



## **Four lessons for audit committees from high-profile accounting scandals**

### **Introduction**

On February 21, 2007, members of the European and North American Audit Committee Leadership Networks met to discuss issues that are currently shaping their roles as audit committee chairs. Members exchanged views on key issues, including the competitiveness of capital markets, the future of financial reporting, and the global role of the Public Company Accounting Oversight Board (PCAOB), in a series of candid dialogues with guests.<sup>1</sup> They concluded the day by discussing lessons learned from the accounting scandals of the early 2000s. For further information about the networks, see "About this document," on page 9.

Members focused on four major lessons:

- 1. Companies need independent audit committees with deeper financial expertise**
- 2. Audit committees need to see the company through the eyes of others**
- 3. A strong and objective internal audit function must be a priority**
- 4. Audit committees must be attentive to all aspects of the external audit process**

Network members participating in the meeting included:

- Mr. Tom de Swaan, Audit Committee Chair, Royal Ahold and GlaxoSmithKline
- Mr. Per-Olof Eriksson, Audit Committee Chair, Volvo
- Mr. Gene Fife, Audit Committee Chair, Caterpillar
- Sir Anthony Greener, former Audit Committee Chair, BT
- Ms. Marie Knowles, Audit Committee Chair, McKesson
- Mr. Daniel Lebègue, Audit Committee Member, Alcatel-Lucent
- Mr. Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Mr. Oscar Munoz, Audit Committee Chair, Continental Airlines
- Mr. Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Sir Ian Prosser, Audit Committee Chair, BP
- Dr. Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr. Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services
- Mr. Sandy Warner, Audit Committee Chair, General Electric Company

The members listed above sit on the boards of nearly 60 large-, mid-, and small-cap public companies between them. Members from Ernst & Young participating in the discussion included:

- Mr. Tom Flannery, Americas Director, Audit Committee Communication
- Mr. Steve Howe, Americas Managing Partner
- Mr. Tom McGrath, Managing Partner, Northern Europe, Middle East, India, and Africa Client Service

*ViewPoints* reflects the networks' 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.

<sup>1</sup> Audit Committee Leadership Summit, "Enhancing trust and competition in global public capital markets," *ViewPoints*, April 6, 2007. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Summit\\_View1\\_Apr07.PDF](http://www.tapestrynetworks.com/documents/Tapestry_EY_Summit_View1_Apr07.PDF).



## Executive summary

High-profile accounting scandals in the early 2000s brought to light a number of reporting deficiencies sufficient to destroy hundreds of billions of dollars of market capitalization. The fact that these deficiencies went unchecked by audit committees has served as a lesson to audit committee chairs the world over.

During the summit meeting, members reviewed four short case studies on Enron, Parmalat, WorldCom, and Royal Ahold. [Case studies can be found in Appendix 1, starting on page 10.](#) Network members reflected on how the role of the audit committee has evolved and how its key relationships have been transformed. The four lessons drawn from the scandals are highlighted below, with more detailed discussion on the following pages:

### **1. Companies need independent audit committees with deeper financial expertise** *(page 3)*

Mainland European members noted that one result of the accounting scandals was the establishment of formal audit committees. In the United States, where audit committees were already in place, the committees became more involved and proactive. Both Europeans and Americans agreed that the accounting scandals led to changes in the behavior of audit committee members, who now bring a healthy degree of skepticism to the committee table. Members agreed that financial expertise is valuable on the audit committee, but they also feel diversity of expertise helps strengthen it.

### **2. Audit committees need to see the company through the eyes of others** *(page 5)*

The audit committee is often expected to have a deeper understanding of the financial reporting process and how a company makes money than the rest of the board. To gain that depth of understanding, the audit committee must develop better networks within the company. Members believe it is important for the audit committee to spend time with the company's operations and sales staff to assess the company's culture. Members also believe that it is important to ask what outsiders are saying about the company. In addition to research reports from analysts, sources of outside information include the external auditor, who can provide comparative data on the accounting principles used in an industry, and the company's directors' and officers' (D&O) insurance provider, who has access to software-based analytics developed for comparative insurance risk.

### **3. A strong and objective internal audit function must be a priority** *(page 6)*

Members see the internal audit function as an important asset of the company in the prevention and detection of fraud. Several members said that due to internal audit's importance, they spent more time on the internal audit plan than the external audit plan. Members have also been focused on upgrading the quality of the internal audit staff.

