



The audit committee and the board: Four keys to sharing responsibility

The Mid-Atlantic Audit Committee Network met for the fifth time on October 12, 2005. The theme of the teleconference discussion was “Shared responsibility: the audit committee and the board.” The members of the network present for the teleconference, who sit on the boards of about 14 large-, mid-, and small-cap public companies between them, were:

- Jim Brady, Audit Committee Chair, Constellation Energy
- Mike Ressler, Audit Committee Chair, Magellan Health Services
- John Schwieters, Audit Committee Chair, Smithfield Foods
- Jim Zug, Audit Committee Chair, Amkor Technology
- Mark Bartlett, Partner, Ernst & Young
- John Tierney, Partner, Ernst & Young

Executive Summary

Lively discussion among the members of the Mid-Atlantic Audit Committee Network brought out four important ideas with implications, summarized below and expanded on subsequent pages:

- **The audit committee can stimulate the board to assign responsibility for risks and can serve as a catalyst for risk assessment (*Page 2*)**

The audit committee cannot and should not assume responsibility for enterprise-wide risks. Committee charters should state which committee is responsible for what risks. The audit committee might usefully take the lead in ensuring that these responsibilities are assigned. Major risks, even when assigned, nevertheless remain the responsibility of the entire board, which must weigh in on all key decisions.

- **Silence on the part of board members during audit committee reports and discussions should not be interpreted as comprehension (*Pages 2-4*)**

Some board members ask astute questions during the audit committee report; others seldom participate in discussion. Audit committee chairs must engage the board, not simply deliver reports that can trigger a “glazed-over” look. Effective chairs think in terms of a dialogue with the board rather than a report.

- **The board needs more accounting-related education (*Pages 4-5*)**

Education is both a substantial need and a significant challenge. Audit committee members need timely briefings on complicated accounting and audit issues (e.g., derivatives, purchase accounting) – and if audit committee members themselves need education, audit chairs worry about the ability of other board members to fully engage in the issues. Audit firms are obviously positioned to provide the requisite education. Education must be tailored to the specific needs of each company and delivered “just in time.”



- **Audit committees should consider formalizing their relationship with other board committees – particularly the compensation committee (Pages 5-6)**

Members recognize the need for interaction and coordination among board committees. In particular, they say there may be value in establishing a more formal relationship between the audit and compensation committees, in part because of the audit committee’s clear need to fully understand the triggers for specific incentive compensation arrangements.

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.

Audit committees can serve as a catalyst for risk assessment

Members agree that responsibility for enterprise-wide risk extends well beyond the purview of the audit committee. The optimal role of the audit committee in enterprise-wide risk management is unclear. More coordination between board committees is needed. One member observed, *“This is the evolving issue with boards: how to deal with risk management in a thorough, comprehensive manner. We’re getting there, but it’s difficult to do.”*

Some members wonder if the audit committee’s role has become too expansive. One member described the audit committee as *“somewhat of a catchall,”* while another noted wryly, *“It’s simple to determine what goes in the audit committee. If it’s complicated and takes a long time to do, it gets assigned to the audit committee.”*

Some members felt the audit committee should lead the oversight of enterprise-wide risks, ensuring that all risks were assigned to one committee or another. Others disagreed, saying that *“the full board is responsible for oversight to ensure that the risks are all covered.”* Regardless of disagreements, however, members generally supported the view that *“the audit committee can be a catalyst to ensure a comprehensive risk assessment is done.”*

Board silence during audit reports does not necessarily indicate understanding

Clearly, the audit committee needs to communicate effectively with the full board. Although they understand the need for effective communication processes, audit committee chairs also struggle with the challenges identified in 1999 by the National Association of Corporate Directors’ (NACD) Blue Ribbon Commission on Board Leadership. In their report, the commission wrote, “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.”¹

¹ National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Board Leadership* (Washington, DC: National Association of Corporate Directors, 2004), 25.



While Mid-Atlantic ACN members seem quite satisfied with the scope and detail of their reports to the board, they mentioned two key challenges:

- Compressing the details of lengthy audit committee meetings into a 10- to 30-minute report
- Engaging fellow board members

Compressing details

Members agreed that they were sharing more with their board colleagues, in both the written committee minutes and in their verbal reports. As one member said, *“At no time do I want any board member to say any important matter wasn’t reported to the full board. That causes me to give reports that are possibly more detailed than they need to be.”* Another agreed: *“I will over-inform the board as opposed to under-inform. The reports I take to the full board meetings are far more detailed than before Sarbanes-Oxley. If I have to err on the side of telling them too much, I’m fine with that.”*

Several members said they held executive sessions at the end of audit committee meetings, during which they agreed collectively on issues that should be brought to the board. During their verbal reports, most chairs ask their committee members to highlight any issues that may have been inadvertently omitted.

Engaging board members

Some board members ask astute questions during the audit committee report; others seldom participate in discussion. Silence should never be taken to indicate comprehension. Few people interrupt to admit ignorance about issues that do not require a decision or do not seem to fall under their own responsibility. Therefore, the audit chair needs to be sensitive to meeting dynamics and should deliver the report as a dialogue rather than a monologue. Said one member, *“If I’m not in a discourse with the board, I’m doing something wrong.”*

In order to keep their colleagues engaged, members said the audit committee report *“should not be an expedition into technical accounting matters.”* As one member noted, *“If someone was going into technical details, my eyes would glaze over too.”*

Members agreed that it was important for the audit committee chair to report not only on specific decisions but also on the texture and tone of the committee’s discussions. Tone becomes especially relevant in reports concerning ethics issues and whistleblower matters.

