



ppoint, compensate and oversee outside auditors.

**Implement procedures for employees to report financial concerns, anonymously.**

**Prove yourself financially literate—against increasingly stringent standards.**

**Review for accuracy every company report, financial release, and SEC filing.**

**Welcome to the new Audit Committee -- the central clearinghouse for a majority of the regulations aimed at regaining public trust and rebuilding investor confidence after a year of stunning corporate misconduct. What's ahead for independent directors? Are they up to the challenge?**

BOARDROOM CONSULTANTS

TOPIC # 32

*Boardroom Consultants, a leading firm specializing in governance consulting, succession planning, and director selection, in collaboration with Hogan & Hartson, a major international law firm with a large corporate governance practice, recently held a roundtable discussion on the regulatory fall-out from this year's high-profile cases of corporate fraud and the impact on Audit Committees. The discussion was led by Ray Groves, a corporate director of Marsh & McLennan and CEO-elect of the company's Marsh Inc. division. He is a former Chairman and Chief Executive of the accounting firm of Ernst & Young and had been Chairman of Legg Mason Merchant Banking Group. He serves on the boards of American Water Works, Boston Scientific, Electronic Data Systems, and The Gillette Company.*

### GAINING PERSPECTIVE

Where will it all end? The answer, it appears, is with the Audit Committee.

In rapid succession, new laws are being enacted and new regulations are being enforced to help clean up the mess left by a year's worth of highly publicized corporate scandals.

"Taken one by one, it seems that the Audit Committee is the focal point or the funnel which many of the new requirements will be going through," noted Ray Groves, Chairman

and CEO-elect of Marsh Inc. "The big question now is, what are these new responsibilities going to be and how will they be implemented?"

In part, that question will be answered by the SEC, which is charged with implementing the requirements of the new Sarbanes-Oxley bill, the legislation that passed with lightening speed this summer to reform corporate America.

Portions of this multi-part legislation package place new responsibilities squarely with the Audit Committee, including overseeing

## Corporate Cleanup: The Audit Committee's New Role

auditors and mediating disagreements between auditors and management. While the Audit Committee may not be fully responsible for some of the bill's requirements, many of them will at least flow through the committee, such as ensuring formal procedures for employees to raise questions or concerns, anonymously, about a company's financial endeavors.

"Ultimately," suggests Groves, "each Audit Committee is going to have to decide exactly what its responsibilities are."

### *SARBANES-OXLEY IMPACT*

The new regulations and requirements specified in the Sarbanes-Oxley bill will be implemented in phases over the next year. Some, such as developing a code of ethics for senior financial officers, may be easier to implement than others.

For instance, the bill requires that at least one member of the Audit Committee qualify as a financial expert. But "financial expert" remains somewhat undefined. And, how long committees will have to make the transition to meet the new standards of financial literacy is still unknown.

One director cautions that this new legislation may cause regulatory agencies to overreact. "You can go too far taking steps to correct problems with the prior system. Once the momentum gets going, it just keeps building," he notes, "until, finally, it gets to the point where it turns around again."

Sarbanes-Oxley gives regulators and directors more room to probe into a company's operations and uncover discrepancies or conflicts of interest before they become crises. It is especially important, the participants agree, to

have clearly defined laws that outline specific requirements. "Otherwise," suggests one director, "it would be very difficult to ask tough questions of management when the stock is up, earnings are strong and analysts are giving the company high ratings. This way you're not picking on anyone. Everyone has to do it."

One participant allows that the legislation "puts a discipline into the process that will, in some ways, make it easier to do our jobs."

However, Sarbanes-Oxley will challenge directors already pressed for time. "What we'll need," explains a director, "is more time, more advance preparation and, perhaps, more than a little education."

### *A REDISTRIBUTION OF POWER*

With an emphasis on oversight and greater authority being given to the Audit Committee to question management decisions, there is an obvious shift of power, leading participants to ponder how they will keep the relationship from turning adversarial.

"Successful companies will be careful to hire qualified people and continue to give them the authority to run the organization," advises one participant. "Then we need to provide reasonable oversight with the proper checks and balances. It may not have worked in a few prominent cases, but the system is still sound. It's our job now to make sure it works."

Clearly, scandals like those at Enron and WorldCom have forever changed the business landscape, and the directors feel that there will be little pushback from management in the current environment.

"No intelligent management team is going to resist the board's efforts to be diligent," notes one director. "Having tighter regulations in

*"We need to provide reasonable oversight with proper checks and balances. The system is still sound. It's our job now to make sure it works."*

place may not make us any happier to do it, but it takes the reluctance out of it.”

## LIABILITY AND RESPONSIBILITY

One of the most profound changes to arise from Sarbanes-Oxley and other new regulations may be the issue of liability.

“We won’t see too many more instances where management gives us information and we give it a green light just because the stock is good and the analysts are happy,” says one director. “The new regulations have intensified the pressure and increased our liability.”

As a result, the Audit Committee will have to ask tough questions and management will have to answer. The issues that arise from these discussions may fall outside of the Audit Committee’s expertise. At that point, the directors concur, they may need to bring in outside help.

“It’s not just that we need to ask the tough questions so much as we need to ask the right questions,” shares one participant. “That’s where we may need additional expertise.”

