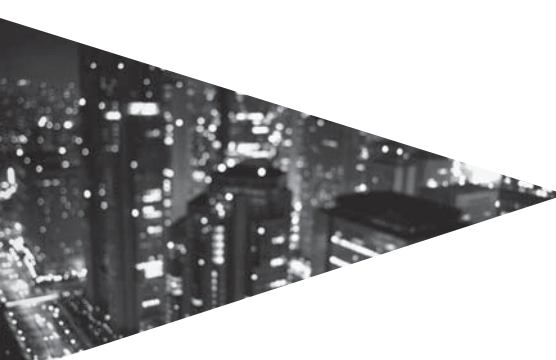


# Government intervention is driving audit committee agendas



The G-20 agenda extends well beyond economic stimuli and financial-sector reform.

## Executive summary

In 2009, governments around the world came together to address the global economic crisis. The Group of 20 nations (G-20) worked tirelessly throughout the year and committed to forceful efforts to stabilize and stimulate their economies and repair the global financial system.

Ernst & Young commissioned Tapestry Networks to engage a diverse group of subject matter experts to determine how the G-20 agenda may affect audit committee agendas over the coming years. (For a complete list of research participants, please see appendix on page 15). Research participants highlighted that the G-20 agenda extends well beyond economic stimuli and financial-sector reform.<sup>1</sup> The broad agenda of government intervention, within and across borders, raises significant risks that will become increasingly important to audit committees, and necessitates ongoing vigilance of funding issues. Key findings from the interviews were:

▶ **Tax authorities are cracking down**

Driven by the need to reduce massive deficits, tax authorities are enforcing tax rules more aggressively, and in some cases changing tax laws. Research participants expect more and faster tax audits, larger fines, and transfer pricing arrangements to continue to be extremely thorny issues. Audit committees will likely have to step up oversight of tax strategies and gain a more fulsome understanding of evolving tax risks. (Page 3)

▶ **Investigations and litigation surrounding competition law are increasing**

The European Commission and national authorities have steadily increased their enforcement of competition laws over the past decade. 2009 saw the highest ever fine and participants expect fines will continue to increase. Some participants believe that competition-law enforcement, both in Europe and the United States, will intensify even more, making oversight of corporate compliance efforts a priority. (Page 6)

▶ **The compliance risks of operating in emerging markets are increasing**

G-20 leaders are putting energy behind efforts to clamp down on bribery and corruption in developed and emerging markets. Audit committees will need to remain vigilant on compliance programs, and ensure the committee is well prepared to assess the magnitude of these risks. (Page 8)

# Executive summary *continued*



▶ **When regulators and standard-setters act decisively, sustainability will move up the agenda**

While corporate sustainability initiatives have increased steadily over the past decade, they have typically remained the preserve of management. However, participants noted that, as and when regulators and standard-setters offer a benchmark for the cost of carbon or tough emission reduction targets, sustainability will move quickly up the audit committee agenda. Several believed the recent, long-expected ruling by the US Environmental Protection Agency (EPA) that greenhouse gases threaten public health is a sign of the future. Audit committees may want to take a proactive approach in advance of such changes. (Page 10)

▶ **Capital market dynamics require ongoing audit committee vigilance**

Participants believe that the financial crisis unleashed forces that will likely have a medium-term impact on the way in which companies raise and manage capital. It's not clear how capital markets will evolve or further stabilize. In the absence of a finance committee, audit committees will likely have to keep funding issues on their agenda, including ensuring that their companies can tap a variety of sources and manage working capital, investments and hedging activities conservatively. (Page 12)

▶ **Conclusion: government intervention creates enhanced risks for companies**

Audit chairs are gradually acknowledging that regulatory risks are on the rise and may need to form a core part of their committee agendas going forward. However, research participants fear that audit chairs greatly underestimate the broad range of risks their companies now face as a result of increased government intervention, at the domestic and international levels. They also remain concerned that audit committees may move too quickly to limit their oversight of funding issues. (Page 14)

### About this document

*InSights* is produced by Tapestry Networks to provide assessments of key issues of interest to audit committee members. It will be distributed by Ernst & Young and Tapestry Networks. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

*The views expressed in this document represent those of the individuals who participated in the research. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks.*

<sup>1</sup> G-20, "The Pittsburgh Summit," leaders statement, 25 September 2009.



# Tax authorities are cracking down

Research participants agreed that the economic crisis has elevated taxation to the top of governmental agendas for one simple reason: the looming need to reduce massive deficits that governments have incurred in responding to the crisis. As deficit reduction, rather than fiscal stimulus, becomes an increasing priority, governments will focus much harder on tax enforcement. As one participant put it, *“Tax authorities are under pressure to increase yield – [getting] better compliance, rather than pushing up tax rates [which is politically difficult].”*

## Trends in cross-border tax administration

Research participants validated the trends Ernst & Young identified in *Tax administration without borders*.<sup>2</sup> These trends include more information sharing among tax authorities (about specific companies, as well as tax administration best practices) and more cooperation among authorities on joint audits (although some participants saw this development as still being only in the early stages).

Authorities are speeding up audit cycles, *“not waiting three or five years after taxes are paid, but acting sooner,”* and they are going deeper in certain areas and reserving the right to return to a given year. Transfer pricing is a current major focus for authorities, as is scrutiny of operations and tax arrangements in jurisdictions that authorities have labeled as “tax havens.” One participant remarked, *“In the past, there would be an overall tax audit looking at one year, and you had the feeling you could check off that year. But now, they may come back to that year, too.”* Moreover, a trend toward better disclosure means that, increasingly, companies have to *“put uncertain tax positions right in front of [the tax authority].”* See “Cross-border tax arrangements are under scrutiny”.

