

Audit Committees—A More Visible and Demanding Role

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The audit committee's responsibility to effectively oversee the integrity of the financial reporting process has become a mandate of the capital markets in the aftermath of the sweeping changes affecting corporate governance. This uncertain and rapidly shifting regulatory landscape has created intense and sharpening focus on audit committee members, whose role as protectors of investors' interests now attracts higher visibility, higher expectations—and requires more commitment than ever.

In a relatively short period of time, legislative, regulatory, and market changes have influenced management, audit committees of the board of directors, and the accounting profession in unprecedented ways, impacting corporate accountability and the financial reporting process dramatically. The Sarbanes-Oxley Act of 2002 (S-O), together with the resulting rules from the Securities and Exchange Commission (SEC) and pending proposals from the major U.S. stock exchanges, have broadly redefined and reemphasized the roles, responsibilities, and accountabilities of all the participants in a company's financial reporting process. These participants include management and internal audit; the board of directors, including the audit committee; and the external auditor.

To be sure, the audit committee process has been changed fundamentally by the current corporate accountability reforms, although many of the underlying concepts have been debated and considered since the 1999 report

of the Blue Ribbon Committee and the 1987 report of the Treadway Commission.

THE BLUE RIBBON COMMITTEE

In the autumn of 1998, in response to concerns about public companies' earnings management practices, former SEC Chairman Arthur Levitt announced the formation of a blue ribbon committee charged with developing a series of recommendations to enable audit committees to function as the "ultimate guardian of investor interests and corporate accountability." Officially called the "Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees," the committee was sponsored jointly by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD).

The Blue Ribbon Committee developed a series of 10 recommendations and five guiding principles for improving the effectiveness of corporate audit committees. These recommendations were designed to improve financial reporting, particularly the oversight function where discretion and subjective judgments influenced the quality of financial reporting. The Blue Ribbon Committee recommendations were aimed at:

- Strengthening audit committee independence.
- Making the audit committee more effective.

- Enhancing accountability among the audit committee, external auditors, and management.

While the Blue Ribbon Committee's findings, recommendations, and conclusions were not new, a new emphasis had been placed on them. They were drawn from a number of sources, but principally from the audit-committee-related recommendations of the 1987 Treadway Commission and the 1994 AICPA Public Oversight Board Advisory Panel on Auditor Independence.

The final report of the Blue Ribbon Committee, released in February 1999, resulted in new rules affecting audit committees issued by the SEC and the major U.S. stock exchanges. These new rules were seen at the time as a "wake-up call" to the less-than-effective audit committees that existed at some public companies.

LANDMARK LEGISLATION

The Blue Ribbon Committee report had a positive impact on many audit committees, including a renewed emphasis on identifying independent, knowledgeable, and engaged members and additional interaction with management and the auditors. However, who could have predicted it would be only a precursor to the fundamental shift in the increased expectations and responsibilities that audit committees now face?

In 2002, corporate accountability reforms again took center stage due to a number of very high-profile financial reporting failures and restatements. The outrage of the investing public and regulators resulted in the landmark Sarbanes-Oxley Act, as well as new SEC regulations and pending listing requirements from the major U.S. stock exchanges (including the NYSE and the Nasdaq Stock Market, Inc. [Nasdaq]). These changes are the most far-reaching securities reforms to be enacted in nearly 70 years and are meant to restore the public's trust in the capital markets, corporate management, corporate directors, and the professionals who serve them.

The reforms are changing not only *what* audit committees do but, equally important, *how* they might function in the future. As audit committees consider the impact of these new requirements we expect that many new approaches and practices will be identified, developed, and, ultimately, become the standard against which each audit committee (and its members) is measured. Already, the impact can be seen, although given the demands for compliance with these ever-unfolding rules, audit com-

mittees are faced with the mounting challenge of maintaining their focus.

Audit committee members need to be more focused than ever on enhancing the effectiveness of their committees to meet the expanding scope of activities they must manage. One inherent danger in the many aspects of the reforms, however, is that audit committees will become "overwhelmed by" and unduly focused on compliance for compliance's sake, with the potential for impairment—rather than enhancement—in the overall effectiveness of their oversight function.

