the responsibilities of the audit committee. These include: “to review the company’s internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems”.¹² For SEC registrants, the New York Stock Exchange listing rules indicate that audit committees must discuss guidelines and policies for governing the process by which the company handles its exposure to risk.¹³

However, continuing to expand the audit committee’s oversight role beyond the integrity of financial statements and the financial reporting process will require more time from directors who are already coping with a significantly increased workload. Although all the members are adamant that risk management is management’s responsibility, there are wide differences in the role of the audit committee:¹⁴

- **Oversight of the risk management process.** Audit committees with some risk responsibility tend to oversee the process of risk management. One member explained that his company’s risk and compliance oversight committee reports to the audit committee, is chaired by the chief

¹⁰ Audit Committee Leadership Network in North America, *ViewPoints*, “Enterprise Risk Management and the audit committee”, 22 December 2003, page 6. Available for download at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Dec03_View3.pdf

¹¹ Key results and major trends prepared by Ernst & Young for the Federation of European Risk Management Associations, *Risk Management: An assessment of European practices in 2004*, FERMA 30th anniversary seminar, 5 October 2004, page 11.

¹² Organisation of Economic Co-operation and Development Steering Group on Corporate Governance, *Survey of Corporate Governance Developments in OECD countries*, November 2003, page 71.

¹³ *Final NYSE Corporate Governance Rules 303A.07(c)(iii)(D)*, <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>

¹⁴ See also European Audit Committee Leadership Network, *ViewPoints*, “The future of the audit committee in Europe”, 17 May 2005, page 5. Available for download at: http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May05_View.pdf

compliance officer and has each business unit represented on it. The audit committee and the board assess the performance of the committee and check that the process is functioning effectively.

- **Oversight of financial risk only.** The emphasis for some audit committees is on financial risks. One member said: *“Risk is delegated to the audit committee on the financial side and [another committee] does health and safety and environmental risk. As audit committee chair, I talk to the other committee chair to coordinate our agendas to cover all the issues”.*
- **Oversight of all material risks.** Other audit committees are involved in all types of risk but tend to focus their time on material ones. One audit chair said in his company: *“Risk management is a standing agenda item for every audit committee meeting. We look at a specific risk area and over the course of the year we cover all the areas”.* Another member reported that in the financial services sector, audit committees may spend half their time on risk management: overseeing the process and tools, reviewing the portfolio of risks and investigating deficiencies.
- **Reinforcing accountability for risk mitigation.** Several audit committees are used to reinforce accountability for risk factors. One member described how the committee receives a *“hit list of risk items”* from the internal and external auditors. The list is discussed every meeting: *“We will also haul in anyone who misses. This forces the business units to take it seriously”.* Members agree that reinforcing accountability is particularly important if the company is in a crisis situation. One member said: *“The audit committee chair can become a full time job when you are trying to dig the company out of a difficult situation”.*

Regardless of the role taken by the audit committee, members felt that successful risk management was dependent on *“...transparency and confident relationships between the CFO, internal auditor, external auditor and the chairman of the audit committee. The relationship among these four parties is key”.*

Managing risk: the role of the external auditor

In most European countries, external auditors cannot undertake risk management work for their audit clients without contravening independence rules. However, in Germany the external auditor has to testify that there is a risk management process in place and that it is effective. Management of risk factors falls to the management board, but the audit committee also has a role to check that a risk management process is in place. In France, the external auditor has to report on the board’s internal control report. In other countries, members say they are simply *“...thankful for what we get [from the external auditor] but don’t expect anything”.*

Many risk experts believe that auditors will need to become more involved in the risk management effort in the future. One reason is that involvement in the attestation of the management assessment of internal controls, such as Sarbanes-Oxley Section 404, will almost certainly lead to involvement with risk management. One member said: *“Many audits are not control-oriented but are balance sheet-oriented. Sarbanes-Oxley has brought the profession back to internal control auditing”.*

Some members report that greater involvement by the external auditor has already started: *“We have the head of a division and the audit partner [for that division] sit across the table and talk about risks and how they are complying with local culture”.* Another audit chair commented: *“We look to the external auditor [to identify] faults in the planning process and for the audit plan to be based on risk areas. We need to ensure that materiality is covered. [The external auditor] should step back from immaterial issues and deal with those on a rotational basis”.*

Disclosing risk

From 1 January 2005, the EU Directive on Accountancy and Accounting Standards (2003/51/EC) came into effect. This directive sets out annual reporting requirements for EU companies, including risk reporting. The text says: “The annual report shall include at least a fair review of the development and performance of the company’s business and of its position, together with a description of the principal risks and uncertainties that it faces”.¹⁵ Disclosures do not “concentrate on risk factors and market risks, but comprehend forward-looking information on corporate risk exposure covering risks of all categories”.¹⁶

There is continuing debate across Europe about whether it is better to disclose risks, or risk management systems, or both. Germany is widely considered to have the toughest standards for risk management reporting as part of the annual report to shareholders (German Accounting Standard, GAS 5). However: “Empirical evidence from Germany implies that risk disclosures just slightly improved after explicitly obliging firms to report on their risks”.¹⁷

The SEC also requires foreign private issuers to complete a 20-F which includes the disclosure of a list of risk factors, preferably prioritised. Members are critical of the format with one member commenting archly: “*The 20-F says it is dangerous to do business and it is dangerous to live*”.

