

Navigating challenging situations

Introduction

On 25 June 2008, the European Audit Committee Leadership Network met in Stockholm for its 10th stand-alone meeting. Members discussed navigating challenging situations that require significant input from, or leadership by, the audit committee. In a separate session, members also discussed the evolution of internal audit.¹

For further information about the network, see *About this document* on page 8.

During the discussion in Stockholm, members focused on three aspects of challenging situations faced by audit committees:

- **Preventing challenging situations**
- **Planning and preparedness**
- **Managing and concluding investigations**

The members of the network participating in the meeting sit on the boards of over 45 large-, mid- and small-capitalisation public companies. Network members participating in the meeting included:

- Mr Tom de Swaan, Audit Committee Chair, GlaxoSmithKline and Royal Ahold
- Mr Per-Olof Eriksson, Former Audit Committee Chair, Volvo
- Dr DeAnne Julius, Audit Committee Chair, Roche Holding
- Mr Daniel Lebègue, Audit Committee Chair, SCOR
- Mr Anders Nyrén, Audit Committee Chair, Sandvik and SCA
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Ms Guylaine Saucier, Audit Committee Chair, Areva
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa
- Mr Gerhard Schulmeyer, Former Audit Committee Chair, Zurich Financial Services
- Dr Bernd Voss, Audit Committee Chair, ABB

Ernst & Young was represented by Mr Tom McGrath, Sub Area Managing Partner, Europe, Middle East, India and Africa, Financial Services.

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 before and during meetings are not attributed to individuals or companies.

¹ European Audit Committee Leadership Network, *The evolution of internal audit*, *ViewPoints*, 21 July 2008. Available at: http://tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Jul08_View16.pdf.

Executive summary

The roles the board and audit committee take in addressing challenging situations depend on the nature of the issue and management's involvement. During difficult times, the board's role often increases to provide real-time counsel to management and the bright line between them may fade. Whether the audit committee takes a lead in overseeing the situation will depend on the situation itself. However, the audit committee is often responsible for communicating financial information related to the situation to the board, in part because that information often comes to the audit committee first.

Members discussed the following ideas, which are covered in more detail in the following pages:

- **Preventing challenging situations** (*Page 3*)

Members agreed that the CEO and senior management can play a central role in preventing challenging situations from occurring by establishing an ethical tone at the top and nurturing a company-wide culture of compliance. Members also agreed that the board and audit committee can play a role in supporting an ethical tone at the top by creating an environment of trust and communication with management beyond the executive team, supporting zero tolerance for wrongdoing and discussing with the remuneration committee the links between incentive compensation and undesirable behaviour.

- **Planning and preparedness** (*Page 5*)

While members know that challenging situations are almost always unexpected, they believe that a thorough and cost-effective response can be enhanced by a degree of contingency planning. Preparing for the worst-case scenario may be as simple as spending some time thinking through how the audit committee would respond to different types of situations. Some boards and audit committees also identify an array of outside advisers in advance so that they know whom to turn to should an issue surface.

- **Managing and concluding investigations** (*Page 6*)

An appropriate, balanced response to a challenging situation is critical and can set the tone for the board or audit committee's future interactions with management throughout an investigation and eventual resolution of the problem. Members stressed the importance of proactively determining the facts behind any allegations. Depending on the type of issue and the involvement of management, outside advisers, starting with outside legal counsel, may be called upon to ensure the independence of the investigation. However, members are concerned about losing control to outside counsel and being unable to draw the investigation to a close. After the event, members want to understand what lessons have been learned.

Preventing challenging situations

Opening the discussion, members outlined several types of challenging situation that an audit committee chair may face:

- **Allegations of fraud, corruption or violations of law.** This type of challenging situation is one of the most common faced by audit committee chairs, particularly from subsidiaries in emerging markets. Ernst & Young's tenth global fraud survey found that incidents of fraud and corruption continue to rise globally (one in four respondents said their company had experienced an incident of bribery and corruption in the past two years).² The work of the Organisation for Economic Co-Operation and Development (OECD) has triggered many countries to enact legislation to strengthen penalties and fines for corrupt practices. In addition, global companies may face problems when their subsidiaries' referral payments or facilitation fees run afoul of the US Foreign Corrupt Practices Act (FCPA).
- **Allegations of collusive financial statement fraud.** The European Union's 8th Company Law states that its objective is to "restore credibility of financial reporting and to enhance the EU's protection against the type of scandals that occurred in the past at companies such as Parmalat and Ahold."³ National corporate governance codes and laws do not always specify the precise responsibilities of boards or audit committees for overseeing fraud prevention activities, such as whistleblowing processes, formal codes of conduct or ethics programmes.
- **Sudden financial executive departure.** If a key financial executive such as the CFO leaves unexpectedly, the audit committee will want to understand the reasons for the departure. The audit chair may conduct an enquiry with members of management and interview the departing executive to understand the circumstances surrounding the departure. Whether the succession has been planned or not, the audit committee may also work with the CEO to find a replacement.
- **Other shocks to the system.** Examples could include the resignation of the external audit firm, enquiries from regulators, litigation, financial crisis or the reporting of a weakness in internal control over financial reporting.

Many members agreed with one audit chair who said: *"You can't do anything to exclude these types of things from happening."* However, members agreed that the CEO and senior management can play a central role in preventing challenging situations by establishing an ethical tone at the top and nurturing a company-wide culture of compliance.

Members also agreed that the board and audit committee can play a role in supporting an ethical tone at the top and in identifying risks; they can also work closely with the internal and external auditors to identify warning signs of problems. One member felt that much of the audit chair's work in this field is informal: *"You look at how someone is spending money on expense accounts. It creates a feeling*

² Ernst & Young, *Corruption or compliance – weighing the costs: 10th global fraud survey* (New York: Ernst & Young, 2008), page 2. Available at [http://www.ey.com/Global/assets.nsf/International/FIDS_Corruption_or_compliance_weighing_the_costs/\\$file/Corruption_or_compliance_weighing_the_costs.pdf](http://www.ey.com/Global/assets.nsf/International/FIDS_Corruption_or_compliance_weighing_the_costs/$file/Corruption_or_compliance_weighing_the_costs.pdf).

³ European Commission, *8th Company Law Directive on statutory audit – Vote in EP Plenary*, 28 September 2005. Available at http://ec.europa.eu/internal_market/auditing/docs/dir/statutory_audit_info_note_en.pdf.

about people. It is intuitive.” This member also suggested encouraging leadership to align their own behaviour with the condition of and directives from the company so that there aren’t any obvious conflicts: “We let [thousands of] people go, and the CEO was building a house [worth millions]. It was legal, but not really right at the time. This is an indication of the ethics of the leader.”

However, other members recommended a more formal approach to creating an environment of trust: *“You have to create from the audit committee a level of trust that will encourage [management] to bring things in [to the committee] – whether it’s internal audit, the CFO or [subsidiary] management coming in once a year to explain things.”* Members made the following practical suggestions:

- **Establish a closer link between the audit committee and management below the executive team.** *“I visit [management training] meetings and talk to them and get their input on tone at the top. It creates a tremendous bond between you and that layer of the company. You see how they view top management on integrity.”*
- **Oversee recruitment and succession of top financial and internal audit executives.** *“If you have the right culture ... you can always find a good person to bring tone at the top. When recruiting from outside, we need to see if that person’s integrity ... matches the kind of culture they will be working in ... We need to find people to set the tone.”* Another member said: *“You need a good succession plan in place for the top positions, both for the long term and if they are hit by a bus.”*
- **Support an attitude of zero tolerance towards wrongdoing.** One member noted: *“With fraud and corruption, you need a firm standpoint of zero tolerance, even the Middle East or China ... If you don’t say this, it won’t be clear, but it’s not so easy to do. People in the local area will resist. You need to be firm.”* Another member noted: *“Part of the solution may be that you need a sacrifice, and an individual may be out, whether that is good or not.”* However, some members noted the problems associated with a zero tolerance approach: *“A public statement of zero tolerance will get you into trouble ... There is a big difference between criminal law and internal rules.”*
- **Oversee codes of conduct and associated ethics programmes.** The audit committee may oversee the company’s ethics-related programmes. For companies doing business in the United States, this is also the guidance contained in the US Federal Sentencing Guidelines.⁴ *“The problem is not zero tolerance, but [that] what is unethical in one place is legal and ethical in another. How do you transfer the code of conduct in different situations?”*
- **Talk to the remuneration committee of the board.** *“Have a relationship between the audit committee and remuneration committee.”* Compensation plans for senior managers may have the unintended consequence of motivating unethical behaviour. Audit committee members can familiarise themselves with the structure, weighting and metrics of compensation plans by interacting formally or informally with the remuneration committee and by studying the written compensation plans.