AUDIT COMMITTEE CHALLENGES

Many audit committee members recognize, and are concerned about, the challenges they face. The gap between the audit committee's oversight role and shareholders' possible expectation of the committee as a "guarantor" of financial reporting is a very real risk. The audit committee's role is one of oversight. The Sarbanes-Oxley Act has defined the audit committee as: "A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer, and audits of the financial statements of the issuer."

Some of the challenges expressed by participants at the Spring 2003 Audit Committee Roundtables sponsored by KPMG's Audit Committee Institute (ACI) include:

- "Balancing practicality and priorities with the new governance environment";
- "Ensuring that we not only focus on the form [reporting, meeting all the myriad requirements] but also the substance";
- "Instituting required changes in attitude, culture, approach";
- "Too many pronouncements leading to too much checking off requirements and not enough thinking."

The SEC also has recognized the additional risk inherent in the multitude of new reforms. In March 2003, SEC Chairman William Donaldson stated, ". . . a 'check in the box' approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting 'politically correct' dictates."

SWEEPING CHANGES

The new corporate accountability reforms represent some of the most sweeping changes ever to affect the board and audit committee. Some of the more significant changes consist of the following:

- New rules concerning audit committee member independence (stock exchanges);
- Disclosure of the name of the “audit committee financial expert,” or if one does not exist, why not (S-O);
- Direct responsibility for the oversight of the external auditor including its appointment, retention, and compensation (S-O);
 - Pre-approval of audit and non-audit services;
 - Resolution of disputes between management and the external auditor;
- Additional required external-auditor communications including the audit firm’s quality controls (NYSE);
- Discussion of risk assessment and risk management policies set by management (NYSE);
- Oversight of legal and regulatory compliance (NYSE);
- Oversight (including budget, staffing, and performance) of the internal audit department (NYSE);
- Additional communications from management regarding internal controls and any instances of fraud involving management or other employees with a significant role in internal control (S-O);
- The establishment of a “whistleblower” communications process (S-O);
- Audit committee self-evaluation (NYSE);
- Continuing education (stock exchanges).

These new roles, responsibilities, and activities are also causing audit committees to feel more “empowered,” which in some cases has prompted friction between the audit committee and management. When we asked the participants at the Spring 2003 Audit Committee Roundtables in the United States if their audit committee activities resulted in the appropriate level of knowledge and interaction implicit in the concept of oversight without taking on the role of management:

- 63% said yes;
- 25% said additional audit committee activities were needed to fulfill its oversight role;

- 3% said the audit committee was overreaching its oversight role;
- 9% were not sure.

How audit committees approach the reforms may vary, but a failure to address them may be a significant detriment to the audit committee, the board, and, most of all, the shareholders.

AUDIT COMMITTEE MEMBERSHIP

As a result of the 1999 report of the Blue Ribbon Committee, the stock exchanges issued new listing standards that addressed audit committee membership. The standards required each public audit committee to have at least three independent, financially literate directors and at least one member who had “financial expertise.” Financial literacy was broadly defined as “the ability to read and understand basic financial statements,” and the definition of “financial expertise,” although more stringent, was also fairly general. These listing-standard changes resulted in a close evaluation of, and some changes to, directors serving on audit committees, most notably those members who did not meet the new definition of independence.