## The tax optimization balance

Heightened tax scrutiny creates a real conundrum for companies. Achieving optimal tax positions is extremely important today, when companies must control costs, but pushing the boundaries of tax planning when tax authorities are clamping down and tax laws and policies are continually changing could be foolhardy. Several participants urged companies to be wary of aggressive plans to minimize tax payments – euphemistically called tax optimization – and instead to adopt an approach that balances reducing the tax burden with the risks associated with various tax strategies. These participants said the advice applied particularly to global companies operating across multiple jurisdictions.

## Cross-border tax arrangements are under scrutiny

A large percentage of world trade consists of cross-border transactions between different units of multinational companies, so the transfer prices – the payments used to account for these transactions – can have significant tax ramifications for both the companies and countries involved. Companies are incentivized to maximize their after-tax profits, and those operating across borders have to determine appropriate transfer pricing arrangements between their various operations. Transfer pricing issues can even have implications for organizational structure: one participant pointed out, *“It has to do with the whole way you organize yourself and your reporting function. One extreme is to organize [your firm] so your production site is in one tax-efficient place and then offices around the world are just sales offices.”*

The commonly accepted method for achieving fair transfer prices is the so-called arm’s length principle, which says that the transfer price should match the price arrived at by two separate companies transacting in the marketplace. It can be difficult to apply this principle, however, which is why authorities are devoting more resources to the problem and cooperating more closely. Experts anticipate considerably more transfer pricing audits and penalties in the coming years.<sup>3</sup> One research participant noted that while charging for intangible assets have already been receiving extensive scrutiny, tax authorities are now expanding their area of review to include *“goods and services, digging into these kinds of transactions [and their related transfer prices] more than they have in the past.”*

# Tax authorities are cracking down *continued*



A group of leading tax administrators from across the globe encouraged “management and audit committees of large enterprises (e.g., CEOs and boards of directors) to take greater interest in, and responsibility for, their tax strategies.”<sup>4</sup>. Directors need to understand who is involved in tax management and how the tax process works; they must ensure that it is integrated with risk management and adequately resourced and that a robust framework for communications among the tax team, senior management and the board is in place.

Several participants noted that board members are rarely experts on taxation, and audit committee interactions with tax executives can be infrequent. For those reasons, communications from the tax team must be “*simple and transparent – it’s an education process.*” One participant noted that, in his experience, audit committees are spending more time on overseeing tax risk, particularly “*given the [higher] volume of inter-governmental disputes on tax matters.*”

Participants recommend audit committees focus on the following factors:

- ▶ **Integration with business.** One participant advocated a change in the role of the tax function, given the current environment: “*Tax can’t be an advisory role – it must be more embedded in the [business planning] process.*” Tax personnel need stronger, trust-based relationships with business managers and should be more actively involved in decisions about structuring businesses and reporting lines so that the chosen tax strategy will fit the “business purpose.” Documentation and communications about the tax strategy should reflect this approach.
- ▶ **Strong relationship with tax authorities.** Participants say that better relationships with tax authorities will pay dividends by:
  - ▶ Creating more certainty on taxes by facilitating mutually beneficial arrangements between companies and tax authorities wherein tax liabilities are agreed upfront. When such arrangements are in place, there is “less audit activity, a win-win [for everyone].”
  - ▶ Enabling better interactions during audits: “Compared to previous years, tax audits are becoming more of a soft skill [in how to work effectively with tax officials].”
  - ▶ Helping companies understand the red flags that trigger audits.



## Red flags that trigger audits

- ▶ Financial or tax performance that varies substantially from industry patterns
- ▶ Significant variations in the amounts or patterns of tax payments compared to past performance and relevant economic indicators and industry trends
- ▶ Unexplained variation between economic performance, productivity and tax performance
- ▶ Unexplained losses, low effective tax rates, and cases where a business or entity consistently pays relatively little or no tax
- ▶ A history of aggressive tax planning by the corporation, group, board members, key executives or advisers
- ▶ Weaknesses in the compliance structures, processes and approaches
- ▶ Tax outcomes that are inconsistent with the policy intent of the tax law

## Questions for audit committees:

- ▶ What tax risks does your company face?
- ▶ How do you evaluate the company's approach to tax planning and specific key tax strategies?
- ▶ Are you satisfied with the audit committee's approach to overseeing tax matters?
- ▶ Are there ways to improve the committee's ability to evaluate the tax function?
- ▶ How often do you meet with the tax director?
- ▶ What is your company's relationship with tax authorities in the jurisdictions in which it operates?
- ▶ Do you have a good sense of which tax positions are most vulnerable or the extent of tax audits currently being undertaken in your company?

<sup>2</sup> Ernst & Young, *Tax administration without borders: Navigating the changing global tax controversy and risk management landscape* (Ernst & Young Global Limited, 2009).

<sup>3</sup> Ernst & Young, "Transfer pricing enforcement takes center stage in the post-crisis environment," *Tax policy and controversy briefing*, November 2009.

<sup>4</sup> OECD Forum on Tax Administration, "General Administrative Principles: Corporate governance and risk management," *Information Note*, July 2009, page 5.