### **4. Audit committees must be attentive to all aspects of the external audit process** *(page 7)*

Members indicated that their relationship with the external auditor has improved over the last five years. They believe that digging into the detailed scope of the audit plan and good communication with the lead audit partner are important, but they cautioned that it is impractical for the audit committee to manage that relationship day-to-day. Members are also turning to their external auditor for more advice on risk management.

# ViewPoints

FROM THE AUDIT COMMITTEE  
LEADERSHIP SUMMIT



## What changes made over the last five years have had the most positive impact on investors?

- The creation of a mandatory audit committee and using that committee as a link between external audit and management. *"We're more accountable, we have more responsibility, and we're more independent."*
- The determination of the audit committee to bring a healthy level of skepticism to its work. *"Ask questions; be proactive. That is what came from the accounting scandals."*
- More engagement among audit committee members. *"A recalibration of the relationship between the audit committee and management. We were receivers of reports, listeners at meetings, accepters of agendas, and wise when asked. Now we have equal weight; we're asking questions and not waiting to be asked."*
- Increased independence of the internal and external audit functions. *"We've increased the independence and qualifications of both internal and external auditors, especially internal."*
- An improvement in the consistency and quality of financial reporting. *"Our companies give more simple, rapid, and accountable information to shareholders."*
- The fact that those involved in the high-profile scandals have gone to jail. *"It emphasizes that this is not a make-believe process."*

## 1. Companies need independent audit committees with deeper financial expertise

Since 2002, countries have enacted legislation and listing exchanges have changed their requirements regarding corporate governance in an effort to prevent the sorts of fraud embodied in the corporate scandals of the early 2000s. In the United States, the Sarbanes-Oxley Act has had a substantial impact on how audit committees work. In Europe, the EU, various listing exchanges, and national governments have all strengthened their requirements for audit committees. For an overview of audit committee regulations affecting countries represented by network members, see Appendix 2, on page 14.

### A convergence of approach between Europe and the United States

Mainland European members noted that in Europe, one effect of the accounting scandals was the establishment of formal audit committees. One European audit chair said that *"the introduction of the audit committee to serve as a link between external audit and management"* was the most significant change in corporate governance in the last five years in mainland Europe. Another European audit chair said that the *"biggest development has been the requirement to have independent directors,"* a significant change from the days *"when the CEO would pack the board [and thus the audit committee] with friends."* For their part, American members noted that audit committees, already an established element in U.S. corporate life, became more involved.

Both European and North American audit chairs agreed that the accounting scandals led to the strengthening of audit committees, not just through legislation or regulation, but also through the changed focus and



behavior of audit committee members. Several members stated that one of the keys to success as an audit committee was to bring a healthy degree of skepticism to the committee table: *“Ten years ago, the definition of a good audit committee meeting was that it was short and had no surprises. The main focus was on hammering the auditor on fees and was relatively non-substantive. But now we’re far more engaged, which has also led to higher expectations of our performance.”*

### **The definition of financial expertise**

Sarbanes-Oxley stipulates that the audit committee’s “financial expert” have a minimum, defined level of financial expertise.<sup>2</sup> Additionally, many European governance codes require an audit committee to have a member who possesses what the UK code calls “recent and relevant” financial experience. In practice, results vary widely. According to a November 2006 global study by Ernst and Young, 69% of audit committees have two or more financial experts.<sup>3</sup> However, another 2006 global study of listed companies showed that “37% of audit committee financial experts appeared to have neither an accounting nor finance background.”<sup>4</sup>

A common element in many of the high-profile accounting scandals was the lack of true expertise on audit committees. Audit chairs who sat on the boards of companies in the same industries as the companies in the case studies agreed that the scandal-ridden companies’ success was hard to believe. One member said, *“We all knew the business models were too good to be true. Now there are people who want to know where, why, how, when, etc.”*

All members agreed that financial expertise is valuable on the audit committee, with one noting that *“it is very important to know where the numbers are coming from ... you need that knowledge.”* Another member commented, *“We needed to get an expert on the audit committee due to all of the complexity. His specific expertise was very important.”* Another member expressed the opinion that the key to a strong audit committee is diversity in expertise: *“If you have five accountants on the audit committee, you’re headed for disaster. You need different ways of looking at a company, so diversity is key.”*

