

## Shared responsibility: the audit committee and the board

### Introduction

The Audit Committee Leadership Network held its seventh meeting by telephone on December 3, 2004. The theme for the discussion was “Shared responsibility: the audit committee and the board” and covered:

- **The relationship between boards and their audit committees**
- **Reporting at the board meeting**
- **Interaction across committees**

The members of the network participating in the meeting, who sit on the boards of about 30 large-, mid-, and small-cap public companies between them, were:

- Mr. Jim Adams, Audit Committee Chair, Texas Instruments
- Mr. Bob Burt, Audit Committee Chair, Pfizer
- Mr. John Clendenin, Audit Committee Chair, The Home Depot
- Dr. Scott Cowen Audit Committee Chair, Newell Rubbermaid
- Mr. John Ferraro, Vice Chairman, Ernst & Young
- Mr. Gene Fife, Audit Committee Chair, Caterpillar
- Mr. Tom Flannery, Americas Director, AABS Quality, Ernst & Young
- Mr. Roland Hernandez, Audit Committee Chair, Wal-Mart
- Mr. Fred Salerno, Audit Committee Chair, Viacom
- Mr. Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company

*ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations.

In 1978 the New York Stock Exchange (NYSE) first required companies listed on the exchange to have independent audit committees. Twenty years later, the Securities and Exchange Commission urged the NYSE to study the effectiveness of audit committees. The result was the 1999 report of the Blue Ribbon Commission on Audit Committees. The report set out the role of the audit committee: “On behalf of the board, the audit committee generally oversees the organization’s financial reporting, risk management, and audit functions, and serves as a link between the board and these three functions.”<sup>1</sup>

The chairman of that commission observed in his preface to the report: “The ultimate governance body in any corporation is the board of directors. The role of the audit committee cannot and should not be allowed to supersede that of the board ... Without the explicit support of the entire board and management, the audit committee will have difficulty being fully effective.”

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<sup>1</sup> National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Audit Committees: A Practical Guide – Updated 2004 Edition*. (Washington DC: National Association of Corporate Directors, 2004), 1.

Despite the commission's work, the corporate scandals of the early 2000s revealed that some audit committees were still not operating effectively enough. In response, the Sarbanes-Oxley Act of 2002 gave the audit committee new roles, responsibilities, and accountability.

In their December 2004 meeting, network members wrestled with the dilemmas involved in keeping board and audit committee processes streamlined while ensuring that their board colleagues shared responsibility for and knowledge of the work the audit committee undertakes on the full board's behalf.

## Executive Summary

The specific issues found to be most important to members are highlighted below, with more detailed discussion on the following pages.

- **The relationship between boards and their audit committees** (*Page 3*)

There is a growing concern about what one member called a “*tiered level of responsibility*,” with fellow board directors relying too heavily on audit committee members to be the financial experts. Audit committee chairs are providing detailed information to other board directors in both written and verbal reports, but are not convinced there is full understanding of the content. Members outlined six tips for improving shared responsibility, including developing a syllabus for ongoing education for the full board that would incorporate audit committee topics.

- **Reporting at the board meeting** (*Pages 4-5*)

Recent research has shown that the audit committee chair spends about 100 hours on audit committee activity (including preparation for meetings, oversight of the internal audit function, and discussions with senior management) for every hour or two put in by fellow board directors who are not on the committee.<sup>2</sup> The challenge for audit chairs is to summarize significant issues for the board without taking up time that could be spent on more strategic matters. The lack of time and the technical nature of many of the items addressed by the audit committee leave members working hard both in and between board meetings to ensure that colleagues focus on key items, engage in the discussion, and ask pertinent questions.

- **Interaction across committees** (*Page 6*)

Members made it clear that the issue of shared responsibility does not impact the audit committee alone. They shared different approaches for enhancing interaction between board committees: either have cross-attendance or overlapping committee memberships to improve collaboration, or have no overlapping committee memberships, thereby creating more time for full board discussion of each committee's work by freeing directors from multiple committee assignments. Last year members suggested that audit committees become more active in the compensation arena. Members now recommend that strategic compensation issues be discussed by the full board, particularly before contracts are signed.

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<sup>2</sup> Audit Committee Leadership Network, “Audit committee agendas,” *InSights*, October 29, 2004: 5.