# Investigations and litigation surrounding competition law are increasing

Over the past decade, the European Commission has burnished its enforcement credentials by prosecuting more and larger cases tied to competition law and by increasing fines. With the passing of the competition portfolio to Joaquín Almunia from his predecessor Neelie Kroes, companies may be wondering if there will be a change in philosophy or approach. Participants in our research believe not, particularly given Mr Almunia's "deep commitment to the effective functioning of markets." Indeed, there are signs that the focus on competition law may intensify, both in Europe and the United States.

## A number of factors are driving the increased focus on competition laws

Participants identified a number of factors that will likely push compliance with competition laws up corporate and audit committee agendas over the next few years:

- ▶ **Increased financial exposure.** European Commission fines for competition-law violations have been steadily increasing in recent years, culminating in the record-high fine of €1.06 billion against Intel in May 2009.<sup>5</sup> As one participant remarked, "The fines can be big, really hitting the bottom line." With the potential emergence of private litigation in Europe, which would allow those who have suffered damages from violations of competition law to seek redress in the courts, "the financial exposure implications are huge," noted one participant. That participant explained that policymakers have been debating whether Europe "can create a better framework for private litigation." Under Ms Kroes, the Commission made several statements on the topic,<sup>6</sup> but the job of proposing a directive will fall to Mr Almunia.
- ▶ **More transatlantic alignment on enforcement.** In the United States, the Obama administration has signaled a return to the energetic enforcement that has typically characterized antitrust policy in the United States. Several participants noted that the Bush administration pursued less aggressive enforcement, leaving a gap between the United States and Europe that was starkly illustrated by the attempted General Electric-Honeywell merger in 2001.<sup>7</sup> Participants believe the United States and Europe are again philosophically aligned and determined to cooperate closely.

- ▶ **More effective enforcement.** One participant mentioned that the Commission has started to carry out sector-wide inquiries to assess whether certain markets are working effectively. While these inquiries are fact-finding exercises, they can ultimately lead to prosecutions and other corrective measures. As the participant noted, "For any sector where there is a general concern about whether there is enough competition or not, corporations would be well advised [to know] that the EU has this general inquiry power." In addition, national competition authorities in Europe are expanding their activities. One participant remarked, "Don't forget the national level – all of them have the power to enforce European law. Investigations can start in one country and spread to others, and be coordinated."
- ▶ **Criminal prosecutions of individuals.** While the Commission currently cannot pursue criminal prosecutions against individuals involved in competition-law cases, nine national authorities can. Only a few cases have been decided so far, but if this form of enforcement becomes more prevalent, it will raise the stakes even more. As one participant noted, "More and more countries are introducing legislation to criminalize [violations] and prosecute individuals, and not necessarily [just very] senior ones. People could end up in jail, a new concept in Europe."

## Audit committees will need a strong focus on compliance

Compliance with competition laws has long been an issue for companies, and most established companies are organized to address it. However, as scrutiny in compliance with competition laws increases in Europe and across the globe, and as the consequences of prosecutions become more severe, audit committees may want to ensure their companies bolster both their compliance processes and their relationships with regulators. Participants had several suggestions:

"For any sector where there is a general concern about whether there is enough competition or not, corporations would be well advised [to know] that the EU has this general inquiry power."



“Having an independent [person] outside the corporation whom one can invite people to talk to if they believe there might be a problem is certainly a feature of an effective compliance program.”

#### Questions for audit committees:

- ▶ Are you confident that your company’s compliance systems adequately address competition-law issues?
- ▶ How well has your company tested these systems?
- ▶ How do you ensure the systems and policies are aligned with current thinking from European and American competition authorities?
- ▶ What is the level of awareness among employees regarding competition laws, and how is their understanding maintained and updated?
- ▶ What kind of relationship does your company have with competition authorities?
- ▶ Would your company’s management feel confident consulting the authorities about potential problems?
- ▶ What kind of perceptions do competition authorities have of your company?

- ▶ **Implement a robust compliance system.** As one participant remarked, “*The application of strict compliance programs in relation to the behavior of employees is a fundamental safeguard in any corporation.*” Compliance policies and processes need to be promulgated throughout the organization, on a routine basis, such that every employee knows what a cartel is and what types of agreements or discussions with competitors are not acceptable. One participant noted, “*Everyone has to be trained to the point where bells go off in their head.*” Several participants highlighted that this is particularly important for companies that benefit from a dominant market position. Resources should be available for employees who have questions so they can answer those questions easily. One participant stated that, “*Having an independent [person] outside the corporation whom one can invite people to talk to if they believe there might be a problem is certainly a feature of an effective compliance program.*”
- ▶ **Test the compliance system.** Companies need to ensure that the compliance system works as intended. Is it reaching all employees? Is it built into the due diligence performed during acquisitions of other companies? If the program appears to be inadequate, forensic measures may be in order to ferret out any problems. External advisers can be helpful in assessing the system, performing, for example, mock raids that can expose weaknesses. Since determining compliance in some areas can be difficult (for example, if a company is in a dominant market position, when exactly has it abused that position?), participants recommended companies keep abreast of the increasing Commission guidance on competition laws.<sup>5</sup>
- ▶ **Open, proactive communication with regulators.** Several participants noted that regulators are more forgiving of companies that are forthcoming with information. One remarked, “*[Authorities] can reward those that give [them] additional information, but not those who wait around to see if they get prosecuted or not.*” If companies suspect that there is a problem, they should quickly let regulators know.

<sup>5</sup> Richard Waters and Nikki Tait, “Intel settles antitrust AMD case for \$1.2bn,” *Financial Times*, 13 November 2009.

<sup>6</sup> See, for example, Commission of the European Communities, *Damages actions for breach of the EC antitrust rules* (Brussels: Commission of the European Communities, 2008).