Members are divided on whether the chair of the audit committee needs to be a designated financial expert:

- **Audit chair should be a financial expert.** One member said, *“The chairman [of the audit committee] should be the financial expert because if [the chair] can’t ask the right questions, who can?”* Another member, supportive of the idea that the chair should be a financial expert, nevertheless cautioned, *“I pushed to have two financial experts on the committee because all the other members relied on me too much when I was the only one.”*

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<sup>2</sup> SOX Section 407 requires that a financial expert have (1) an understanding of generally accepted accounting principles and financial statements; (2) experience in both (A) the preparation or auditing of financial statements of generally comparable issuers and (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves; (3) experience with internal accounting controls; and (4) an understanding of audit committee functions.

<sup>3</sup> Ernst & Young, *Audit Committee Perspectives: 2006 Audit Committee Survey and Industry Insights* (New York: Ernst & Young, 2007). Available at [www.ey.com/global/download.nsf/Luxembourg\\_E/Audit\\_Committee\\_Perspectives\\_06/\\$file/EY\\_Audit\\_Committee\\_Perspectives%202006.pdf](http://www.ey.com/global/download.nsf/Luxembourg_E/Audit_Committee_Perspectives_06/$file/EY_Audit_Committee_Perspectives%202006.pdf).

<sup>4</sup> Huron Consulting Group, *2006 Audit Committee Research Report* (Chicago: Huron Consulting Group, 2006), 4. Available at [www.huronconsultinggroup.com/uploadedFiles/Huron\\_AuditCommReport%20Email%20Version.pdf](http://www.huronconsultinggroup.com/uploadedFiles/Huron_AuditCommReport%20Email%20Version.pdf).

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LEADERSHIP SUMMIT



- **Audit chair need not be a financial expert.** Other members felt that the chair should not be required to be the financial expert: *“It’s very important to have people on the audit committee with executive responsibilities. Pulling all this stuff together is an executive skill. Many CFOs don’t have it.”*

## 2. Audit committees need to see the company through the eyes of others

Members reflected on both the board’s and audit committee’s relationship with management. In the five years since the scandals broke, boards of directors and audit committees have become more independent of management. One member commented, *“The tone at the top is where it all starts, and the job of a director is real. Passive directors aren’t good. This is a job. Even great cultures need monitoring.”*

Members discussed a growing trend for directors to become more engaged in understanding how the company works. One member mentioned a board that sends its directors out to specific country operations to evaluate the company’s management and then has the directors report back to the full board. Another member noted that in one company, there is a process whereby *“[board] members will spend the day with an employee, doing the work. It gives us a good sense of what is going on [at] the grassroots.”*

### Oversight by walking about

Members of the audit committee are often asked to develop a deeper understanding of the financial reporting process and how the company makes money than other board members. One member noted that *“other members of the board are looking to [the audit committee] to be their proxy.”*

Gaining a deeper understanding of the company often means developing better networks within the company. One audit chair talked about *“digging down and talking to people further down in the organization. You can see if the story down there is the same one that’s being told in the boardroom.”* Many audit chairs already do this with the finance organization and the internal audit function, but some network members reported that they also spent time in the field with sales representatives to understand the conduct of the business and to hear what customers say about the company.

Most members feel that it is important for the audit committee to get out into the company to assess its culture. One member commented, *“I am not smart enough to pick up on the culture of a company just from looking at statistics. I need to get a pulse.”* Another suggested that the accounting scandals *“have encouraged us to walk around with our coffee cups to get a sense of what is going on.”*

However, one member cautioned, *“There are some board members who have lots of time and also have outdated knowledge, and they just want to hold court. That does not add a lot of value. You need ‘management by walking about’ – go meet people, see a lot; it helps with your questioning. But it needs to be for the right reason.”*

### Collaboration with the compensation committee

Members of audit committees are also looking more closely at how executive compensation practices, influenced by the pressures of quarterly reporting in the capital markets, can negatively affect management behavior. One audit chair said, *“Compensation is a big issue. You need to know how the variable basis for*

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*compensation is constructed and audited properly.”* Members believe that tackling this issue, which is both a reputation and fraud risk factor for a company, will require a much closer working relationship between the audit and compensation committees.