Conclusion

Audit committees’ roles and practices are evolving. In the Members States of the EU, regulation is driving a pragmatic convergence of corporate governance standards using a principles-based approach of comply or explain. For audit committees, the convergence of roles is driven by a combination of regulation and best practice benchmarking and is likely to be matched by considerable divergence of practice based on national laws and customs, corporate cultures and board leadership style. How individual companies share responsibility between the board and the audit committee reflects this divergence of practice.

The role of the audit committee in risk management is a prime example. At a minimum level, the audit committee should ensure that management has put in place an effective risk management process that works. At the level of best practice, the audit committee may also have oversight of particular risk factors and use its authority to reinforce accountability through the management hierarchy. It is critical for audit committee chairs to exercise their leadership role and determine where they want to stand along this spectrum of practice.

¹⁵ The full text of the directive can be found at http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_178/l_17820030717en00160022.pdf

¹⁶ Michael Dobler, *How informative is risk reporting? – A review of disclosure models*, Munich Business Research, January 2005, page 1.

¹⁷ *ibid*, page 20.

Appendix: Illustrations of two ERM frameworks

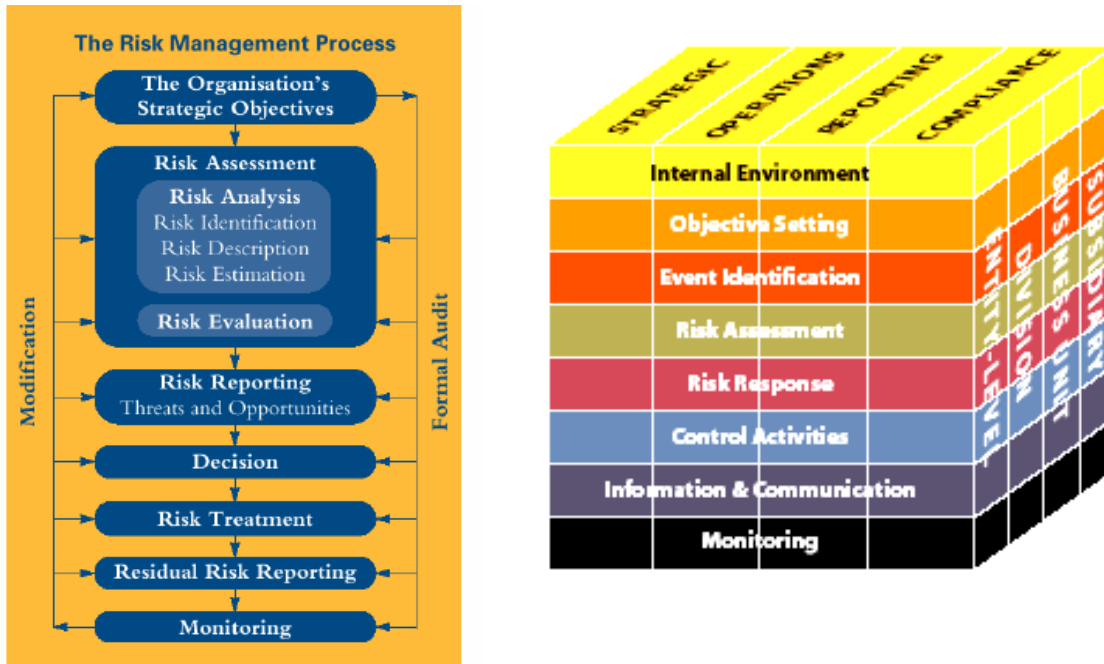


Figure 1. Illustrations of FERMA (left) and COSO (right) risk management frameworks.^{18,19}

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, their advisers and auditors, as they endeavour to fulfil their respective responsibilities to the investing public. ViewPoints is a synthesis of key issues arising from discussions among members of the European Audit Committee Leadership Network. 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, advisers and auditors who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European Audit Committee Leadership Network, a select group of audit committee chairs from Europe's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

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¹⁸ Key results and major trends prepared by Ernst & Young for the Federation of European Risk Management Associations, *Risk Management: An assessment of European practices in 2004*, FERMA 30th anniversary seminar, 5 October 2004, page 4.

¹⁹ Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management – Integrated Framework*, Executive Summary, September 2004, page 5.