<sup>7</sup> General Electric attempted to buy Honeywell, only to have the deal quashed by the European commissioner for competition at the time, Mario Monti. Jack Welch, then CEO of General Electric, appealed to the Bush administration, a move that infuriated Mr Monti; the deal did not go through. (See Michael Elliot, “The Anatomy of the GE-Honeywell Disaster,” *Time*, 8 July 2001.)

<sup>8</sup> European Commission, “Communication from the Commission: Guidance on the Commission’s enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings,” Official Journal of the European Union, 24 February 2009.

# The compliance risks of operating in emerging markets are increasing

Economists have been predicting a global shift in economic power from west to east for years, and many believe the fallout from the economic crisis has accelerated this trend materially. Antoine van Agtmael, who coined the term “emerging markets,” said to a group of large-company European and American audit committee chairs in August 2009, “In the last 10 years, we have seen a fairly dramatic shift in total sales to emerging markets ... Large companies can no longer afford to see these economies as peripheral.”<sup>9</sup> Audit chairs recognize this trend, with one noting, “For my company, strategically, we have no choice but to consider emerging-market opportunities. Developed markets do not support our growth aspirations.”<sup>10</sup>

Beyond the strategic issues this trend raises, which audit chairs universally see as a topic for the full board, the question has been for some time, what role should the audit committee play, if any? Participants in this research see a role for audit committees addressing increasing compliance risk, notably risk relating to anti-bribery rules, which are now on the front burner again due to a push by G-20 leaders.

## **Globally, anti-bribery efforts are intensifying**

At the September Pittsburgh G-20 meeting, world leaders added significant momentum to global anti-bribery and corruption efforts by calling for “the adoption and enforcement of laws against transnational bribery,”<sup>11</sup> with specific reference to the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions established by the Organisation for Economic Co-operation and Development (OECD), among other initiatives.<sup>12</sup>

Secretary-General Angel Gurría of the OECD said recently, “Thanks to the Convention and the commitment to the countries that are Parties to it, foreign bribery is now a criminal offense in much of the world ... Because of this collective crackdown on corruption, some 150 sanctions have been imposed for cases involving foreign bribery. Another 250 cases are under investigation.”<sup>13</sup> A new anti-bribery recommendation recently adopted by signatories to the Convention includes provisions to combat small facilitation payments, to protect whistleblowers and to improve lines of communication between public officials and law enforcement

authorities.<sup>14</sup> The United States, which has a strong law against foreign corruption in its Foreign Corrupt Practices Act (FCPA),<sup>15</sup> has increased enforcement of the law dramatically. Last year saw 40 enforcement actions, 26 brought by the Department of Justice and 14 by the Securities and Exchange Commission, compared with 33 actions in 2008.<sup>16</sup>

Audit chairs are well aware that cultural differences in the ways of doing business in emerging markets can make companies inadvertently run afoul of anti-bribery laws. The potential for transgressions remains high, as shown by the 2009 results from Transparency International's *Global Corruption Barometer*, an annual report on corruption. Its survey of over 73,000 people in 69 countries revealed that 50% of respondents saw the private sector as corrupt, an increase of more than 8% over five years ago, and 56% viewed government anti-corruption measures as ineffective.<sup>17</sup> (Needless to say, fraud issues are also in existence in developed markets, for example, accounting fraud.)

## **Authorities in emerging markets are stepping up their enforcement efforts**

Domestic regulators in emerging markets are increasing enforcement actions in a number of areas. Chinese competition authorities, for example, have recently begun to flex their muscles, handing down a number of important rulings that include extraterritorial demands. In a November 2009 ruling, Chinese authorities made local approval for the Japanese company Panasonic's proposed acquisition of another Japanese company, Sanyo Electric, dependent on Panasonic's sale of important assets in Japan.

The ruling also required Panasonic to reduce its stake in a joint venture with Toyota, a demand that went beyond the actions of European and American authorities.<sup>18</sup> Actions such as these add potential complexity for firms operating in China, particularly if China's rulings diverge from Western standards. One participant said, “China's [competition-law] efforts could create another complication for [European] companies, or be a way that they don't get the return [on investment] that was [desired].” Beyond competition laws, recent trends show evidence Chinese authorities will also be focusing on taxation in the coming years.<sup>19</sup>



## The question has been for some time, what role should the audit committee play [in emerging markets], if any?

### Audit committees have a role to play

Audit chairs point to a number of ways their committees can be proactive in dealing with compliance risks in emerging markets:

- ▶ **Consider board or audit committee representation from important markets.** At the meeting of large-company audit chairs mentioned earlier, participants discussed the value of adding board directors with backgrounds in the emerging markets in which the company operates. Views were mixed on the benefit of such representation.<sup>20</sup> However, to the extent that a particular market is of great strategic importance, yet creates significant regulatory and political uncertainty, having local knowledge in the boardroom can be beneficial.
- ▶ **Ensure robust communication flow to the audit committee.** Audit chairs highlight the importance of a steady flow of information from the CFO, internal audit and other reporting channels (such as whistleblower hotlines) to provide insight into the culture and operations in these markets. Several recommend board members visit the firm's operations in those markets to get a sense of the ethical tone there.

### Questions for audit committees:

- ▶ How have anti-bribery and corruption legislation and enforcement impacted your company's business – or considerations regarding doing business – in emerging markets?
- ▶ Are there ways in which your company can improve the effectiveness of its anti-bribery compliance efforts?
- ▶ Have you?
- ▶ Have you scheduled board or audit committee meetings in key emerging markets?
- ▶ Do you encourage audit committee members who visit these countries for any reason to meet with your local management?