## The relationship between boards and their audit committees

One leading corporate director described the role of the audit committee post Sarbanes–Oxley: “... the audit committee is the center of the action – the place to be if you want maximum engagement. The audit committee is the one board entity that constantly monitors what management does.”<sup>3</sup> The National Association of Corporate Directors (NACD) Blue Ribbon Commission on Board Leadership noted: “Directors who are not members of a particular board committee should feel sufficiently updated on that committee’s issues, work, and recommendations. This requires a thoughtful balancing act: keeping non-committee members informed about the committee’s work without repeating all committee work at the board level.”<sup>4</sup>

There is a growing concern about what one member called a “*tiered level of responsibility*,” with board directors relying on audit committee members to be the financial experts. One network member commented, “*It’s a pretty specialized world. We rely on the specialization of committees. Other directors are reluctant to get into the details, so how do you have good substantive dialogue?*”

One way is to ensure there is adequate information sharing. However, one member asked, “*Information provision is a starting point, but can they understand it to the degree they should? If they don’t, will their [expert] colleagues be held to a higher responsibility as a result?*”

### Six tips for improving shared responsibility

- Clearly articulate to the governance committee and the full board what topics the audit committee will cover, their implications for the board, and when the audit committee will report on them.
- Ensure that board committees meet before the board meeting and can provide real-time summaries of what they have just decided.
- Add the audit committee agenda to the board book, together with supporting documents for key items raised at the committee meeting so that all directors see them before any board discussion.
- Add approval of the audit committee minutes to the agenda for the next board meeting and use this as an opportunity to ask if directors want to dig deeper into issues that may have been discussed only briefly in the audit committee report the first time around.
- Involve the audit committee chair in developing a syllabus for ongoing education for the full board that would incorporate audit committee topics such as accounting policies.
- Systematically rotate directors across committees to broaden their knowledge and experience.

<sup>3</sup> Hon. Barbara Hackman Franklin, “Moving Toward Excellence: A New Dawn for Corporate Governance,” in *Corporate Governance: A Guide to Corporate Accountability* (New York: Institutional Investor, 2003), 34.

<sup>4</sup> National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Board Leadership* (Washington DC: National Association of Corporate Directors, 2004), 25.

## Reporting at the board meeting

The NYSE's revised listing requirements set out that audit committees must "report regularly to the board of directors." The commentary published by the NYSE in November 2003 states, "The audit committee should review with the full board any issues that arise with respect to the quality and integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function."<sup>5</sup>

### Time: the constraint on information

*InSights* reported that most members said they spent "between 100 and 200 hours per year serving as audit committee chairs." Audit committee members are spending 50-100 hours a year on audit committee activities, with just under 20 of those hours devoted to attending meetings.<sup>6</sup> Yet, all this time invested in the detailed work of the committee is reduced to about six reports to the full board each year, with each report lasting only 10-20 minutes on average. The audit committee chair is spending almost 100 hours on audit committee business for every one or two hours spent by board directors who are not on the committee.

Members feel that even though the report often does not allow for full board deliberation, it must at least give board directors the opportunity to discuss the main issues. They also face the challenge of balancing the time they take for their report to the board against the other items being discussed at the board meeting, many of which may have strategic ramifications for the business.

Although the audit chair already has one allocated item on the board agenda (the audit committee report), most members reported that they were also given the opportunity to break out items from the audit committee meeting and add them to the board agenda as discrete items in order to increase the time available for discussion. As one member said, "*There are times when you need to take an agenda item to the full board so that the board can soak in the detail on that issue.*"

In one company all the committee chairs meet with the board chairman, the CEO, and the CFO to explore the agendas for each committee and to plan the subsequent board meeting. This group then identifies agenda items that require further board discussion and allocates the appropriate time for each one.

### What is presented?

Members either give verbal audit committee reports or supplement these with a written report:

- **Verbal report only.** Those presenting verbal reports prefer the flexibility of deciding what items to focus on and feel they can more easily engage their colleagues when they are not presenting a written report. Those members also note that handing out written material can distract attention from the discussion.

<sup>5</sup> *Final NYSE Corporate Governance Rules 303A.07(c)(iii)(H)*, Commentary, <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>

<sup>6</sup> Audit Committee Leadership Network, "Audit committee agendas," *InSights*, October 29, 2004: 5.

- **Verbal and written report.** The advantage of adding a written report is that other board directors can take it with them to read in more depth at a later point.