## **Independent and comparative financial data**

Several members agreed with one audit chair that *“it’s also very important to have access to different information – financial-analyst notes, studies by audit firms, etc. It’s important to receive all this information and understand all the accounting questions. You can’t work exclusively with management reports.”*

Before the summit, one member recounted the practice of *“seeing comparisons of all sorts of metrics with our competitors’ [metrics]”* at every audit committee meeting. The member said this was extremely useful because *“if something were out of kilter, we would see that at every meeting, and we would ask [about it].”*

Members agreed that it was important to ask what outsiders are saying about the company and noted that audit committee members should have access to research reports written by equity and industry analysts. In addition to reports from the analysts, members suggest:

- Asking management for benchmark data from across a variety of sectors to gain better insight into how the company is doing.
- Asking the external auditor for comparative data on accounting principles in the industry.
- Contacting their directors’ and officers’ (D&O) insurance provider to gain access to software-based analytics developed for comparative insurance risk.

## **3. A strong and objective internal audit function must be a priority**

Members see the internal audit function as an important asset of the company in the prevention and detection of fraud: *“They are the ‘belt and suspenders’ [belt and braces] of an organization.”* Specifically, members view internal audit as an integral tool of the audit committee. In several European countries, there has been increased emphasis on developing objective internal audit functions. One European audit chair noted, *“Internal audit is now a major corporate function in our country.”*

Subsequently, several members said that they spent more time on the internal audit plan than they did on the external audit plan. One member commented, *“The internal audit scope is much broader.”* Another member said internal audit *“used to be at the back of the agenda and didn’t get as much time as necessary. Now it’s at the beginning of the agenda and usually takes about one to one-and-a-half hours.”* There is also a focus on upgrading the staffing of the internal audit function: *“We have substantively increased the standard. Their quality has gone up considerably.”*

Members anticipate that the PCAOB’s proposed Auditing Standard No. 5 (AS5), which may replace the current Auditing Standard No. 2, will allow the external auditor to rely more heavily on the work of the internal auditor, encourage the upgrading of internal talent, and permit more choices in how to use internal audit. One member commented, *“[The proposed] Auditing Standard 5 will drive the role choices home because it is explicit on [external audit’s] reliance on internal audit.”*



Members acknowledged that the duties of internal audit vary. Some companies use internal audit purely for financial audits and work on internal controls – *“ongoing work focusing on internal control deep dives”* – while others may add risk management or operational audits to the internal audit mandate. Some companies are attempting to combine work on internal controls with operational audits: *“Internal controls [are] embedded in operations, and [internal auditors] coach management [on implementing internal controls through operational audits].”*<sup>5</sup>

#### 4. Audit committees must be attentive to all aspects of the external audit process

Prior to the summit meeting, an expert who helped put together one of the case studies commented, “The audit committee chair should evaluate the scope of the audit. You should go back and do a zero-based budget with last year. What kind of changes have occurred? Have we bought something or sold something? The scope is [always] different [from year to year]. It’s not anyone’s favorite thing to do, but [audit chairs] probably should dig into the details of the audit.”

However, most members were against this idea: *“Why go back and reinvent the wheel? If you have strong internal audit and management who are good and that you trust, and you are working to manage the relationship between the external auditor and management, why get involved?”*

Network members believe that the audit plan should take into account changing business conditions, but remain broadly consistent from year to year – for practical reasons. One member said, *“It is totally impractical to do [a zero-based budget]. I think as long as the scope of the audit work is being paid attention to, then it shouldn’t be necessary.”* Another member noted that continuity is important to company staff and the audit team: *“Continuity is key, and starting from scratch is not the best way to capture hearts and minds. We lay out a three-year plan around those critical processes. Don’t shift the goalposts.”*

Members did identify two scenarios in which zero-basing the audit plan might make sense:

- **Company in crisis.** One member said *“[A zero-based audit plan] isn’t overkill when the company is in crisis mode.”*
- **Audit committee member rotation.** Another member noted, *“There is a good opportunity for change when the audit committee [membership] changes.”*

One member pointed out that it was important for the external auditor not to *“treat the audit plan discussion as a check-the-box exercise, but [as] a really informative discussion with the audit committee.”*