One participant cautions directors not to take too much comfort in the popular wisdom that if they act with “duty of loyalty and duty of care,” they have nothing to worry about. “The plaintiffs’ lawyers are sharpening their swords,” he declares. “The additional duties being imposed on Audit Committee members, whether it is proper selection of the auditor or proper monitoring of the auditing function, are ultimately those directors’ responsibilities.”

## A CLEAN SWEEP: CAN IT WORK?

The new laws and regulations aimed at keeping management honest and directors on their toes are pressing for companies to rotate

lead auditors and even auditing firms.

“This makes us vulnerable,” declares one participant. “When you rotate auditing firms, you lose integral inherent knowledge. Multinational companies have people and operations all around the world. You might be able to rotate the lead partner within the same firm because there is still a body of knowledge there. You may even benefit from a fresh perspective. But when you have to move to a new firm and it has not had experience with the company, or even the industry, before, that is a problem. Companies are more exposed when that happens because there are usually problems that occur in the early days of any relationship.”

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Traditionally, best corporate governance practices have called for companies to ask shareholders to ratify the choice of the outside audit firm and most have adopted this practice. However, Sarbanes-Oxley may render it irrelevant by requiring the Audit Committee to have sole hiring and firing authority over the auditors. In some cases, this may prevent foreign companies that do place the obligation for designating auditors in the hands of shareholders from listing on US stock exchanges, a fairly serious and negative unintended consequence.

And the challenges don’t end here. “There are additional SEC initiatives on critical accounting policies and other areas of disclosure that will also need to be filtered through the Audit Committee,” remarks Groves. “So it’s going to be a considerable burden.”

Ultimately, Groves maintains, the end result of this process should be quality reporting. “If what we end up with is improved

reporting that more accurately reflects the health of the company – reporting that companies feel confident with and investors can rely on – then the effort will have been worth it.”

## NOTES FROM BOARDROOM CONSULTANTS

Behind the issue of new regulations and their impact on Audit Committees lies a deeper issue: integrity.

That’s what we’re all striving for. That’s what the public expects and what investors demand.

Boards capable of ensuring integrity as we move forward will share some common traits:

*A balance of oversight and insight.* We are seeing what can happen when a board does not engage in reviewing current management actions, especially with regard to financial reporting. So a board’s oversight function should not be underestimated. However, companies that focus only on oversight will fail to harness the strategic and creative contributions of their board. This would be a step backwards.

The power of a board is the power of knowledge. Combine that knowledge with the directors’ ability to positively influence management and you have a board that brings more value to the shareholders. Independent directors can ensure that management answers the right questions; they can inspire management to stretch while following realistic plans. Their job is to prevent as many mistakes as possible, but when mistakes occur (and they will), their job is to ensure that management deals with the challenge—quickly and ethically.

*Knowledge of limitations.* Boards must remain knowledgeable and independent. When pertinent information, such as the creation of special business partnerships, is withheld from the board, it’s very difficult for directors to act prudently. For such reasons, it is advisable that boards know when to turn to advisors, such as forensic accountants, to help them “ask the right questions.”

Audit Committees, in particular, should have the funding to hire any independent advisors they need to help them carry out their responsibilities. In today’s environment, this goes beyond the issue of integrity into the issue of liability.

As we move forward, we must be careful that, when calling for independence, we do not achieve separation instead. An independent board is not separate from management. On the contrary, it should be fully engaged with management.

*Appointing a Lead Director.* Boards can best manage themselves when there is someone whose primary focus is governance. Be it a lead director or the chair of the Governance Committee, someone must be accountable for ensuring that the board works professionally and diligently together with management.

This process leader will also ensure that the board runs efficiently. With new laws and regulations being imposed in rapid succession, directors no longer have the luxury of time.

Boards that place a high value on integrity will put processes in place to draw on their strengths, provide ample opportunities to address concerns, and will use feedback from outside advisors to help shape the future.

## *ABOUT BOARDROOM CONSULTANTS*

Founded in 1974, Boardroom Consultants was the first firm to specialize in governance consulting and director selection. Since that time, the firm has become a recognized leader in succession planning and top-level management recruiting as well. Because Boardroom Consultants believes that the best and worst things that happen to a company start with the board of directors, our mission is to help companies improve their corporate governance. Services include counseling with chief executives and boards on such issues as board structure, committee charters and best practices; benchmarking for succession planning purposes; and providing in-depth governance reviews involving top management and the entire board. The firm's Advisory Directors, sixteen former chief executives of major corporations, are an exceptionally valuable consultative and due diligence resource.

## *ABOUT HOGAN & HARTSON'S DIRECTORS ADVISORY SERVICES*

Hogan & Hartson offers an interdisciplinary response to the questions and uncertainties of boards of directors and individual directors as they adjust to today's spotlight. Our attorneys include some of the nation's most experienced corporate advisors including former U.S. Attorneys, Assistant U.S. Attorneys and attorneys who once served in top positions at the Securities and Exchange Commission and other federal and state agencies. With an extensive knowledge base and a focused perspective, our attorneys provide practical solutions to the many questions facing boards today.

Hogan & Hartson is an international law firm with more than 900 attorneys contributing to a broad-based national and international practice that cuts across virtually all legal disciplines and industries. Founded in Washington, D.C. in 1904, Hogan & Hartson now has 19 offices throughout the U.S., Europe and Asia. Further information about Hogan & Hartson is available at [www.hhlaw.com](http://www.hhlaw.com).



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