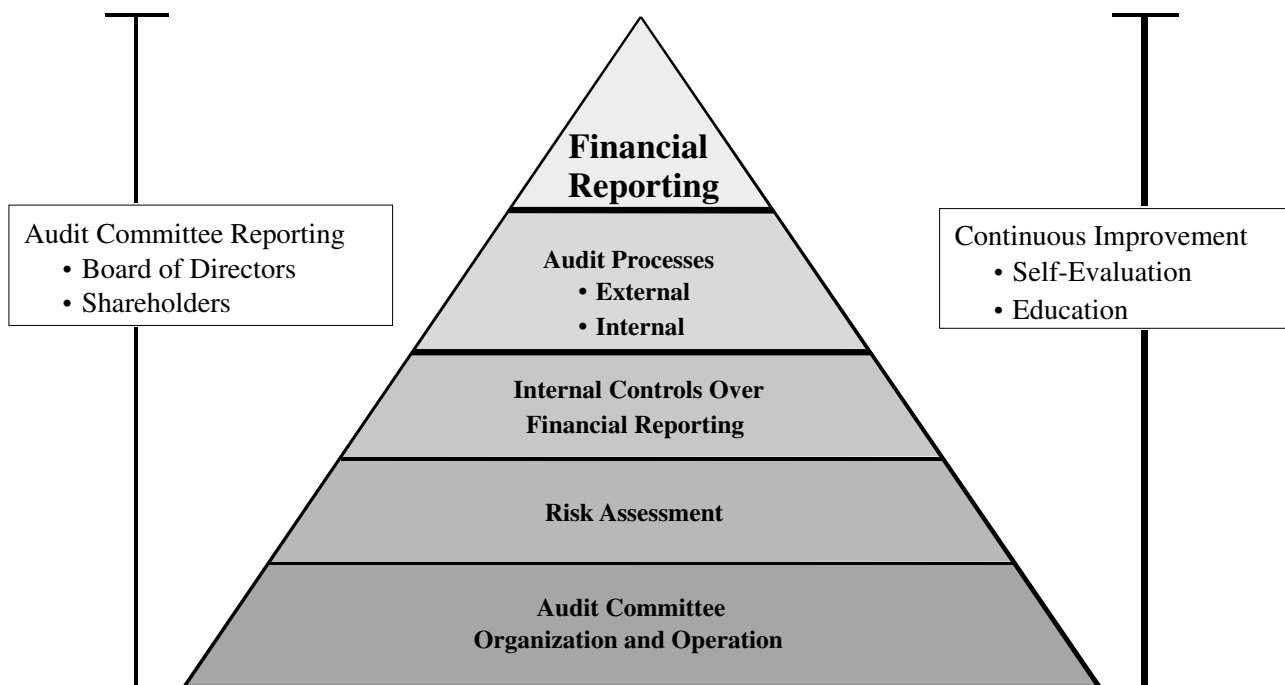
We believe the current corporate accountability reforms will have an even greater impact on audit committee membership for the following reasons:

- A stricter definition of independence, including a limitation that audit committee members may not receive any compensation from the company other than for board service;
- A significant increase in the time needed to serve on an audit committee. In a Fall 2002 ACI poll, 40% of audit committees thought they would meet in person or via conference call eight or more times in 2003;
- A perception of increased personal liability and reputational risk, compounded by changes in directors’ and officers’ insurance coverage and exclusions;
- The new SEC requirement to disclose whether there is an “audit committee financial expert,” and if not, why not.

Boards of directors are taking a much closer look at the makeup of the audit committee, considering not only whether the members have the right background, but also

EXHIBIT

Elements of Audit Committee Oversight



Source: ACI's Spring 2003 Audit Committee Roundtables—"Building a Framework for Effective Audit Committee Oversight."

any relationship that might suggest something other than a completely independent mindset. KPMG's 1999 publication, *Shaping the Audit Committee Agenda*, suggested that independence "must assume the ability to make objective decisions that may be in conflict with the interests of management." Boards are now evaluating independence from management much more carefully, in some cases considering issues and elements beyond those addressed by "the rules."

This new landscape may result in significant turnover in audit committee membership over the next few years. We believe that audit committee members in the future will be even more proactive and focused on their responsibilities with an underlying attitude of healthy skepticism.

AUDIT COMMITTEE FRAMEWORK

In this demanding environment, we believe it is more important than ever for audit committees to focus on a process that supports effective oversight. This goes beyond mere compliance with the new rules; it requires careful consideration of an audit committee framework that facilitates the coordination of the activities and information

needed to support the committee's understanding and monitoring of the company's financial reporting process.

The accompanying Exhibit represents the elements of audit committee oversight that support strong financial reporting.

One of ACI's primary messages at the Spring 2003 Audit Committee Roundtables was that audit committees should take a fresh look at their activities and allow the most important issues facing their companies to drive their process and agenda. Although 81% of roundtable participants responded that a formal (23%) or informal (58%) consideration of financial reporting risks was made as audit committee agendas were set, 15% said there was little or no discussion of risk as part of the audit committee agenda-setting process. (The remainder were unsure.)

Financial reporting risks facing the company need to be the primary driver of the audit committee process. A well-defined framework should allow the audit committee to receive the right information, at the right time, from the right individual, and in the right context to provide effective oversight.