Members indicated that their relationship with the external auditor had improved over the last five years. The Sarbanes-Oxley Act and legislation in certain European countries hold audit committees responsible for

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<sup>5</sup> For further discussion of members’ views on internal audit, see European Audit Committee Leadership Network, “The future of internal audit in Europe/Tax governance,” *ViewPoints*, October 31, 2005 (available at [www.tapestrynetworks.com/documents/Tapestry\\_EY\\_EuroACLN\\_Oct05\\_View5.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_EuroACLN_Oct05_View5.pdf)) and Audit Committee Leadership Network in North America, “The future of internal audit,” *ViewPoints*, November 6, 2006 (available at [www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Nov06\\_View15.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Nov06_View15.pdf)).

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compensating the external auditor, but as *ViewPoints* has previously reported, “The audit committee is typically more involved in providing input to audit plan scope than in negotiating audit fees.”<sup>6</sup>

Regarding whether the audit committee or the board should manage the relationship with the external auditor, one member commented, “*It is totally impractical for the board to manage the relationship with the external auditor.*” Members do see an important role for the audit committee, however. One member pointed out that audit chairs can proactively “*communicate with audit partners, to discuss how they want things and really [make] sure that all the parts are working as a unit,*” but added that the company’s finance organization, not the audit committee, must handle day-to-day interactions.

Members expect the external auditor to push back both on the finance organization and the audit committee. One member commented, “*I want a brave auditor.*” Another said, “[*The audit committee and external auditor*] often have disagreements, and [*the external auditor isn’t*] afraid to say so.”

Network members are also turning increasingly to their external auditor for advice on risk management. One member said, “*Our external auditor has been doing a better job communicating risks as part of our audit plan. We have a planning meeting where the concurring [or reviewing] partner comes in. Then we have another meeting again about halfway through [the year] to get an update.*”<sup>7</sup>

## **What changes made over the last five years have had the least beneficial impact on investors?**

- The requirement for increasingly complex securities disclosures. “*Increasingly, the number of investors able to comprehend our financial statements is limited. We have to devote lots of time to financial disclosures. Regulators should really rethink this demand for complexity.*”
- Section 404. “*I think directionally it’s been correct – it’s allowed us to take care of a lot of deferred maintenance. It just got overdone.*”
- The U.S. regulatory environment. “[*U.S. regulations have*] gone from good to really bad; there is pressure on the SEC to look after the universe. That is the true tax we are paying.”

## **Conclusion**

There is no doubt that the transformation of the legislative and regulatory environment has dramatically impacted the role and status of the audit committee. However, audit committee members have also taken to heart the importance of their own behavior in the effective working of the audit committee. The days of boards and committees packed with friends of the CEO have passed, replaced by questioning, engaged directors with an extensive workload. Both the regulatory response and the change in audit committee behavior reflect the lessons learned from the high-profile accounting scandals of the early 2000s.

<sup>6</sup> Audit Committee Leadership Network in North America, “Maximizing the value of the audit and the external auditor,” *ViewPoints*, December 9, 2005, 2. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Dec05\\_View10.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Dec05_View10.pdf).

<sup>7</sup> For further discussion of members’ views on external audit, see European Audit Committee Leadership Network, “The future of accounting and the accounting profession,” *ViewPoints*, November 14, 2006 (available at [www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Euro\\_ACLN\\_Nov06\\_View11.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Nov06_View11.pdf)) and Audit Committee Leadership Network in North America, “Maximizing the value of the audit and the external auditor,” *ViewPoints*, December 9, 2005 (Web address given above).

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## About this document

The Audit Committee Leadership Networks in Europe and North America are groups of audit committee chairs drawn from leading global companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

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

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## Appendix 1: Four case studies of high-profile accounting scandals in the United States and Europe

### 1. Enron: the failure of an apparently robust corporate governance system

Perhaps the most egregious and devastating of the financial scandals at the beginning of the decade was at Enron. Once the seventh-largest company in the United States by market capitalization, Enron's value was almost completely destroyed in the wake of the scandal.

