



Navigating challenging situations

Introduction

The Mid-Atlantic Audit Committee Leadership Network¹ (MA ACN) met for the 11th time on July 18, 2007. Discussion focused on the unanticipated, challenging situations every audit committee confronts from time to time. While network members agreed that it is difficult to anticipate all possible situations, they believe the insights gained by sharing past experiences will help them address future issues more effectively.

The members of the network present at the meeting, who sit on the boards of 18 large-, mid-, and small-cap companies between them, were:

- Jim Brady, Audit Committee Chair, Constellation Energy Group
- Paula Cholmondeley, Audit Committee Chair, Dentsply
- Jay Morse, Audit Committee Chair, Host Hotels and Resorts
- George Muñoz, Audit Committee Chair, Marriott International
- John Schwieters, Audit Committee Chair, Smithfield Foods

Other participants in this meeting included:

- Mark Bartlett, Managing Partner, Baltimore office, Ernst & Young
- Rich Jeanneret, Mid-Atlantic Area Managing Partner, Assurance and Advisory Business Services, Ernst & Young

VantagePoint 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.

Executive summary

Members define “challenging situations” in broad terms, but agree that they include *“things you don't deal with everyday, but [that can] wind up leading to hellacious situations.”* Our discussion focused on four key points:

- **Challenging situations vary significantly, making planning for them difficult** (page 2-3)
Members described the extreme variety of potential challenges and said that not only is advance planning

¹ The Mid-Atlantic Audit Committee Network is composed of audit committee chairs drawn from leading companies based in the Mid-Atlantic region of the United States. 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 audit environment.

VantagePoint is a synthesis of some key issues arising from a facilitated discussion among members of the Mid-Atlantic Audit Committee Network. It is intended to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, executives, and advisers who become systematically engaged in this dialogue, the more value will be created for all.



for challenging situations difficult, it may actually be inappropriate, as the diversity in challenges calls for flexibility in response.

- **Sarbanes Oxley has improved prevention and detection** (page 3-4)

Sarbanes Oxley has encouraged companies to focus both on ways to avoid challenging situations, such as a through a renewed focus on ethics education, and on ways to detect such situations quickly when they arise. Members said this may be one of the most valuable contributions of the Act.

- **A serious but proportionate board response is essential to proper resolution** (page 4-5)

Boards must strike a balance between the need to respond to allegations rapidly and the need to respond judiciously. Leadership from the board ensures appropriate independence, with the audit committee often taking on a central role within the board.

- **Navigating challenging situations provides valuable experience** (page 5-6)

One benefit that boards can wring from challenging situations is experience, which will help them avoid, detect, and effectively respond to such situations in the future.

Challenging situations vary significantly, making planning for them difficult

Broadly defined, challenging situations include unexpected developments that demand significant time and attention from the board or audit committee. One member said, “*These things come in all shapes and sizes,*” and members noted that they can include issues as disparate as accusations of fraud and differences of opinion with management or advisers. Network members outlined a variety of challenging situations they have faced as audit committee chairs:

- **Issues with a small, foreign subsidiary.** Several members agreed that often “*the biggest problems come from the smallest places.*” Seemingly small issues can “*suddenly become material,*” requiring the audit committee to help management ensure that the appropriate tone is being set and controls are in place throughout all of the company.
- **Minor fraud.** Several members noted that large-scale fraud is very rare, but even minor issues can reveal additional problems. One member said a relatively minor impropriety led to a Department of Justice investigation, which in turn uncovered additional unethical behavior by the employee.
- **Key executive departures.** When the general counsel or a key finance executive departs unexpectedly, the audit committee needs to be sure there is nothing untoward behind the decision. One member described a scenario in which as audit chair, he believed the CFO needed to be replaced, but had to convince the CEO and the rest of the board. Over time, it became clear from the external auditor and others in the finance organization that a change was needed.
- **Mergers and acquisitions.** Though the audit committee is not necessarily the entity with primary responsibility for transaction oversight, “*the audit committee plays a major role,*” especially following an acquisition. Several members described issues that can arise from transactions, including disclosure and independence issues.



