Deloitte.

April 2023



Center for Board Effectiveness

On the audit committee's agenda

Who's in charge: The audit committee's role in ethics and compliance oversight

Background

Corporate compliance and ethical behavior (or their absence) are not new topics; corporate scandals and misdeeds have generated media and public interest for decades. However, beginning in the 1990s, a series of court decisions reminded boards and managements alike that their duties include oversight of these areas and that they can be held responsible when the lack of oversight results in ethical and compliance lapses.

The first such reminder of board oversight responsibility for compliance occurred in the Caremark case decided by the Delaware Chancery Court in 1996. In that case, the Court stated that this responsibility stems from the directors' duty to act in good faith and to be "reasonably informed concerning the corporation" and "that the corporation's information and reporting system [must] in concept and design [be] adequate to assure the board that appropriate information will come to its attention in a timely manner as matter of ordinary operations."[1]

The many court decisions that have subsequently reinforced board oversight responsibility for ethics and compliance have involved cases relating to lapses occurring in a variety of contexts: contaminated ice cream, product defects, and sexual harassment in the workplace, among other matters. In cases of this type, the Delaware courts have stated that corporate boards need to make good-faith efforts to exercise the fiduciary duty of care and that a failure to make those efforts breaches the fiduciary duty of loyalty.

Of course, courts were and are not the only ones calling for board oversight and accountability. As noted above, ethical and compliance breakdowns have long generated media and public interest in the role of the board. Consequently, regardless of whether a financial scandal, an industrial accident, mere negligence, or some other omission is involved, the question "Where was the board?" is not uncommon.

[1] In Re Caremark International, Inc., Delaware Court of Chancery, 698 A.2d 959.

The audit committee's role

The cases referred to earlier and similar rulings make it clear that the board's oversight duties extend to compliance and ethics. However, those cases have not focused on where in the board structure these duties should reside.

To some extent, that governance gap has been addressed by statute and regulation. The Sarbanes-Oxley Act of 2002, enacted to a large degree in response to a series of financial reporting scandals in the late 1990s and early 2000s, made it clear that at least some of these duties belong to the audit committee. Specifically, Securities and Exchange Commission (SEC) Rule 10A-3, implementing a provision of Sarbanes-Oxley, states that "[e]ach audit committee must establish procedures for the receipt, retention, and treatment of complaints … regarding accounting, internal accounting controls, or auditing matters … and [t]he confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters." As a result of this rule, public companies that did not already have employee hotlines were well advised to install them and to report certain complaints and concerns to the audit committee.

While hotlines may have been implemented initially to deal with accounting and auditing matters, they have inevitably become repositories for a wide variety of employee concerns, ranging from code of conduct violations to hostile work environment matters to general complaints and suggestions. However, rather than develop a separate process for reporting non-audit and accounting matters to others within the company, at many companies the audit committee received—and continues to receive—reports on many of such matters. Consequently, the audit committee often exercises the ultimate governance oversight function for many types of employee complaints and concerns.





The audit committee's responsibilities and resources

While it may have ultimate oversight of such matters, the audit committee has extensive responsibilities other than those associated with compliance and ethics. Accordingly, it is appropriate for the committee to consider whether it is the proper committee to oversee a particular area of compliance. For example, there are certain types of risks—generally not involving financial and accounting matters—that may more properly be overseen by the compensation or nominating/governance committee, thereby conserving the audit committee's resources for matters that more directly relate to its key areas of risk management oversight.

The committee can also consider the processes by which it receives and reviews information relating to compliance and ethics. For example, at many companies, the audit committee is the only board-level committee that receives reports of hotline submissions. Given the number of submissions and the fact that many submissions typically do not involve areas relevant to the audit committee's jurisdiction, the committee may opt to review only select submissions that meet a defined threshold of severity or subject matter relevance, delegating to management liaisons responsibility to assure that no legitimate submissions slip through the cracks and/or to report to the committee on trends or on issues raised in submissions directed to other committees or members of management. Logistical concerns may also increase as companies expand the use of hotlines to other stakeholder

groups, such as customers or vendors. (It is important to note, however, that the audit and other committees should not necessarily treat as good news the receipt of few submissions or a decline in the number of submissions. This may indicate technical problems that make it difficult to access the hotline, poor communications about its availability or purpose, or lack of trust among employees.)