Good news: members say their board colleagues, motivated perhaps by a heightened awareness of personal liability, are typically asking a lot of questions and taking a significant interest in the audit committee’s work. As one member said, the audit committee report is *“where people sit up straight and listen carefully.”* Another agreed: *“There is no issue of shared responsibility because [board members] feel both accountable and responsible.”*



Improving the Art – Reports to the Board

- Err on the side of over-informing the board
- Avoid excessive technical detail
- Engage in a dialogue with the board, not a monologue
- Report not only decisions but also the tone and texture of the discussion, especially for sensitive ethics and whistleblower-related topics
- Agree during committee executive session which issues should be shared with the full board
- Distribute audit committee meeting minutes beforehand, if possible
- Distribute the audit committee meeting agenda before the meeting takes place
- Ask specific questions of board members to promote engagement

Audit committees seek more effective education

Reflecting on board colleagues who do not sit on the audit committee, one member said, *“I have been surprised at how astute the questions are, given their [non-accounting] background.”* Members did not feel that board members’ lack of formal accounting education negatively impacted their ability to understand the audit committee report.

Knowledge gaps may cause undue dependence

Despite members’ view that colleagues are adequately informed, one member described a situation in which a board member admitted he didn’t understand the accounting for a particular transaction, but was willing to defer to the judgment of his colleagues. As committee chair, the network member privately expressed to his board colleague his discomfort with such a delegation of responsibility.

While this may be an isolated case, it was not clear that board members would always be so forthcoming in admitting knowledge gaps rather than simply deferring to the financial experts on the audit committee.

Theory is less helpful than applied knowledge

However, members were more concerned with the ability of directors to develop and maintain the level of knowledge required to serve effectively on the audit committee. One member said, *“From an audit committee standpoint, it is the responsibility of the chair to ensure members are educated in an area when their skills are not where they should be.”*

Noting that *“education for education’s sake is interesting, but only for about 23 minutes,”* members struggle with the best way for audit committee members to acquire knowledge and immediately apply it to a current situation. Despite a plethora of written materials from auditors and lawyers, some prefer presentations in order to limit committee colleagues’ reading load. Some audit committees devote time during each meeting to exploring a particular issue of interest, such as tax accruals or purchase accounting.



Members noted that audit firms are well-positioned to provide the requisite education, but cautioned that the form and content of this education will vary widely by individual and by company. Accounting rules and regulatory developments often have different implications within different industries, so any educational program must be tailored to meet a committee's specific needs. Furthermore, education should be delivered "just in time," given directors' desire to apply knowledge at the same time it is acquired.

While audit committee members must possess a high level of technical expertise, members noted the limitations of an overly technical orientation. One member asserted, "*Management and the external auditor can do a better job of [also] explaining the economic impact of a transaction rather than [only] the accounting impact.*"

Audit chairs contemplate managed relationships with other board committees

In its report, 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."²

Members recognize the need for interaction and coordination among board committees, and they generally describe an informal relationship between the audit committee and other board committees. However, members recognized the benefits of expanding formal links between committees, with one member admitting, "*We are not always as disciplined as ... others suggest [we should be].*"

While all board colleagues are allowed to observe audit committee meetings, members report that few actually attend. Furthermore, members believe this is appropriate. As one member said, "*We're already a well-diversified group, and we report back.*" Another agreed: "*I'm comfortable with their not showing up. The [audit committee] meeting gets unwieldy if it gets too big.*"

Cross-membership elicited a mixed response. Some viewed it as a benefit: "*One of our committee members also sits on the compensation committee, so that helps our visibility.*" However, others saw cross-membership as a liability: "*I thought the point was to divvy up the work. Isn't that the efficient way to do it?*"

Need to understand executive compensation "triggers"

Members agreed that the strongest logical inter-committee relationships lay between the audit committee and the compensation committee. Members said it was important for audit committee members to understand potential compensation liabilities as well as the timing of liabilities. In addition, "*the audit committee should be totally familiar with the triggers for incentive compensation*" so it can be sensitive to the potential for management to manipulate the financials to set off the triggers.

² National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Audit Committees*, 14.



One member said his audit committee invites *“the head of HR to make a presentation to the audit committee on all elements of compensation, with a clear delineation of the triggers.”* He said the 20-minute annual presentation is *“incredibly helpful in sensitizing people.”* His comment highlighted the opportunity to utilize management as a vehicle for committee coordination.

Improving the Art - Relationships With Other Board Committees

- Place one member of the audit committee on the compensation committee
- Institute routine dialogue between the audit and compensation committee chairs
- Schedule the HR head for an annual report on incentive compensation and triggers
- Share all committee agendas with all board members

Views you can use – from related networks

The Audit Committee Leadership Network and two of the other regional ACNs have also discussed the topic of shared responsibility in their recent meetings. Not surprisingly, these groups arrived at many of the same conclusions and perspectives as did the Mid-Atlantic ACN – but several of their additional ideas for “Improving the Art” seemed worth passing on in this *VantagePoint* document.

- Meet in person with the internal audit staff at least annually – they report to the audit committee
- Meet periodically with key operating executives to learn about their perspectives on business risks
- Tune in closely to how management communicates corporate values and cascades these down through the organization
- Solve the problems that arise, but to prevent recurrence, talk to the organization about what you did and why

Final thoughts

After several years of evolution, members believe corporate governance is moving toward a new steady state. As one member said, *“This model of managing boards and responsibilities is here to stay. People are beginning to get comfortable with the structure.”*

Having said that, audit chairs agree that there is a great deal of “art” in effectively leading the committee. The opportunity to learn how others practice the art is perhaps the greatest benefit of sharing insights with peers and advisers. We hope that *VantagePoint* plays a modest part in that dialogue.



About this document

The Mid-Atlantic Audit Committee Network is a group 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 new audit environment.

VantagePoint is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, executives, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power 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.

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