

Caribbean Association of Audit Committee Members Inc.

Audit Committees:
Making Corporate Governance Work in the Caribbean

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Audit Committees: Assessing Critical Issues

Mr. Chairman, I thank you for your warm words of introduction, and for the invitation that you and your team have extended to me to share my thoughts on this important matter as part of the opening ceremony for this conference.

On behalf of the partners and staff of PricewaterhouseCoopers East Caribbean firm, I wish to congratulate the Caribbean Association of Audit Committee Members for their foresight in highlighting the need for such an initiative, and the various sponsors and presenters for embracing and supporting the initiative. I have no doubt that you, the participants, will find the programme insightful and inspiring.

I wish to commend the Caribbean Association of Indigenous Banks for being the catalyst in the establishment of the Caribbean Association of Audit Committee Members. This entity has moved from concept to creation within one year – truly an outstanding achievement in the Caribbean environment where we often forget that action speaks louder than words. As with any milestone, the first anniversary of the CAACM provides us with the opportunity to review and reflect, but more importantly to build on the lessons learnt and chart a path for the future.

Why are we here?

Although there are always a number of compelling reasons to visit Saint Lucia, our presence is driven by the acknowledgement that, in the region and globally, there are new rules being developed and applied to the business environment, particularly with regard to governance. Indeed, the participation of so many key persons in this initiative is eloquent testimony to the mature approach we now apply to managing our affairs and cognizance that, despite our achievements, our on-going success is highly dependent on continuous improvement.

The new rules to which I have alluded have been driven by a series of catastrophic corporate failures, the most notable being Enron. Enron: the largest market cap company in business history to go bankrupt. Notwithstanding a long list of precursor events, well publicized corporate failures in a number of countries, the collapse of the Internet bubble among others, Enron was the straw that broke the camel's back. It brought into sharp focus the flaws in the capital markets and has shaken the public trust in key institutions.

It is ironic that these egregious failures were driven by an initiative that was designed to build, and not destroy, corporate value. Let us not forget that in the 1990s we embraced executive compensation schemes that were to ensure we recruited and retained the best talents. These schemes provided cash bonuses and stock options based on the ability of these individuals to enhance shareholder value. We were blinded by the raging bull market of that era, with its unsustainable growth and unrealistic price/earnings ratios. In hindsight, we now recognize that much of this value was fictitious. But it did not prevent executives of failed or failing companies from garnering substantial compensation even as their companies and the retirement savings of their employees have collapsed.

But the Enron collapse also provides us with the opportunity to sharpen our focus on the critical elements that will restore such trust. Sam DiPiazza, CEO of PricewaterhouseCoopers, in his book 'Building Public Trust - the Future of Corporate Reporting' outlines three core concepts that must be embraced in order to achieve this objective. These are:

- *A spirit of transparency.* Corporate executives must stop playing the 'earnings game' which seeks to manage earnings and market expectations, and instead report forthrightly on the businesses' critical value drivers.
- *A culture of accountability.* Everyone must be accountable: management for producing relevant and reliable information; boards for ensuring that management adequately discharge this obligation; external auditors for ensuring the objectivity and independence of their audit opinions; and analysts for producing high quality, unbiased research and assessments. Investors and other stakeholders must also hold themselves accountable for the decisions they make.

- *People of integrity.* Rules, standards, and frameworks can only go so far. Transparency and accountability can only be achieved by people that are committed to integrity, jointly and severally.

In these circumstances, the bar has been raised significantly. There is no longer a rush for persons to embellish their CVs with a list of company boards on which they sit. In fact, the concept of ‘sitting’ is extinct – if you are not prepared to serve, the board room is not the place for you. Indeed, a recent Booz Allen Hamilton report indicated that given these challenges, many corporations are facing the prospect of an empty boardroom.

More importantly, the intense scrutiny of corporate governance practices from all stakeholders has placed audit committees firmly in the spotlight. Their function is characterized by an expanded workload, which has been coupled with the need to develop and maintain strong working relationships with management – all in a dynamic environment where the standards are constantly evolving, regulators have become more intolerant of inappropriate behaviour, and shareholders have exhibited an increasing tendency to take legal recourse for losses incurred or other violations of their rights. The challenge is not only to discharge these duties effectively, but to avoid personal liability and reputational damage.