TONE AT THE TOP

The National Association of Corporate Directors Best Practices Council identified setting the “tone at the top through conduct and communication” as one of its basic principles for protecting shareholders against fraud and other illegal acts. Setting the tone was defined as “establishing a corporate culture committed to ethical, lawful behavior, both inside and outside the company, that begins at the highest level and permeates the entire organization.”

Accordingly, one component of audit committees’ organization and operation is the need to assess, and help establish, the “tone at the top.” The tone at the top has been dissected and addressed by many reports and corporate governance observers but its importance cannot be overemphasized. In hindsight, many financial reporting scandals might have been prevented if the board and the audit committee recognized, and acted upon, a tone at the top that did not support proper financial reporting.

DIRECT RESPONSIBILITY FOR THE OVERSIGHT OF THE EXTERNAL AUDITOR

One of the most significant changes brought on by the corporate accountability reforms is the audit committee’s direct responsibility for the oversight of the external auditor. William Ripley, in the 1926 publication, *Main Street and Wall Street*, stated that there could be no hope for the independent audit “unless and until it be tied in with the positive creation of some body independent of management to which the auditor shall be accountable.”

Historically, the external auditor has practically served two groups, management and the audit committee (as representatives of shareholders). A Fall 2000 ACI survey found that 50% of respondents believed, at that time, that the external auditor was more accountable to management than to the audit committee. In addition, 9% of audit committees rarely, if ever, met in executive session with the external auditors.

This has all changed. The shift from the external auditors being “ultimately accountable” to “directly responsible” to the audit committee is powerful, and a change that audit committees and external auditors are taking very seriously. Audit committees now are meeting with the external auditor much more often and in many cases outside the formal audit committee meetings. They are also closely evaluating, and pre-approving, all services

provided by the external auditor. Further, they are evaluating the external auditor’s qualifications and independence, participating in fee discussions, and asking more questions about audit scope and complex accounting matters, including alternate treatments that may have been discussed with management. The bottom line: the external auditor works *with* management but works *for* the audit committee, and the audit committee expects to be treated as “the client.”

WHISTLEBLOWER COMMUNICATIONS

In May 2003, the SEC gave final approval to a regulation implementing the S-O requirement that each audit committee establish a mechanism to receive, retain, and process complaints on auditing, accounting, and internal control issues. The procedures must encompass the confidential, anonymous submission by employees of concerns on questionable accounting and auditing matters. The SEC went no further than specifying the basic requirements for the mechanism, and each audit committee is expected to establish an approach suitable to its circumstances. This “whistleblower” communication process will represent both a new source of information for the audit committee and a new responsibility. Audit committees are asking questions such as:

- How will complaints initially be captured?
- How will the audit committee know it is notified of all significant communications?
- Who will be responsible for the overall process?
- What resources will be used to investigate matters in an objective fashion?

A variety of approaches are being taken in establishing the “whistleblower” communication process. During the Fall 2002 Audit Committee Roundtables, participants responded that the company’s in-house counsel would be primarily responsible for the “whistleblower” program (26%). Other responses included internal audit (13%), the CEO or CFO (8%), the ethics officer (8%), external counsel (2%), other external provider (3%), and 38% had not yet determined who would have this responsibility. In addition, based on an online survey conducted by ACI through June 2003 at www.kpmg.com/aci, about 30% of companies plan to use an external service provider as part of the “whistleblower” communication process.

Companies with internal audit departments may, in

many cases, use this group to initially review complaints and external forensic specialists may be asked to investigate significant matters. We received the following responses when we asked participants at the Spring 2003 Audit Committee Roundtable what best describes the whistleblower reporting that will be provided to the audit committee:

- 20%—A list of every whistleblower-related communication and status of investigation;
- 28%—A summary of all communications (number and type of calls) with detail of only those communications deemed significant;
- 12%—Only significant communications;
- 1%—The audit committee will not review whistleblower communications;
- 39%—Participant was unsure or had not yet discussed what level of detail the audit committee would receive.

It's clear from the feedback we've received that many audit committees are still consulting with their legal counsel and considering the best approach to take in establishing the whistleblower communication process. Listed issuers other than small-business and foreign-private issuers must be in compliance with the new provisions by the date of their first shareholder's meeting after January 15, 2004, but in any event no later than October 31, 2004. The SEC gave foreign-private and small-business issuers more time.