⁴ The United States Sentencing Commission *Guidelines Manual* is available at http://www.uscc.gov/2007guid/tabcon07_1.htm. Please see the section titled “Effective Compliance and Ethics Program,” 8B2.1, available at http://www.uscc.gov/2007guid/8b2_1.html.

- **Oversee effective whistleblower processes and reporting.** Most audit committees insist on effective whistleblower processes. Differences in national, legal and regulatory requirements, as well as differing national cultural attitudes towards whistleblowing, make the establishment of such processes a difficult but not impossible procedure for multinational companies. The audit committee might choose to receive reports on any illegality or ethical lapse, no matter how small.

One member outlined “*three informal indicators of tone at the top*” that audit chairs can use:

Three indicators of tone at the top

- **Is the CEO fully transparent in communication with the board?** Does the CEO communicate “*spontaneously, ... rapidly, sincerely, fully*”?
- **Do the CEO and the board (and the remuneration committee) engage in an honest discussion about the CEO’s compensation package?** “*Every successful CEO is well paid. In discussions of their package, do they put their own interest above all?*”
- **Is management paying enough attention to shareholders’ interests?** “*On one board, we don’t speak about the share price or the expectations of shareholders. There are no regular meetings with institutional investors. It does not seem to be a priority for management, and that is a bad signal.*”

Planning and preparedness

If an issue rises to the attention of the audit committee and the full board, a rapid, serious response is required, but mounting such a response can be difficult because many of the challenging situations that arise are unexpected. When Ernst & Young surveyed board directors from 176 companies around the world in 2006, it found that “although audit committees have primary responsibility for accounting and financial reporting, only 25% of the respondents indicate their audit committees have a formal crisis plan for dealing with financial errors, irregularities or compliance issues.”⁵

One member said: “*What happens when something goes wrong? Who does what? Do you have a plan to simplify [the situation]? ... How do you protect your position legally? What are the processes? There are always very interesting reactions from all the parties involved.*”

This member recommended that the audit committee spend some time thinking through how it would respond to different types of situations: “*It is worthwhile to play certain scenarios in your own mind: Do you go to a law firm? Who will you go to in the US or Europe? If you had agreed practices in place, you would do better at managing the crisis than if not.*”

Some audit committees identify outside advisers in advance so that they know whom to contact should an issue surface. One member reported having a list of law firms with different specialisations available for specific kinds of challenging situation. In some cases, the audit committee may even keep a law firm or forensic accountant on retainer to preclude them from working for management. That course of action ensures the firm or accountant’s independence and saves vital time when a crisis erupts.

⁵ Ernst & Young, *Audit Committee Perspectives: 2006 Audit Committee Survey and Industry Insights* (New York: Ernst & Young, 2007), page 2. Available at [http://www.ey.com/Global/download.nsf/Canada/Audit_Committee_Survey_2006/\\$file/Audit_Committee_Perspectives_2006.pdf](http://www.ey.com/Global/download.nsf/Canada/Audit_Committee_Survey_2006/$file/Audit_Committee_Perspectives_2006.pdf).

One member noted wryly, “[Even] succession planning is not always addressed by the board, so we are not [going to be] equipped for a crisis,” but another member stressed the importance of trying to be prepared, reminding the group that “the shareholder pays the bill for this.” Nevertheless, even if boards have crisis plans in place and audit committees develop contingency plans outlining the initial steps to take if a situation arises, ultimately the response will depend on the details of each unique case.

Managing and concluding investigations

Often, the most important aspect of how companies handle difficult situations has less to do with the specific plan being followed and more to do with the manner in which directors approach the overall process. An appropriate, balanced response is critical and can set the tone for the board or audit committee’s future interactions with management throughout the resolution of the problem.

Establishing the facts

One member noted: “The most difficult thing is to establish the facts. There are two sides, but you hear one side first. You need to kick something off, whether it’s a three-month forensic investigation or a [simple] board meeting, to determine what to do. You can’t just call a lawyer or the PR people until you establish the facts and your best understanding of what happened.” Until you do so, the member continued, “the advisers can’t advise you, or will give you the wrong advice ... You should ask yourself if you understand enough about [the situation] to make a decision.”