The audit committee needs to be aware of, and make appropriate use of, all of the resources available to it in connection with its ethics and compliance oversight role. Perhaps the most important resource is the company's compliance function, which typically performs a critical role in aggregating and reporting to the audit committee on the overall performance and effectiveness of the ethics and compliance program. Another resource may be internal audit (IA). For companies that have an IA function, it can be used in a variety of ways, such as analyzing data, developing standard protocols for following up on ethical or compliance concerns, or assessing whether the company's internal controls need to be enhanced to capture ethical or compliance breaches. IA can also work with a wide variety of functions both within and outside the company to assist committees in overseeing these areas. Other resources available to audit committees include internal and external counsel, investigators, consultants, and others; a combination or "ensemble" of these resources can help the committee to bridge the gap when other resources may not be adequate.

Beyond these resources, the committee may need to consider new approaches, tools, and processes as the company evolves and grows.





Foundational elements—risk as a starting point for ethics and compliance oversight

The audit committee's remit with respect to ethics and compliance is broad and deep and may be difficult to address without a focus on the most important risks. Thus, the first questions that an audit committee might consider in overseeing compliance and ethics may include "What are the greatest areas of ethical and compliance risks we face?" "Are we looking at the right risks, and if not, what risks should we be looking at?"

The audit committee should consider its oversight of ethics and compliance in the context of the company's existing risk profile, including its enterprise risk management process and policies designed to address specific risks. However, relying upon existing processes and policies may not suffice, particularly for companies that have just become publicly held or are initiating a product/service or geographical expansion or other departures from historical businesses and operations. And even companies that are mature and/or relatively stable may benefit from a fresh look at the risks that need to be addressed. This fresh look can be implemented through a number of approaches, such as peer company benchmarking or evaluations or assessments conducted by independent third parties.

Increasingly, companies are also using data-driven risk assessments and monitoring. For example, the US Department of Justice issued guidance in late 2020 emphasizing this approach, in contrast to static, point-in-time risk assessment processes. If a company is not integrating "big data" into its compliance program, the committee may request management to introduce it to facilitate its oversight role.

Of course, in some areas, data-driven risk assessments and monitoring may generate unclear or ambiguous results; this may be the case in areas where technology and key performance indicators are still developing, such as compliance with policies to address climate change. Consequently, reliance on big data to the exclusion of other methods may be unwarranted or present additional risks from a completeness and accuracy perspective.

Next steps and the critical importance of employee communications

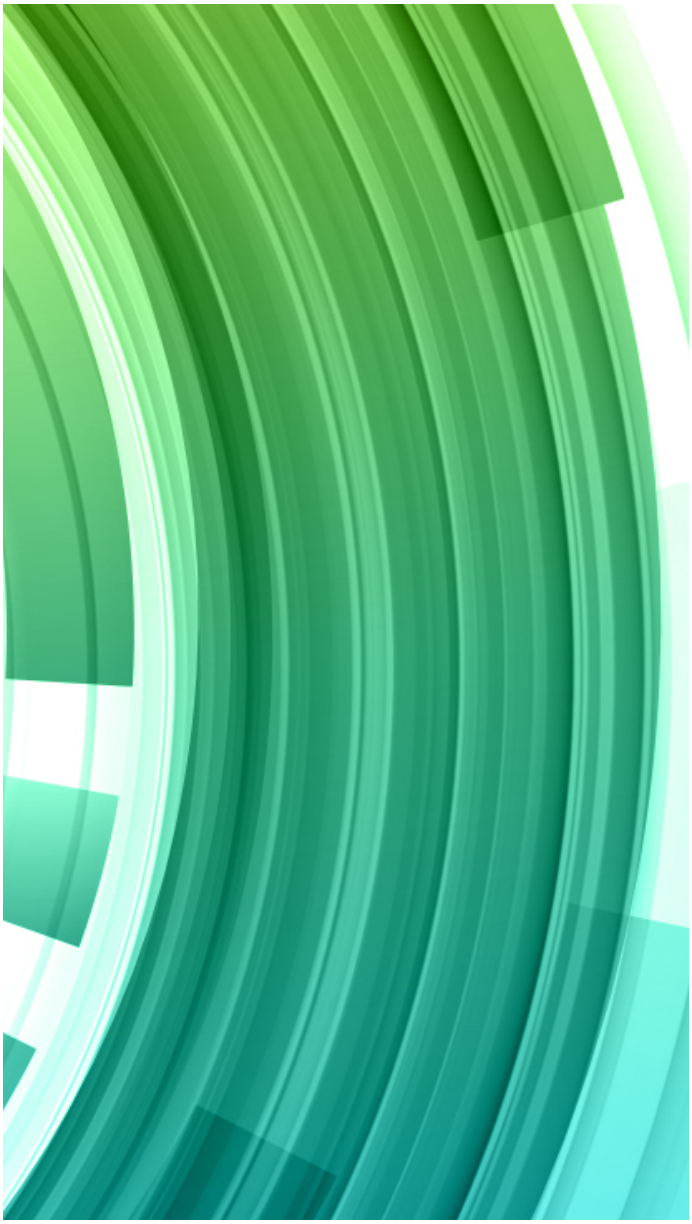
Assuming that the relevant risks have been identified, the committee should seek management's assistance in determining whether the company's ethics and compliance policies, processes, and procedures optimally address those risks. The following are some of the key questions the audit committee can ask about the company's ethics and compliance policies:

- Do we have the right policies in place? Are there key risks for which we don't have policies?
- Have existing policies been updated to address recent developments, including changes in the company, in law or regulation, and otherwise?
- Do we have the right management resources to monitor and enforce compliance with our policies? How are we using technology to monitor and enforce our policies?

Again, peer company benchmarking and independent evaluations and assessments can be useful tools in addressing these areas.

However, even the best policies, processes, and procedures may not succeed if the company is unable to get its employee communications "right." To be effective, communications need to attract and retain employees' attention, and companies need to determine whether their communications are achieving these goals and making their messages "sticky." The dramatic increase in hybrid and remote work arrangements in the current environment has complicated these challenges at the same time that it may lead to heightened incidence of fraud.





Wrapping it up

The importance of corporate ethics and compliance is not diminishing; if anything, given the current focus on environmental, social, and governance issues and a growing focus on corporate responsibility and so-called "stakeholder capitalism," it seems likely that ethics and compliance will continue to grow in importance. Consequently, audit committees will likely need to maintain or increase their oversight efforts of these matters. In that environment, it is important that audit committees view their ethics and compliance responsibilities holistically, taking into account the above and other factors, maintain an open posture to keep what is working, and consider new approaches as needed.

Authors



Krista Parsons
Managing Director and
Audit Committee Program Leader
Center for Board Effectiveness
Deloitte & Touche LLP
kparsons@deloitte.com



Robert Biskup
Managing Director
Regulatory, Forensics & Compliance
Deloitte & Touche USA, LLP
rbiskup@deloitte.com



Bob Lamm
Independent Senior Advisor
Center for Board Effectiveness
Deloitte LLP
rlamm@deloitte.com

Contact us



Carey Oven
National Managing Partner
Center for Board Effectiveness
Deloitte & Touche LLP
coven@deloitte.com



Maureen Bujno
Managing Director and
Audit & Assurance Governance Leader
Center for Board Effectiveness
Deloitte & Touche LLP
mbujno@deloitte.com



Audrey Hitchings
Managing Director
Executive Networking
Deloitte Services LP
ahitchings@deloitte.com



Caroline Schoenecker
Experience Director
Center for Board Effectiveness
Deloitte LLP
cschoenecker@deloitte.com

About this publication
This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

About the Center for Board Effectiveness
Deloitte's Center for Board Effectiveness helps directors deliver value to the organizations they serve through a portfolio of high quality, innovative experiences throughout their tenure as board members. Whether an individual is aspiring to board participation or has extensive board experience, the Center's programs enable them to contribute effectively and provide focus in the areas of governance and audit, strategy, risk, innovation, compensation, and succession. For more information, contact us at centerforboardeffectiveness@deloitte.com.

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (DTTL), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. In the United States, Deloitte refers to one or more of the US members firms of DTTL, their related entities that operate using the "Deloitte" name in the United States, and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/about to learn more about our global network of member firms.

Copyright © 2023 Deloitte Development LLC. All rights reserved.