This list represents only a sampling of the situations that can and do arise in all companies. Because of the vast differences in the types of challenging situations, members said it is difficult to plan for them in advance. When Ernst & Young surveyed 176 board directors 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.”² MA ACN members did not find that surprising. One member said that not only is there no “cookie cutter” plan that boards or audit committees can establish in advance, but “a one-size-fits-all approach is totally contrary” to the way boards should address challenging situations.

Sarbanes-Oxley has improved prevention and detection of issues

Despite common concerns about the efficacy and cost of many of the provisions of the Sarbanes-Oxley Act of 2002 (SOX), members agreed that a renewed emphasis on ethics education and the establishment of whistleblower lines have improved companies’ ability to prevent some challenging situations and to detect them more quickly when they do arise. One member said, “*My gut feel is that [whistleblower mechanisms] are one of the best things to come out of SOX.*” Although whistleblower lines can be misused by employees and although one network member pointed out that “95% of the issues [that come through the whistleblower line] are human resources issues,” companies have developed ways of rating the calls to be sure those of relevance and importance get top-level attention. Furthermore, one member noted that “sometimes the HR stuff can key off a financial issue” that may not have been apparent before investigating the whistleblower’s claims.

It is essential that employees view whistleblower lines as an “important part of governance” rather than simply a box-checking requirement. One member said, “[Whistleblower mechanisms] are given a lot of lip service,” but are not always reinforced appropriately. One member said the company’s CEO constantly reinforces the whistleblower program’s importance during regular talks and discussions with employees. Another member’s company built a whistleblower program audit into its internal audit plan. That ensures appropriate follow-up and an opportunity for internal audit to emphasize the program’s importance during visits to operating units.

Network members expressed some concern that whistleblower programs are often targeted lower in the organization and noted that senior executives, fearful of repercussions, rarely use whistleblower mechanisms. One member said the name “whistleblower” has some negative connotations and that media coverage of the ordeals some whistleblowers have endured discourage executives from using these mechanisms. One way members have addressed this is to encourage executives and others, especially in the finance organization, to contact them directly with any relevant issues or concerns. One member said, “I bring as many business cards as I can to finance conferences in the company, so that people know they can contact me directly.”

² Ernst & Young, *Audit Committee Perspectives: 2006 Audit Committee Survey and Industry Insights* (New York: Ernst & Young, 2007), 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).



Ensuring the effectiveness of whistleblower programs

- Senior management, starting with the CEO, needs to constantly reinforce the importance of whistleblower mechanisms and stress how and when employees should use them.
- When an issue emerges, management must make it clear to employees that the issue is being seriously addressed at the highest levels.
- Regular reviews of the program through internal audit ensure that the program is being properly supported and that issues are being reported and handled appropriately.

Ethics education programs are one effective way to set the tone at the top and reinforce policies. Members said SOX has prompted companies to focus more attention on ethics education modules. These ethics programs serve as a “constant reminder” of ethical and legal standards and of the mechanisms for reporting potential issues.

A serious but proportionate board response is essential to proper resolution

The board is often asked to take the lead in addressing challenging situations, even when senior management is not directly implicated in the problem, to ensure the independence and integrity of the investigation and resolution. Members emphasized that boards, much like the challenging situations they encounter, vary greatly. How boards respond to challenging situations varies according to “*the personalities on the board. That dynamic governs the whole thing.*”

Though members said their boards do not have formal processes or plans in place for addressing situations when they arise, they agreed on a basic method for quickly identifying the best approach. In almost every case, members said the lead independent director assumes initial responsibility and quickly identifies who needs to be brought into the process and whether the issue needs to be handled by the full board or by a committee. One network member said, “*The process develops through conversations with other board directors.*” According to another member, the key to developing a proportionate response is to “*separate the facts from supposition.*” Those investigating must ask the right questions and quickly gather information to be sure the board can scope the issue before establishing a process for resolving it.