AUDIT COMMITTEE EDUCATION

Proposals from NYSE and Nasdaq both address the need for continuing board member education. In addition, a number of groups that "grade" corporate governance are also tracking the continuing education of directors. This has resulted in a proliferation of external education programs available to directors and audit committee members, including those sponsored by the National Association of Corporate Directors, The Conference Board, various prominent universities, and others.

Audit committees also are expecting much more internal and external support concerning developing trends and issues. Some audit committees have been requesting tailored education sessions with modules led by management, internal audit, in-house or external counsel, external auditors, and others. Some 33% of participants at the Spring 2003 Audit Committee Roundtable

series expected that a company-specific education session would be provided to the audit committee during the next year. Thirty-four percent did not expect this type of session and 33% were not sure.

We see this as a growing trend that will allow audit committees not only to explore current issues but also to identify issues that might need be addressed during future audit committee meetings.

ACHIEVING THE RIGHT BALANCE: FIVE BASIC PRINCIPLES

The current environment is a challenge for audit committee members due to the sweeping changes and increased expectations of shareholders, regulators, the media, and other directors. ACI encourages corporate leaders to consider its *Basic Principles for Audit Committees*, which we believe provide the foundation for, and the framework within which, each audit committee develops and adopts its own "best practices" that support its independent and objective oversight of the financial reporting process. Published in mid-2002, ACI's five "basic principles" are:

1. Recognize that the dynamics of each company, board, and audit committee are unique—one size does not fit all.
2. The board must ensure the audit committee comprises the "right" individuals to provide independent and objective oversight.
3. The board and audit committee must continually assert that, and assess whether, the "tone at the top" embodies insistence on integrity and accuracy in financial reporting.
4. The audit committee must demand and continually reinforce the "direct responsibility" of the external auditor to the board and audit committee as representatives of the shareholders (as is now required by S-O).
5. Audit committees must implement a *process* that supports their understanding and monitoring of the:
 - Specific role of the audit committee in relation to the specific roles of the other participants in the financial reporting process (oversight);
 - Critical financial reporting risks;
 - Effectiveness of financial reporting controls;
 - Independence, accountability, and effectiveness of the external auditor;
 - Transparency of financial reporting.

Consider these basic principles as you establish an effective audit committee framework. Establishing a framework for effective audit committee oversight promotes a focus on the financial reporting risks facing the company and will allow you to concentrate on performance effectiveness as well as compliance.

CONCLUSION

Audit committees today are dealing with a multitude of issues that will require their thoughtful, active participation to effectively integrate them into their culture and oversight approach. This dynamic, changing environment requires everyone to adapt to new developments as they emerge. It is causing the roles, responsibilities, and accountabilities of boards of directors, including the audit committee, senior management, internal auditors, and external auditors, to be reshaped and redefined.

The audit committee's oversight role is a critical element of the financial reporting process. An audit committee member's role is more time-consuming and challenging than ever. Audit committee members must be independent of management, engaged, experienced, ethical, inquisitive, and intuitive to provide effective oversight and help rebuild the public's trust in the capital markets.

ENDNOTES

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Editor's Note

KPMG's Audit Committee Institute (ACI) is a national resource for corporate board members, including audit committees and senior management. ACI can be reached at auditcommittee@kpmg.com, 1-877-KPMG-ACI, or through the website, www.kpmg.com/aci. The views and opinions expressed herein are those of the authors and do not necessarily represent the views and opinions of KPMG International.

KPMG's Audit Committee Institute (ACI) has been communicating with audit committee members since our formation in 1999. ACI initiatives include semiannual roundtables, publication of KPMG's Audit Committee Quarterly, seminar and board presentations, a toll-free hotline, periodic distribution of time-sensitive information, and our Web site, www.kpmg.com/aci. Wholly sponsored by KPMG International, the ACI communicates with audit committee members and senior officers to enhance their awareness of, commitment to, and ability to implement effective audit committee processes. KPMG's Audit Committee Institute can be reached by calling 1-877-KPMG-ACI (1-877-576-4224) or via e-mail at auditcommittee@kpmg.com.

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