The imperative for audit committee members is to achieve an appropriate balance between overseeing and advising management, while avoiding the tendency to micro-manage. Without any doubt, it is recognized that audit committees can only be successful in these endeavors if, and only if, that can identify, assess and effectively address the critical issues.

But what are these critical issues?

- *Financial statements.* Audit committees must bring the discipline to ensure companies provide information to the investor world that is digestible and reliable. They must understand the different types of information and various perspectives committees need to draw on in order to oversee the integrity of the financial statements, as well as be confident they understand the financial statements.
- *Risk management and internal control.* Increasingly, audit committee oversight is extending beyond financial reporting risks, to the effectiveness

of management's responses to risks that might prevent a company from achieving its strategic objectives. Once there's consensus on the scope of its oversight of risk, the audit committee needs to understand those risks within its purview and to be confident that management's practices - both identifying and assessing risk and responding to it through the internal controls it has established and operates - are satisfactory. And audit committees also should ensure management's reporting on the effectiveness of internal control over financial reporting is complete and understandable.

- *Compliance and ethics.* Directors now clearly understand how quickly corporate and personal reputations can be destroyed by unethical actions. And audit committees are playing an increasingly central role in ensuring ethics, codes of conduct, and tone at the top meet appropriate standards.
- *Oversight of management and internal audit.* The strength and candour of the audit committee's working relationships with management and the internal audit function are key to determining the committee's success. Audit committees always have needed to balance their fiduciary role with their role as advisors to management. However, as audit committee responsibilities have increased and the external pressure to emphasize their fiduciary role mounts, tensions have increased. And committees increasingly are looking to the internal audit function for objective assessments of risk and control in operational, compliance, and reporting areas, and many are taking steps to support internal audit's stature and effectiveness.
- *Relationship with external auditors.* Audit committees now must own the relationship with the external auditors. How? By having direct reporting by external auditors, ongoing communication, frequent meetings, and robust discussions about audit scope and results. Also, by paying more attention to greater levels of detail, such as evaluating potential services to determine whether the committee will grant its pre-approval, ensuring the auditors' independence, and considering how well the auditors perform.

There are a number of factors that must be addressed in order for audit committees to effectively discharge their remit.

- *Committee composition.* Requirements for independence and financial literacy, limitations on the number of audit committees a director can serve

on, and concerns around liability have made it more challenging to recruit qualified members to an audit committee. The success of the committee is highly dependent on various characteristics that must be displayed by audit committee members, individually and severally, and other elements of a committee's composition.

- *Training.* In light of the intricate nature of companies' business activities, the complexity of accounting transactions and policies, and frequent changes to financial accounting standards, even the most experienced audit committee members can benefit from training. New audit committee members also need robust orientation, allowing them to understand their role and the company's financial reporting process, so they can add value sooner.
- *Meetings.* Audit committees have to steer their agendas. Audit committee chairs often provide the foundation for effective meetings—by driving the agenda, facilitating the discussion, holding pre-meetings to explore issues, and ensuring the right people are present. Audit committee members also are on the hook to prepare thoroughly for meetings. And the meetings need to have active meaningful participation, and not simply presentation.
- *Charter and evaluation.* Charters - the clearest articulation of the audit committee's purpose, composition, roles and responsibilities, and authority – should be public documents. That makes it even more important for committees to evaluate regularly whether their charters are appropriate and whether they are discharging all their responsibilities. Committee evaluations are useful in identifying areas for improvement and training needs.
- *Resources and special investigations.* Audit committees' authority and willingness to access needed resources further support their self-sufficiency and autonomy. Given that crises may develop suddenly, committees need to understand the basics of conducting special investigations.

Of course, some of you may be saying that this is not relevant to the Caribbean environment. After all, many of our major corporations are still private companies, and some entities masquerade as public companies, as they are closely held. Statutory corporations simply do not fit into conventional governance models.

We must not forget, however, that we have been, and continuously are being, forced to adopt global standards – whether they are appropriate to our circumstances or not. Sooner or later, adoption of corporate governance standards that are now applicable in the major financial centres will be mandatory, if we are not to be further sidelined in the new world economy. Fortunately for us, time is on our side, and the sooner we start, the less painful the transition will be.

We also need to face other realities.