In both cases, it is the audit chair who decides what is presented to the board, even though management or the internal auditor will have put together the written report. The key question asked by one chair: *“What do others need access to in order to share responsibility?”* Another audit chair commented, *“The real thought goes into preparing the agenda for the audit committee meeting. That agenda in a summarized fashion is what is reported back to the board – it crystallizes what we were talking about and thinking.”*

Members also noted differences in the focus of their reports. Some audit chairs use their enterprise-wide risk management framework to position their report around the significant risks facing the business. Others prioritize their report around the issues that attract the most discussion in the audit committee meeting itself.

### **Encouraging discussion and questions**

Members are concerned about what they call *“the glaze-over factor”* when fellow board directors find it difficult to follow the technical detail in the audit chair’s report. The glaze-over factor can be linked to the specificity of the topics being presented (particularly routine compliance matters) and the pressure on audit chairs to deliver their report in 20 minutes or less, which perhaps creates the impression that asking questions would be seen as a distraction.

One audit chair addresses the glaze-over factor by asking rhetorical questions. *“After I give the report, I purposely raise the questions myself that others have to answer so we all learn more through the dialogue. We learn more from the questions and the answers than [from] anything else we do.”* Several audit chairs also call on audit committee colleagues to add detail and variety to their report. One member said, *“I always call on my colleagues to pick up on topics I have not covered, and they don’t hesitate.”*

### **Information between meetings**

Members agree on the benefit of sharing information with their board colleagues between meetings. Several members ensure that other board directors are up to speed on audit committee items by providing advance reading materials, with written analysis of the issues that will be covered in the verbal report, or by sending them an executive summary of the audit committee’s papers. The audit chair can either send these items directly by e-mail or by asking the company staff that usually support the audit committee’s work to do so.

Audit committee minutes can also be used to stimulate board colleagues to think about audit committee issues between board meetings. One member observed, *“Writing of minutes has changed dramatically in the last few years. We prepare extensive minutes ... They provide a vehicle for directors to ask questions at a subsequent board meeting.”*

## Interaction across committees

The NACD Blue Ribbon Commission on Audit Committees recommended, “In addition to concern with financial reporting and related areas, the audit committee’s work with other committees should reflect basic governance and business needs ... In some cases, it may be advisable for the chair of the audit committee to sit in on meetings of other committees considering matters that relate to the audit committee’s work, or hold joint meetings with these other committees. The need for coordination with other board committees should be considered on a case-by-case basis.”<sup>7</sup>

Members outlined two approaches for enhancing interaction between board committees:

- **Cross-attendance at committee meetings.** Informal cross-attendance can be achieved by the board permitting any director to attend a meeting of any of the committees – the visiting director can ask questions and make comments. Formal cross-attendance can be implemented by ensuring an overlap of committee members, which is seen as particularly beneficial for the compensation and audit committees.
- **No overlapping committee memberships.** One company has just three board committees, and each director serves on only one of them. This creates more time for full board discussion of each committee’s work by freeing directors from multiple committee obligations, and this approach has reduced each director’s total workload.

In their September 2003 meeting, members raised a number of questions about their relationship with the compensation committee on matters that impact the tone at the top, such as CEO compensation. *ViewPoints* reported that many audit chairs believed that audit committees must become more active in the compensation arena, as “the committee of last resort for managing risk.”<sup>8</sup>

This view no longer prevails. As one member argued, “*The audit committee shouldn’t be involved in CEO compensation. We don’t need two committees handling the same risk.*” Another member agreed saying, “*The danger ... is that the audit committee is the ultimate guardian on all corporate risks.*” Instead, members recommend that strategic compensation issues be discussed by the full board, particularly before any contracts are signed. Preparatory work can also be conducted in a joint meeting of the compensation and audit committees to discuss the accounting implications of particular compensation arrangements.

## Conclusion

Ensuring that there is shared responsibility among board colleagues for the work of the audit committee is one of the most challenging tasks facing the audit committee chair. The dilemmas are acute: too much information versus not enough detail; more time at board meetings versus more written materials between board meetings; more interaction with other board committees versus more time for full board discussion. Audit committee chairs will have to resolve these dilemmas in order to improve the performance of both the audit committee and the board, and thus ensure that investors are well-served.

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<sup>7</sup> National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Audit Committees*, 14.

<sup>8</sup> Audit Committee Leadership Network, “Audit committee emerging roles and responsibilities,” *ViewPoints*, October 15, 2003: 3.



## About this document

The Audit Committee Leadership Network is a select group of audit committee chairs from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board directors, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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