Defining the extent of the audit committee’s involvement

The audit committee may become the default committee for addressing a variety of issues if the audit committee chair doesn’t manage expectations. One member said, “*Everything has to be dealt with at the top levels of the board to be sure directors are comfortable that [issues] are being dealt with promptly and effectively,*” and another added, “*The bias is toward making sure the full board is aware.*” But one member said, “*If it’s complicated and takes a long time, it goes to the audit committee.*” To ensure the audit committee does not become overloaded, the audit committee chair needs to set the precedent for what is and what is not within the audit committee’s purview. One member reported having “*to narrow the charter*” to make clear the limits of the audit committee’s responsibility. Another said, “*I have one rule of thumb: if it goes beyond finance and accounting, it doesn’t belong in the audit committee.*” Sometimes, the board will form a special committee; in most cases, the audit committee chair, if not the full audit



committee, is included in the special committee. The audit committee may face special challenges because of the accounting and finance issues they must address. Commenting on the challenges that come with issues like derivatives accounting, etc., one member said, *“There are no facts, only the opinion of the day from the SEC. No board, no processes can handle these.”*

Ensuring independence

Early in the process of formulating a plan to address a challenging situation that has arisen, the board must determine what level of independence from management is required. Boards often bring in the general counsel early on. Most network members have confidence in the general counsel’s independence, though some say the audit committee should consider bringing in outside counsel almost immediately. One member said the right course of action is to bring in outside advisers *“when you have to, and not unless you have to.”* Audit committee charters provide the audit committee with the authority to call on outside advisers as needed, but the costs of significant investigations can mount quickly. One member said, *“Out of courtesy to the CEO, you don’t go off and spend the company’s money without proper cause.”* The board has the difficult task of balancing *“the need for a serious response [with] how much you can spend on resources.”* In addition to relying on the general counsel, audit committees can use the internal audit function to keep much of the work in-house. One member said the external auditor can be particularly useful for global companies, since Big Four accounting firms have deep resources and expertise, with *“tentacles all over the world.”*

Navigating challenging situations provides valuable experience

A network member said, *“I work really hard to make sure we don’t have these problems,”* but most members admitted that there are limits to what the audit committee can do to avoid challenging situations. John D. Rockefeller said, *“I always tried to turn every disaster into an opportunity,”* and that may be the silver lining that challenging situations offer: they present opportunities to assess company policies and controls and to bolster them where necessary. Challenging situations also present an opportunity to communicate with employees regarding the situation at hand, company policies, and how the situation is being resolved. And challenging situations provide valuable lessons that audit committee chairs can apply to subsequent issues that arise.

Members highlighted the need for courage and leadership from directors, especially audit chairs. One member said, *“I will never forget that lesson: even when it feels awkward, you have to speak up.”* Another member added, *“With most troublesome things, you will see something similar: someone on the board didn’t step up or speak up. This is what being on the board is all about: having the courage to stand up.”*

That courage, and the ability to know when that courage is required, comes with experience. Another member said, *“You need experience. If you haven’t lived through things, you would never think of [alternative courses of action].”* After an issue has been resolved, the board will examine what went wrong and ask questions such as, *“What role did we play? What questions should we have asked?”* Most members agreed, however, that reviewing the causes of the problem and how the board resolved it does not often lead to new processes. One member said, *“It doesn’t go that way. You don’t start putting in a process. You*



examine what went wrong, but there are not rules you develop.” Members shared improved practices that had emerged from challenging situations, including changing the ethics training in foreign subsidiaries and working with their external auditor to develop an audit template to be used in small subsidiaries.

Conclusion

It is extremely difficult to plan for challenging situations in advance, and there is no “*cookie cutter*” solution for addressing them, but boards nevertheless must be prepared to address such situations because they will inevitably arise. Although members do not believe there are any rules or processes that can ward off these situations or provide magic bullets for dealing with them, members do believe the collective experience of the board and leadership from the lead director will ensure the formulation of an appropriate response even without an explicit process. Experience aids judgment, but directors also need courage to raise difficult or unpopular issues. Even if it is impractical to develop detailed plans in advance to address every conceivable situation, most audit committees have implicit protocols in place that ensure a rapid, proportionate response when a difficult situation emerges.

Audit committees and boards can derive benefits from challenging situations by reviewing their causes, the mechanisms in place to prevent and detect them, how the company and the board handled the situation once it emerged, and by clearly communicating outcomes to reinforce company policy with employees. By doing so, they can help reduce the likelihood that similar challenges will arise in the future and improve the chances that when such challenges do arise again, they are handled in the most effective way possible.

The views expressed in this document represent those of the Mid-Atlantic Audit Committee Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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