As we look around the region, we can identify a number of institutions of which we can be truly proud. But we must also recognize that many of these entities will face significant challenges to survive in a globalized environment. Strategic alliances will have to be forged. And the other transformational transactions that will provide the basis for sustained growth will best be facilitated through the capital markets, rather than through debt funding. We have seen it just this week with East Caribbean Financial Holdings group undertaking a public issue to finance expansion.

Robust corporate governance is a must. However, yesterday, during the pre-conference training, we would have identified the significant gaps that exist between the current and desired states. There is much to be done, and it must be done well and soon.

If these immediate challenges are not enough, there are other complexities that we must consider.

Hurricanes, earthquakes, severe floods, and other natural disasters struck many areas around the world during 2005, devastating people and businesses, and affecting customers and suppliers. While the direct consequences of physical destruction are easy to see, the indirect effects can be just as devastating, and not only to companies in the affected areas. Critical inputs - such as fuel or construction materials - may skyrocket in price, or simply be unavailable. The results of a disaster may put pressure on debt covenants and other contractual obligations. And a chaotic environment also may increase the risk of misappropriation of financial and physical assets.

These natural disasters and the fact that we are located in an area prone to hurricane activity, are stark reminders of the need for sound disaster recovery plans in every company. While clearly people's safety and security are the top priority, the company also has to consider the implications of disasters on operations. Contingency plans should be in place to protect vital electronic and other information from loss, destruction, theft, and other risks. Plans should cover temporary work sites and systems for communicating with employees, customers, and others. Communication, both internal and external, is critical as compliance with legal reporting requirements may be significantly hampered while the company re-establishes itself. Finally, companies need to perform a robust risk assessment to identify potential risks and ensure mitigating controls are in place and appropriately managed.

The board of directors or the audit committee should oversee the company's disaster recovery plans, ensuring the appropriate focus and processes are in place. They should challenge management to identify not only obvious exposures, but also less apparent ones; not only risks of physical damage to property, operations, and information, but also indirect or intangible effects. The more thoughtful the crisis management process, the better prepared the company will be if a crisis occurs.

In addition to disaster recovery plans, companies need to realize the importance of their embedded culture and values. If everything breaks down and the company's survival depends on the initiative and behaviour of individual employees, embedded values will govern their decisions and conduct. No disaster plan, however detailed and effective on paper, can replace the values instilled in employees. Thus, it's vital management establishes a culture that reinforces those values.

In closing, let me not forget the cynics in our society that will say that events such as the one in which we are now engaged are a waste of time and money. They will readily produce empirical evidence of the lack of major corporate failures within the region in general and specific countries in particular, to support their argument. They will also place significant reliance on our failing memories not to recall the ones that have occurred.

Let me remind such persons that, prior to the end of the 17th century, the only concept of a swan was that of an aquatic bird with snowy plumage. But that was before Dutch explorer Willem de Vlamingh found black swans in the estuary of a river, now known as Swan River, which runs through Perth, Australia. Australia has also opened our eyes that odd, hopping marsupials, called kangaroos, furry duck-billed platypuses, and koalas, bearing striking resemblance to toy teddy bears, are not figments of our imagination, but very much a reality. Just because we have not yet seen a black swan, let us not believe that they do not exist. History is replete to events, which though highly unlikely, have occurred and have been highly consequential. Like 9/11, these events came out of nowhere, but in hindsight, now appear to be inevitable.

We will never be able to avoid these ‘black swan’ events. We must, however, be cognizant of the possibility that they will occur, and prepare as best we can for them. We must forever be prepared and vigilant. If I may be bold enough to paraphrase the Barbados national anthem, we must be ‘...*strict guardians of our heritage, firm craftsmen of our fate...*’

I wish you every success, not only during this conference, but in the weeks and months ahead, as we seek to meet the challenges of the new governance paradigm. I thank you.

Berkeley Greenidge, FCA, FCCA, CISA

Berkeley is a Director in the Advisory Services Department of PricewaterhouseCoopers Eastern Caribbean firm. He is responsible for leading the firm's thrust to provide clients with advisory services in governance, regulatory compliance and risk management, which are designed to enable organizations to be more adept at attracting investors, improve operational efficiencies, win public confidence, and enhance shareholder value.

A former Senior Manager with the firm's Audit and Assurance Division, Berkeley has over 20 years of experience in assurance and risk management gained in serving a wide spectrum of clients across the Caribbean, including financial institutions, public sector organizations, and regional projects funded by international financing institutions.

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