While members of senior management were convicted of or admitted to committing criminal offenses, the audit committee was astonishingly oblivious to the fraud being perpetrated. Obvious fraud red flags that Enron's audit committee consistently overlooked include:<sup>8</sup>

- **Management's over-optimistic news releases with respect to earnings.** Management consistently touted incredible earnings growth, yet the audit committee never saw the need to address earnings management.
- **Aggressive accounting practices.** Enron's use of "mark to market" accounting for certain investments was well out of the ordinary for an energy firm, but the audit committee didn't question the use of such aggressive tactics, despite warnings from Arthur Andersen partners that the tactics being employed were high risk.
- **Rapid growth.** Enron's revenues grew by 150%<sup>9</sup> in just one year, which should have raised doubts in the minds of audit committee members. Earnings growth was even more incredible and was the direct result of transactions with special-purpose entities that were approved by the board.
- **Blatant conflicts of interest.** The board was aware of, and even signed off on, several exceptions to employee codes of conduct, specifically to allow Enron's CFO to take personal financial stakes in private equity funds that bought Enron assets.
- **Poor internal controls that were poorly overseen.** According to the U.S. Senate Committee on Governmental Affairs, "evidence indicates that ... controls [to mitigate the CFO's conflicts of interest] were poorly designed and implemented."<sup>10</sup> The audit committee, which was also in charge of ethics enforcement, never followed up with management to make sure internal controls governing the CFO's participation in special-purpose entities were actually working appropriately.
- **Tolerance of lack of independence of the internal and external auditors.** Arthur Andersen provided both internal and external auditing services to Enron at the same time. The audit committee

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<sup>8</sup> The list of red flags is adapted from Louis Braiotta, "Audit Committee Responsibilities: Lessons from Enron," <http://accounting.smartpros.com/x33341.xml>.

<sup>9</sup> "The amazing disintegrating firm," *Economist*, December 6, 2001. Available at [http://www.economist.com/background/displaystory.cfm?story\\_id=896844](http://www.economist.com/background/displaystory.cfm?story_id=896844).

<sup>10</sup> U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, *The Role of the Board of Directors in Enron's Collapse*, 107th Cong., 2d sess. 2002, Rep. 107-70, 29. A pdf file of the report is available through [findlaw.com](http://findlaw.com) at [news.findlaw.com/cnn/docs/enron/senpsi70802rpt.pdf](http://news.findlaw.com/cnn/docs/enron/senpsi70802rpt.pdf).



was aware of and approved this practice, with the audit committee chair coining the term “integrated audit” to describe the arrangement.<sup>11</sup>

## 2. Parmalat: insufficient corporate governance structure

The Parmalat case is one of individual wrongdoing with little or no oversight. Though the company was not formally required to maintain an audit committee, one did exist, albeit with the CFO as one of its key members. In general, the audit committee “accepted procedures that were clearly inadequate (recall [CFO] Mr. Tonna’s role as member of the audit committee).”<sup>12</sup> Furthermore, “the complexities of the group’s structure and finance required a great amount of work and financial understanding, and [the directors] were not prepared to dig into Parmalat’s intricate business.”<sup>13</sup>

The main problem with this governance structure was that a controlling shareholder – the Tanzi family, which had also founded the company – “exploit[ed] the company rather than monitoring its managers.”<sup>14</sup> The Tanzis oversaw a “disclosure policy [that] was characterised by its management’s opaque and arrogant approach towards analysts and investors,”<sup>15</sup> the loudest and most important warning sign that fraud was taking place. Other signs of fraud that a more competent audit committee might have noticed included:

- **Lots of cash on the books, yet continued management interest in borrowing.** This baffled the financial community and led many leading analysts to steer clear of the firm’s securities.
- **Lowered debt ratings.** More than three years before the scandal broke publicly, rating agencies reduced Parmalat’s ratings to the lowest commercial grade level, signaling the market’s worries about the disconnect between the company’s debt levels and the large amounts of cash on its balance sheet.
- **The creation of a special-purpose entity after a required change in auditors.** With a change in auditors pending, management created a wholly owned subsidiary in the Cayman Islands to house a fictitious cash account worth almost €4 billion.
- **Nepotism at the highest levels.** Tanzi family members were put in charge of various pet projects, such as professional soccer teams and tourism businesses, at the expense of other shareholders, running up large debts with little to show for them.