- ▶ **Consider "deep dives" into existing controls.** One participant note that, in light of the heightened regulatory focus on anti-corruption policies, his audit committee has commissioned a deep dive into the company's approach, particularly to FCPA requirements.
- ▶ **Ensure relationships with regulators and other authorities are strong:** Participants almost unanimously agreed this effort will pay off in the current era of increased regulatory scrutiny. In emerging markets, this may be even more important, given the added factors of differing focus, approach and culture.
- ▶ **Seek the advice of outside experts:** Audit committees can work with local risk advisers, outside legal counsel and their external auditors to gain insight into potential fraud or corruption risks. Auditors can help companies understand the risks involved, even if their operations in emerging markets are still relatively limited. One audit chair said, *"In one firm, we were concerned about several small outposts in emerging markets. On an aggregate basis, they were miniscule. But there was significant reputational risk. So we relied heavily on the internal auditor to assess these outposts ... [and] the external auditor helped."*<sup>21</sup>

<sup>9</sup> Audit Committee Leadership Summit, "Risk in emerging markets," *ViewPoints*, 4 August 2009, page 2.

<sup>10</sup> *Ibid.*, page 6.

<sup>11</sup> Pittsburgh Summit 2009, "Leaders' Statement: Pittsburgh Summit," 24-25 September 2009.

<sup>12</sup> The text of the OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and information on its entry into force and status of ratification.

<sup>13</sup> Angel Gurría, "Foreign Bribery: Who Pays the Price?" Remarks broadcast live from Washington, DC, to the OECD roundtable on foreign bribery in Paris, 9 December 2009.

<sup>14</sup> *Ibid.*

<sup>15</sup> US Department of Justice, "Foreign Corrupt Practices Act: Antibribery Provisions."

<sup>16</sup> Melissa Klein Aguilar, "2009 Another Record Year for FCPA Actions," *Compliance Week*, 7 January 2010.

<sup>17</sup> Transparency International, *2009 Global Corruption Barometer* (Berlin: Transparency International, 2009), pp 2, 17.

<sup>18</sup> Sundeep Tucker, "The people's police," *Financial Times*, 29 November 2009.

<sup>19</sup> Richard Meyer, "China Whets Its Enforcement Appetite," *Compliance Week*, 12 January 2010.

<sup>20</sup> Audit Committee Leadership Summit, "Risk in emerging markets," pp 7-8.

<sup>21</sup> *Ibid.*, page 11.

# When regulators and standard-setters act decisively, sustainability will move up the agenda

Increasingly, there could be significant negative ramifications, from an enterprise risk perspective, of overlooking sustainability.

Over the past two years, global discussion and action on the environmental agenda has increased dramatically, driven by the G-20's prioritization of the issue in 2009 and by governmental efforts to boost energy conservation.<sup>22</sup> One research participant said, *"This is no longer an esoteric issue ... therefore there is a totally different level of engagement."*

## The degree of audit committee attention will depend on new regulation

Companies have gradually increased sustainable business practices over the course of the previous decade. Participants and experts highlight that executives have pushed sustainability for a variety of reasons, including:

- ▶ **Changing consumer demands:** *"Consumers are demanding to know what companies are doing."*
- ▶ **Cost control:** *"It's about reducing costs ... [C-suite executives] may have a corporate responsibility agenda, but it's primarily about reducing energy costs."*
- ▶ **Business opportunities:** *"The world is about to completely change the way it produces and consumes energy. This is going to make a lot of people a lot of money."<sup>23</sup>*

However, the advances have not come without setbacks. For example, despite the obvious momentum leading up to the Copenhagen climate change summit in December 2009, the summit failed to elicit a substantive agreement from the world's largest countries to reduce their greenhouse gas emissions. Several participants said that in the short term, that lack of an agreement will slow the corporate sustainability agenda.

It may also retard the pace at which audit committees step up their oversight of sustainability. Audit committee chairs have repeatedly noted that, outside of specific industries, sustainability issues remain the remit of management. Even those committees whose companies voluntarily issue sustainability reports rarely play an active role in overseeing the reports' development.<sup>24</sup> Nonetheless, participants said there are several factors that could move the topic up the audit committee agenda:

- ▶ **Aggressive regulatory intervention.** In early December, while the Copenhagen summit on climate change was under way, the EPA issued a long-expected ruling that greenhouse gases threaten public health, a move that the business community fears will allow it to regulate these emissions without legislation from the Congress.<sup>25</sup> Participants feel this regulation could be a watershed moment for business. One said, *"Businesses are panicked about this. It will drive industry to have to do something. Audit committees need to get on board."* Another participant said, *"We did an analysis of the regulatory framework on this issue. The focus was really on the US and the EPA forcing companies to report. If that happens, [executives] will have to take notice."* Professor Michael Gerrard, director for climate change law and Columbia Law School said recently that *"there is no doubt that EPA regulation would inflict pain on some industries."<sup>26</sup>*
- ▶ **Heightened compliance risk.** Authorities are increasingly adopting new regulations to counter climate change and support clean technology efforts, most frequently at the national and local levels, creating a complex web and no unifying framework. Between July 2008 and February 2009, 250 climate change regulations were enacted across the globe, with 106 being enacted in the EU alone.<sup>27</sup> Participants expect this trend to continue, so companies doing business across Europe will be increasingly challenged to keep track of specific country regulations as well as the broader regulations of the EU.
- ▶ **New reporting standards.** Participants believe that having a defined cost for carbon will also be a turning point for companies and audit committees. One said, *"Companies need to know the cost of carbon, what it will cost them in the future and how to lower [that cost]."*