Members also reported that serious situations can mean that the “line between management and the board is blurred, as the board has to step in.” Several members said they had personally interviewed company employees during an audit committee investigation in order to establish a fact base. Members recommend great sensitivity during these types of conversations due to the risks of severing relationships and disrupting business. That said, another member felt that involving the audit chair was helpful: “Sometimes you need to keep it top level rather than let it get out to the external advisers. You can lose control to advisers.” Another member observed that in certain situations the “audit committee has to determine what are bad business decisions versus fraudulent or problematic financials.”

Determining who to involve

The board often develops a plan with management to address who will be involved in the work and a process by which the plan will unfold. Even then, the situation may require the “audit committee be proactive in preparation of the decision of the board.” Boards sometimes form an ad hoc committee to take the lead; this committee may include a subset of the audit committee in order to have enough independent directors involved.

Depending on the type of issue and the involvement of management, outside advisers, starting with outside legal counsel, may also be called upon to ensure the independence of the investigation. One member said: “You need to recognise [that] at some point interests will diverge ... it could be management versus the board, or the CFO versus the company. You need to recognise when this has happened and have conversations when interests diverge, and you may need different counsel.” The audit committee will also rely on the internal audit function, the external auditor and the company’s chief legal officer to provide information.

Concluding an investigation

Determining when a challenging situation is resolved can be harder than one would assume. A member stated: *“There is an eagerness to be right, but don’t ignore the process and its impact on shareholders.”* Audit chairs voiced concern over investigations that drag on, often with external auditors and lawyers continuing to take apart the pieces and charge fees. Effective investigations have a beginning, a middle and an end, and it is essential to know when the investigation is complete.

One objective of the audit committee is to limit the likelihood of a recurrence of a similar situation in the future. One way to do so is to conduct what the US military calls an “after-action review” of the issue and the steps taken to resolve it. The goal is to discuss, with the benefit of hindsight, what happened, why it happened and how to build on lessons learned. One member said: *“The best example I have seen was a ... root cause analysis that went five levels down. It was extremely well done, and it explained how we should react and fix [the problem].”*

Tips from North American audit chairs for navigating challenging situations

Over the last two years, a number of US and Canadian audit chairs have met to discuss how to respond to challenging situations.⁶ Their advice is summarised below:

- Be forewarned: challenging situations will likely arise on the watch of every audit chair. They will require the chair’s personal, comprehensive and rapid response. Be sure that protocols for keeping the audit chair advised of potentially serious issues are in place.
- Take potential issues seriously and respond to them quickly. Problems left un- or under-addressed tend to fester and grow more complicated.
- Quickly assess the need for an independent investigation. Prepare to play the coordinating role as leader of the corporate response.
- Recognise that outside counsel is often required to ensure independence and to provide specialised expertise.
- Take care not to lose control of an investigation to outside resources, such as independent counsel.
- Use the resolution of challenging situations to modify or reinforce company policies and values in order to reduce the likelihood of a reoccurrence.
- Fresh eyes often detect hidden issues. Pay attention to executive rotations and scope the audits to shed light on previously unexamined corners of the business.
- Ensure there is a strategy and process for communicating with stakeholders.

⁶ The thoughts of members of the Mid-Atlantic Audit Committee Network are available at http://www.tapestrynetworks.com/documents/Tapestry_EY_MidAt_ACN_Aug07_Van.pdf; those of the North Central network members are available at http://www.tapestrynetworks.com/documents/Tapestry_EY_NCcentral_ACN_July07.pdf; and those of the Canadian network are available in English at http://www.tapestrynetworks.com/documents/Tapestry_EY_CACN_Jul07_View5.pdf and in French at http://www.tapestrynetworks.com/documents/Tapestry_EY_CACN_Jul07_View05_French.pdf.

Conclusion

The operation of the audit committee is usually prepared in meticulous detail. Agendas are developed annually, meetings planned quarterly, and papers distributed and read in advance. Yet every audit committee chair knows that one day something out of the ordinary will occur and that the audit committee will be tested by crisis. Indeed, every audit chair has probably been through several such crises in the past. It seems odd, then, that some audit committees and their chairs do not find the time to prepare for such challenging situations. Contingency planning would give the audit chair a good idea, for particular types of situation that arise, of appropriate responses and the resources that are necessary (and available) to resolve the situation in the interests of the company and its shareholders.

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European 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 committee 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 endeavour to fulfil 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 members, management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European Audit Committee Leadership Network, a group of audit committee chairs drawn from Europe's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.