## 3. MCI WorldCom: financial malfeasance at the highest levels

MCI WorldCom was once a well-respected, high-flying success story in the U.S. telecommunications industry. Its performance was industry leading. One member with telecom industry experience recalled not being able to understand WorldCom’s profitability, even after analyzing its public financial statements and comparing the results to his own company’s numbers. As one expert knowledgeable about MCI

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<sup>11</sup> Ibid., 57.

<sup>12</sup> Guido Ferrarini and Paolo Guidici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, European Corporate Governance Institute Working Paper no. 40 (New York: Social Science Research Network, 2005), 19. A pdf file is available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=730403](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=730403).

<sup>13</sup> Ibid.

<sup>14</sup> Ibid., 2.

<sup>15</sup> Ibid., 8.

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WorldCom’s situation noted in an interview conducted for *PreView*, “with WorldCom, it was clearly too good to be true. It is one of those things where if it doesn’t make sense on the surface, then it doesn’t make sense [at all].”

The audit committee’s role in the company’s collapse is perhaps the most studied among all the modern cases of financial fraud, as WorldCom’s directors were successfully sued in civil court. The class action suit brought against them lays out the two dimensions of the audit committee’s failure:

First, it allowed a ‘serious failure of communication’ between itself and [the accounting firm Arthur] Andersen ... [and] utilized a ‘non-traditional’ approach for its auditing of WorldCom ... However, the audit committee did not understand the non-traditional audit approach Andersen employed, which should have been a matter for great scrutiny by the audit committee and discussion with Andersen.

Second, the audit committee failed to establish a strong reporting mechanism between itself and the Internal Audit Department. As a result, the Internal Audit Department fell under the control of company management and spent much of its time performing operational, not audit-related, functions. Moreover, as the audit committee should have known, Andersen and the Internal Audit Department rarely, if ever, coordinated efforts to audit the Company’s financial statements. As a result, ‘Internal Audit and Arthur Andersen were two ships passing in the night,’ according to the Examiner’s Second Interim Report.<sup>16</sup>

The improper relationship with the external auditor was evident in part, the expert we interviewed said, from the fact that “the fees that were being paid to the auditors were really small.” On the second point, the same expert noted that “it is hard to find an outstanding internal audit person who can stand up against the pressure of the outside and still have the faith to do the right thing for companies,” which was certainly the case at WorldCom, in part because internal audit professionals didn’t have the required attention and support from the audit committee.

#### **4. Royal Ahold: growth outstripping management capabilities**

Royal Ahold was a well-respected grocery market chain that had expanded from a local shop in the West Netherlands to a global corporation with stores located around the world. The company made a name for itself through successful acquisitions and an aggressive growth strategy, which expanded the company’s presence into Europe and the United States, Latin America, and Asia. By early 2002, however, it appeared that Ahold’s growth had outstripped its management capabilities. In February 2002, its stock fell 7% based on reports that U.S. Foodservice, an American subsidiary, had misstated its numbers. Ahold vehemently denied improprieties, and at that time disclosed growth figures that excluded U.S. Foodservice accounts and in general decreased overall transparency. In its 2001 annual report, Ahold confirmed what investors had dreaded. During the ensuing crisis, Ahold board members and management maintained a distant attitude,

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<sup>16</sup> Comptroller of the State of New York, *First Amended Class Action Complaint of Lead Plaintiff Alan G. Hevesi, Comptroller of the State of New York, as Administrative Head of the New York State and Local Retirement Systems and as Trustee of the New York State Common Retirement Fund, on Behalf of Purchasers and Acquirers of All Worldcom, Inc. Publicly Traded Securities* (New York: U.S. District Court, Southern District of New York, 2003), 154. Available at <http://www.worldcomlitigation.com/courtbox/WorldCom8.03cplt.pdf>.

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with one board member saying “we are grocers, not accountants or bankers.”<sup>17</sup> By the end of the scandal, both the CFO and CEO had resigned, few board members remained, and Ahold had negotiated a €3.1 billion emergency loan to cover immediate cash needs. The ramifications of the scandal are far reaching: Ahold has put U.S. Foodservice up for sale and has begun the process of divesting assets in Poland, Slovakia, and Portugal.