The Greenhouse Gas Protocol Initiative, the Climate Disclosure Standards Board and many other organizations have offered standards for measuring and reporting carbon emissions. A research participant said, *"Because there is no global agreement, everyone is doing it on their own. There are 130 [different groups] looking at this issue globally."*



The International Accounting Standards Board (IASB) is currently working with Financial Accounting Standards Board (FASB) to develop guidance on the accounting for emissions trading schemes (ETs) such as the one currently in use in the European Union. In March 2009, the IASB tentatively decided that allowances received free of charge from the government should be recognized as assets that should initially be measured at fair value, and that if the allowances are received for free, the organization is obliged to reduce its emissions below the level represented by those allowances. The IASB expects to release an exposure draft for an International Financial Reporting Standard on ETs by the second quarter of 2010.<sup>28</sup>

Participants agreed that when a common approach to accounting for the cost of carbon has been reached, the audit committee will have a much clearer role: *"The [environmental] agenda is bubbling along, but until there is a standard, I can't see anybody putting this information in the financial statements. When there's a standard, it will be on the audit committee agenda."*

#### **Audit committees may have to put sustainability on their agenda**

As sustainability-related regulations become more burdensome, there are a number of ways in which audit committees could provide additional oversight:

- ▶ **Integrate sustainability into the enterprise-wide risk assessment.** Increasingly, there could be significant negative ramifications, from an enterprise risk perspective, of overlooking sustainability. Many participants described sustainability as an important reputational risk: *"The discussion we see around this is that it's [about] the public relations of the business ... It could be a real reputational danger if [you aren't doing the right things.]"* Audit chairs recognize that reputational risk can be even more devastating than other, more tangible, risks.<sup>29</sup>
- ▶ **Focus on quality of disclosures.** Several research participants said that the poor quality of reporting needs addressing: *"There is a lot of uncertainty around how to measure [sustainability efforts], what to include and what not to include. Also, how should the company set targets? What represents appropriate benchmarking? This is an important issue audit committees will have to face."* Given the likelihood that the EPA will regulate carbon emissions and the soon-to-be-released IASB reporting standard on ETs, audit committees may wish to take a more proactive role sooner rather than later. For example, audit committees could evaluate the rigor of internal controls over carbon and sustainability reporting.

- ▶ **Consider third-party validation of sustainability reporting.** Several participants noted that as reporting standards become more onerous, the pressure to validate sustainability data will grow. To the extent the data makes their way into the financial statements, the external auditor would have to attest to their accuracy. Some companies are getting ahead of this trend and are already seeking voluntary data validation by third parties. One participant said, *"External audit needs to ensure that what is reported is appropriate ... For now, these reports are not of great value."*

#### **Questions for audit committees:**

- ▶ Is sustainability risk captured fully in your company's enterprise-wide risk assessment process?
- ▶ Does the assessment fully anticipate the reputational risks associated with sustainability?
- ▶ What do you see as the key sustainability risks for your company?
- ▶ Are you confident that management has a clear understanding of the regulatory initiatives that are under way and how they could impact your company's risk profile?
- ▶ How have you evaluated the integrity of your company's sustainability reporting and the systems used to generate sustainability data?

<sup>22</sup> For example, in one seven-month period, governments around the world committed to investing more than US\$430 billion of their stimulus package to climate change efforts such as tax credits, grants and incentives. See Ernst & Young, *The business response to climate change: choosing the right path* (Ernst & Young Global Limited, 2009), page 2.

<sup>23</sup> Paul Dickinson, CEO and founder of the Carbon Disclosure Project, quoted in Global Reporting Initiative and the Association of Chartered Certified Accountants, *Getting It: Expert Perspectives on the Corporate Response to Climate Change* (London: Association of Chartered Certified Accountants, 2009), page 4.

<sup>24</sup> See Audit Committee Leadership Summit, "Commentary on 'The governance of sustainability,'" *ViewPoints*, 23 January 2008 and Ernst & Young and Tapestry Networks, "The Governance of Sustainability," *InSights* 16 November 2007.

<sup>25</sup> Alister Doyle, "U.S. moves to curb emissions," *Reuters*, 7 December 2009.

<sup>26</sup> Elizabeth Shogrun, "EPA: Greenhouses Threaten Human Health," *National Public Radio*, 7 December 2009.

<sup>27</sup> DB Advisors, *Global Climate Change Regulation Policy Developments: July 2008-February 2009* (New York: DB Advisors, 2009), page 6.

<sup>28</sup> International Accounting Standards Board, "Emissions Trading Schemes."

<sup>29</sup> Audit Committee Leadership Summit, "Commentary on 'The governance of sustainability,'" page 4.

# Capital market dynamics require ongoing audit committee vigilance

During the financial crisis, funding and especially liquidity became top priorities for boards and audit committees, prompting extra meetings, closer communications with the treasury function and increased scrutiny of counterparties.<sup>30</sup> Research participants acknowledged that during the next several years, the emphasis may shift from immediate liquidity issues and more toward capital structure, but they urged audit committees – in the absence of a finance committee – to continue to pay close attention to the financial landscape, which is still evolving in ways that are difficult to predict.

## Capital markets will remain unpredictable for some time

While participants agreed that capital markets have stabilized, they suggested that the ongoing level of uncertainty regarding how markets will evolve merits attention, and they noted two trends of particular importance to European companies:

### ▶ **Disintermediation has accelerated, but it is unclear how the bond market will develop.**

The crisis accelerated a trend that was already under way in Europe: increasing reliance on the bond markets. This shift was particularly evident among medium-sized companies that had previously relied exclusively on banks for funding and among larger companies that were reducing their reliance on commercial paper.<sup>31</sup> As several participants noted, Europe has seen a “*trend towards disintermediation*” in finance. European bond issuances hit record levels in 2009, doubling to €337 billion for non-financial companies.<sup>32</sup> While the cost to companies was initially high, spreads fell over the course of the year.<sup>33</sup> This in turn increased demand for higher-yield bonds, allowing weaker companies to benefit from the boom, which is expected to continue into 2010.<sup>34</sup> However, demand for bonds could drop off quickly if conditions change – for example, if inflation begins to emerge, or investor appetite wanes. One participant noted, “*Corporate bonds have been attractive of late because of their yields, but with narrowing spreads, [the market] may not be as favorable [for long].*”

Europe has seen a “trend towards disintermediation” in finance.

- ▶ **Funds for bank lending may remain tight for an extended period.** European companies have traditionally been more dependent on banks for their funding than have their US counterparts. Medium-sized and small firms in particular have close, long-term relationships with their banks, which, as noted above, have provided almost all their financing. Large companies have been more apt to turn to the bond markets, but even they have relied on bank credit lines as a back up to their commercial paper programs, which became extensive during the years of easy credit. In the wake of the financial crisis, however, banks have restricted their lending as they have sought to de-risk their business, rebuild their balance sheets and meet regulatory demands for higher capital reserves and liquidity cushions. Direct loans as well as syndicated loans have dropped sharply.<sup>35</sup>

## Financing risks should remain top of mind for audit committees

Participants believe capital availability will not return to pre-crisis levels in the short to medium term. Companies may not be able to count on steady improvements over the next several years, and they must plan accordingly. Boards and audit committees need to be sure that their companies take the following steps:

- ▶ **Review the long-run capital structure.** Companies must take into account what may be a permanent shift away from bank lending. They need to take a broader view of funding, and they must prepare to be nimble in tapping various sources as those sources wax and wane. In addition to banks, bonds and rights issues, companies might consider alternatives such as private equity and sovereign wealth funds.<sup>36</sup> At the same time, companies should ensure that they diversify and strengthen core relationships with banks, because banks will continue to play an important, if reduced, role in funding.
- ▶ **Be sure processes for managing working capital are robust.** It is critical to ensure that a process for managing working capital effectively is firmly in place for the long haul, so that inflexible balance sheets and overreliance on commercial paper do not become an issue again, as they did for many companies during the crisis.<sup>37</sup>
- ▶ **Ensure investment and hedging policies are sufficiently conservative.** Companies’ investment and hedging strategies should reflect the realities of capital availability and the true extent of counterparty risk, and audit committees should remain on guard against the use of more opaque financial securities deemed to be cash equivalents.



Companies need to take a broader view of funding, and they must prepare to be nimble in tapping various sources as those sources wax and wane.

- ▶ **Ensure that the finance team has the right skill-set.** The shift in the financial landscape requires a shift in the capabilities of the finance team. One participant commented, *"In the past, CFOs were primarily focused on the relationships with their shareholders, not financial policy ... now, CFOs may be more focused on ratings, bond issuances, and looking at the financial policy in terms of leverage and the optimal financing structure."* Despite perceptions that there is a general surplus of management talent in the current environment, companies face a different reality in finance, noted participants: *"The skills we are fighting over are different. For the finance organization, there is a limited amount of talent."* Noted another, *"Young CFOs may not have experience with [the right] kind of financing that more seasoned [CFOs] have."*
- ▶ **Ensure the governance of capital matters is well defined.** Capital matters may be covered by several board committees – especially if a finance committee is in place – as well as by the full board. It is important that the audit committee coordinate its oversight of capital and funding matters with other committees and the board.

Many companies are already taking these steps; for many, funding and management of working capital have become high-level strategic issues. But audit committees need to review their companies' strategies in these areas to ensure that this is indeed the case.

#### Questions for audit committees:

- ▶ In what ways has your company's review of its capital structure taken long-term shifts in capital availability into account?
- ▶ How does your company allow for flexibility in raising funds?
- ▶ What steps have been taken to tighten the management of working capital?
- ▶ How will you ensure your company avoids the types of practices that created problems in the past, such as an excessive use of short-term debt?
- ▶ Do your company's investment policies take into account the new financial landscape and its risks?
- ▶ Has your company considered setting up a finance committee of the board?
- ▶ If you have one already, how does the audit committee coordinate effectively with the finance committee?

<sup>30</sup> See European Audit Committee Leadership Network, "Funding and liquidity in today's capital markets," *ViewPoints*, 8 May 2009.

<sup>31</sup> Aline van Duyn, "Supply shocks in store after switch to bonds," *Financial Times*, 24 December 2009.

<sup>32</sup> Caroline Hyde and Esteban Duarte, "Banks Hoarding Cash in Europe Drives Treasurers to Record Bonds," *Bloomberg.com*, 15 December 2009.

<sup>33</sup> Jennifer Hughes, "Companies welcome new issues demand," *Financial Times*, 13 October 2009.

<sup>34</sup> Michael Wilson, "Europe's Bond Boom to Continue," *Wall Street Journal*, 9 December 2009.