The key problem for Ahold was management’s consistent drive to expand without any corresponding corporate governance changes. While the company’s rapid expansion may have initially looked good to investors, it decreased the opportunities for the board of directors and audit committee to catch problems. An expert we spoke with stated that after the crisis, Ahold’s audit committee processes had to be rebuilt from the ground up. Several steps the reconstituted audit committee took to enhance its capabilities included:

- **Implementing a tough attendance policy to demonstrate commitment.** Before the scandal, the audit committee did not always require that the members appear at audit committee meetings in person. This changed under new audit committee leadership.
- **Providing audit committee members with as much information as possible.** Audit committee members now receive regular and detailed reports on whistleblowing, fraud, and internal controls.
- **Committing to professionalism.** In searching for new audit committee members as well as other directors, the remaining board members were determined to find people committed to professionalism. They looked for people who had a broad professional background and who would take the work of the board seriously.

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<sup>17</sup> Stewart Hamilton and Alicia Micklethwait, *Greed and Corporate Failure: The Lessons from Recent Disasters* (New York: Palgrave MacMillan, 2006), 143.

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## Appendix 2: An overview of audit committee regulations

Countries represented in the networks	Purpose and oversight	Membership
France <sup>18</sup>	Inseparable from board of directors; approve corporate accounts and prepare consolidated accounts	Two-thirds independent, no officers
Germany <sup>19</sup>	Handle accounting and risk management and the issuing of the audit mandate, ensure auditor independence, and oversee auditing focal points and fees	Half represent shareholders, half represent employees; chair cannot be ex-management
Italy <sup>20</sup>	Evaluate internal controls system, approve balance sheets and half-yearly reports, and ensure the external auditor is supported properly	Three to five board members; majority independent
The Netherlands <sup>21</sup>	Prepare the supervisory board to evaluate the management board	Board members must not be executives; one must be a financial expert
Sweden <sup>22</sup>	Ensure financial reporting and controls principles are followed; assure independence of the external auditor	At least three independent members
Switzerland <sup>23</sup>	Provide independent assessment of the quality of the external auditors, internal controls, and financial statements	Financially literate and independent board members
United Kingdom <sup>24</sup>	Ensure implementation of financial reporting and internal controls principles; maintain proper relationship with the company auditors	Board members must be independent and must not be executives; one must be a financial expert
United States <sup>25</sup>	Oversee audits not only of financial statements but also of the processes used to generate them; oversee the performance of the internal audit function. The external auditor's primary reporting relationship is now with the audit committee, not with management.	A minimum of three independent directors, all of whom are financially literate; at least one member of the committee should be considered a financial expert

<sup>18</sup> The French corporate governance code for listed companies is available at [http://www.ecgi.org/codes/documents/cg\\_oct03\\_en.pdf](http://www.ecgi.org/codes/documents/cg_oct03_en.pdf).

<sup>19</sup> The German corporate governance code is available at [http://www.ecgi.org/codes/documents/corgov\\_endfassung\\_e.pdf](http://www.ecgi.org/codes/documents/corgov_endfassung_e.pdf).

<sup>20</sup> The Italian corporate governance code is available at [http://www.ecgi.org/codes/documents/codiceautodisciplina\\_en.pdf](http://www.ecgi.org/codes/documents/codiceautodisciplina_en.pdf).

<sup>21</sup> The Dutch corporate governance code is available at <http://corpgov.nl/page/downloads/CODE%20DEF%20ENGELS%20COMPLEET%20II.pdf>.

<sup>22</sup> The Swedish corporate governance code is available at [http://www.ecgi.org/codes/documents/swe\\_codes\\_group\\_en\\_mar2005.pdf](http://www.ecgi.org/codes/documents/swe_codes_group_en_mar2005.pdf).

<sup>23</sup> The Swiss corporate governance code is available at [http://www.ecgi.org/codes/documents/swisscodeofbestpractice\\_english.pdf](http://www.ecgi.org/codes/documents/swisscodeofbestpractice_english.pdf).

<sup>24</sup> The United Kingdom's corporate governance code is available at [http://www.ecgi.org/codes/documents/frc\\_combined\\_code\\_june2006.pdf](http://www.ecgi.org/codes/documents/frc_combined_code_june2006.pdf).

<sup>25</sup> The New York Stock Exchange requirements for listed companies are available at <http://www.nyse.com/RegulationFrameset.html?nyseref=http%3A//www.nyse.com/LeftNav.html%3FFlashVarsID%3D1090921948122&displayPage=/listed/1022221393251.html>.