<sup>35</sup> Caroline Hyde and Esteban Duarte, "Banks Hoarding Cash in Europe Drives Treasurers to Record Bonds," *Bloomberg.com*, 15 December 2009.

<sup>36</sup> Ernst & Young, *Lessons from change* (Ernst & Young Global Limited, 2009), pp 12-13.

<sup>37</sup> Aline van Duyn, "Supply shocks in store after switch to bonds," *Financial Times*, 24 December 2009.

# Conclusion: government intervention creates enhanced risks for companies



“Regulatory risk is getting worse. And companies will need to cope better with this risk.”

A group of audit chairs from leading European global companies met in November 2009 to discuss the 2010 audit committee agenda.<sup>38</sup> One of the most striking conclusions was the emergence of heightened regulatory risk. Several audit chairs agreed with their colleague who said, “Regulatory risk is getting worse. And companies will need to cope better with this risk.”<sup>39</sup> One meeting participant noted, “Regulators are almost interfering in business ... There has been a swing of the pendulum, and some [regulators] are overdoing it.”<sup>40</sup>

Participants in this research concluded that audit chairs greatly underestimate the breadth and intensity of regulatory risk facing European companies, particularly ones operating across borders. Indeed, for them, “regulatory risk” seems too narrow. Instead, audit committees would be well advised to think more broadly about the way greatly increased governmental intervention – at the G-20 and domestic levels – has significantly increased existing compliance risks, and has the potential to create more risks over coming years, for example, in the area of sustainability. In their view, the ongoing need for audit committee oversight of capital and funding matters can be attributed to government intervention in banks and capital markets.

As one participant put it, “We are really entering a very new era in terms of the attitudes of regulators ... It’s a new kind of aggression. [We risk running] afoul of things that were okay and now are not [okay].” One participant noted that “regulation is very much affecting [the] audit committee agenda, and audit committee members are very concerned ... and are pushing the conversation with management.” However, it will be a challenge for audit committees to adapt their agenda sufficiently during the course of this year to appropriately oversee the risk that can be attributed to broad-scale government intervention, particularly as the zeal for enforcement – including cross-border enforcement – picks up speed.

## About Tapestry Networks

Tapestry Networks is a privately held professional services firm that brings leaders together to solve complex problems. Since 2002, networks convened by Tapestry Networks have tackled some of the most significant strategic challenges facing institutions and society, including raising standards in corporate governance in the United States, Canada and Europe, developing strategies for a more sustainable healthcare environment in Europe, and enhancing national security in the United States through public-private collaboration.

Tapestry Networks convenes eight audit committee networks, sponsored by Ernst & Young, that collectively consist of more than 120 individuals, who chair more than 180 audit committees and sit on over 300 boards at some of the world’s most admired companies. For more information, please visit [www.tapestrynetworks.com](http://www.tapestrynetworks.com).

<sup>38</sup> The topics discussed are presented in European Audit Committee Leadership Network, “The 2010 audit committee agenda,” ViewPoints, 10 December 2009.

<sup>39</sup> Ibid., page 3.

<sup>40</sup> Ibid.

# Appendix:

## Research participants

In December 2009 and January 2010, Tapestry Networks interviewed a range of subject-matter experts. All discussions were held under a modified version of the Chatham House Rule, whereby views expressed during private discussions are not attributed to individuals or their organizations.

The participants were:

- ▶ **Jean Baptiste Bellon,**  
Equity Analyst, Cheuvreux
- ▶ **Rupert Bondy,**  
Group General Counsel, BP
- ▶ **James Brady,**  
Vice President, Group Internal Audit, AstraZeneca
- ▶ **Jean-Michel Carayon,**  
Managing Director, Credit Policy Group, Corporate Finance Group-EMEA, Moody's Investors Service
- ▶ **Adrian Cooper,**  
Chief Executive Officer, Oxford Economics
- ▶ **Melba Foggo,**  
Director, Climate Change and Sustainability Services, PMO Leader, Ernst & Young
- ▶ **Felice Friedman,**  
Director, Global Regulatory Affairs and Stakeholder Relations, Ernst & Young
- ▶ **Thomas Fuerer,**  
Group Senior Vice President, Head Group Function Corporate Taxes, ABB Asea Brown Boveri Ltd
- ▶ **Fabien Gitenay,**  
Director, Global Strategy, Ernst & Young
- ▶ **Anita Hoffman,**  
Partner, Heidrick & Struggles
- ▶ **Jeremy Jennings,**  
Global Director, Regulatory & Government Relations, Ernst & Young
- ▶ **Philip Lowe,**  
Director General, Directorate-General for Competition, European Commission
- ▶ **Anne MacGregor,**  
Counsel, Baker & McKenzie
- ▶ **Pascal Macioce,**  
EMEIA Assurance Leader, Ernst & Young
- ▶ **Tom McGrath,**  
Managing Partner, EMEIA Financial Services, Ernst & Young
- ▶ **Christian Mouillon,**  
Global Vice Chair, Assurance, Ernst & Young
- ▶ **Jeff Owens,**  
Director, Centre for Tax Policy and Administration, OECD
- ▶ **Andrea Potter,**  
Assistant Director Americas Markets Planning & Analysis, Ernst & Young
- ▶ **Sabine Renner,**  
Analyst, Credit Policy, Corporate Finance EMEA, Moody's Investors Service
- ▶ **Mark Weinberger,**  
Americas Vice Chairman - Tax, Ernst & Young
- ▶ **Suzanne Wood,**  
Co-leader, Global Financial Officers Practice, Heidrick & Struggles

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