



Audit committee leadership: Balancing art and science

The fifth meeting of the North Central Audit Committee Network¹ was held in Cleveland on October 13, 2005. The theme of the discussion was “Shared responsibility: the audit committee and the board.” The members of the network present at the meeting, who sit on the boards of about 26 large-, mid-, and small-cap public companies between them, were:

- John Baily, Audit Committee Chair, Erie Indemnity
- Jim Boland, Audit Committee Chair, Goodyear Tire & Rubber
- Jim Broadhurst, Audit Committee Chair, National City
- Frank Gori, Partner, Ernst & Young
- Gordon Harnett, Audit Committee Chair, PolyOne
- Donna James, Audit Committee Chair, Limited Brands
- Bill Lawrence, Audit Committee Chair, Ferro
- Mike Losh, Audit Committee Chair, TRW Automotive
- Russ Maier, Audit Committee Chair, FirstEnergy
- Dave McCammon, Audit Committee Chair, Pulte Homes
- Al Paulus, Partner, Ernst & Young

Executive Summary

During their meeting on October 13, 2005, members of the North Central Audit Committee Network engaged in an active discussion about the role of the audit committee vis-à-vis the rest of the board. In discussing the diverse and sometimes novel set of approaches and tactics members employ to manage board interrelationships, the group agreed that there was at least as much art as science in effectively leading the audit committee.

The discussion resulted in three important ideas with implications, summarized below and expanded on subsequent pages:

- **In delivering the audit committee report, the audit chair’s mind-set and objective should be to engage the board, not merely to report to it** (*Pages 2-4*)

Board directors rarely attend meetings of committees other than those on which they serve, so committee minutes and oral reports are the primary means of cross-committee communication. Audit committee chairs say it is often challenging to summarize the tone and content of a three- or four-hour

¹The North Central Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Lake Erie and Ohio Valley regions 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.



meeting in a 10- to 20-minute report to the board. Reports are most effective when they are scheduled at the beginning of a board meeting and when the chair has carefully prepared a synthesis of the committee meeting.

- **Committees should actively coordinate their agendas and their work; a more systematic relationship with the compensation committee may be advisable** (*Pages 4-5*)

Even when they have the authority to act independently, audit committees may engage the full board in certain decisions, such as auditor changes and financial restatements. With regard to enterprise-wide risk management, the audit committee should coordinate closely with the full board to ensure that all enterprise-wide risks are being addressed. The relationship between the audit committee and the compensation committee is especially important given the potential for executives to manipulate financial results to hit incentive compensation triggers. Several members were concerned that the audit and compensation committees' information-sharing mechanisms were not sufficiently systematic.

- **Audit committees can play a vital role in ensuring that the tone at the top cascades down through the organization** (*Pages 5-6*)

As guardians of the ethics hotline, audit committees must be attuned to the ethical culture of the organization. Members believe it is important that company executives not only possess deep personal integrity, but also explicitly articulate to company employees their values on a regular basis. Audit committees can take an active role in supporting and encouraging this effort by regularly discussing policies with corporate executives.

The audit chair's mind-set and objective should be to engage the board, not merely to report to it

In 2003 the New York Stock Exchange approved modified governance rules, which stated, "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."²

Those requirements built on the recommendations made in 1999 by the National Association of Corporate Directors' (NACD) Blue Ribbon Commission on Board Leadership, which 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."³

Board directors who serve on an audit committee prior to assuming chairmanship of the committee are often surprised at the expanded nature of their new role. As one member said, "*As the audit committee chair, things start to feel and sound a little different, even though you have the same responsibility you always*

² *Final NYSE Corporate Governance Rules* 303A.07(c)(iii)(H), Commentary, <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>

³ National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Board Leadership* (Washington, DC: National Association of Corporate Directors, 2004), 25.



had.” Members described the challenge of managing the committee’s longer-term agenda, given time constraints and an ever-increasing set of responsibilities. One member described the role as *“a combination of art and science.”*

Minutes are important, as board directors rarely attend meetings of other committees

Although all members said their boards allow directors to attend any committee meeting, they also note that this practice is rarely adopted except at companies with very small boards. One member said, *“I hate the rule where everyone sits in on everyone else’s meetings,”* and others noted that non-committee members often feel compelled to ask questions when they attend audit committee meetings, *“tracing down minutiae because [they’re] not comfortable.”*

Members said that often the audit committee report has been scheduled toward the end of the board meeting agenda. However, with board colleagues focused on catching outgoing flights, some members felt this timing did not foster an adequate level of engagement. For this reason, members agreed the audit committee report should be the first item on the board agenda.

Although one member reported not sharing audit committee minutes with board colleagues, most members provide both written and verbal reports to their board colleagues. In the past, committee minutes lacked detail, stating simply that various matters were discussed. However, members said they now develop more complete minutes that are *“detailed enough, without naming names.”* When they are well crafted, members say committee minutes *“inform people and generate more interest in the next oral report.”* While most members provide committee minutes prior to the next board meeting, one member said the audit committee minutes are always drafted within two days, and distributed to the full board within five days.

The board report requires thoughtful preparation and crisp delivery, with the intent to engage

Members appreciate the importance of thoughtful communication with the board, but they also recognize the difficulty inherent in effectively summarizing a three- or four-hour meeting in a 10- to 20-minute board report. As one member said, *“It’s a challenge to succinctly give people a perspective on what you do [in a way] that’s really meaningful to people who weren’t in the process.”* Another member agreed, describing a *“heck of a challenge to know what to say [and to] say it effectively in a short time.”*

Members generally agreed that it was important for the audit committee chair to put thought into preparing for the board meeting. One member recommended that the chair look carefully at the committee agenda and reflect on why specific items were discussed. The chair should then write three or four sentences that capture the essence of each item on the agenda.

In order to prevent the “glaze-over” effect in non-committee members, audit committee chairs agreed that the report to the board should be *“very crisp, non-technical, to the point.”* One member suggested, *“Don’t drone on and on about a particular FASB ruling. Don’t provide information for information’s sake.”* Some members limit the topics covered and avoid repeating items that have been reported at prior meetings.



Improving the Art - Effective Board Communication

- Schedule the audit committee report at the beginning of the board meeting, not the end
- Share audit committee minutes that are “detailed enough, without naming names”
- Distribute committee minutes to the full board within five days after each committee meeting
- Summarize each agenda item in three or four sentences
- Avoid technical language and “information for information’s sake”
- Ask executives to provide “color commentary” during the audit committee chair’s report

Committees should actively coordinate their agendas and their work

Members agreed it was easier to coordinate the work of board committees when committee meetings are spread out. However, for practical reasons many boards hold committee meetings closely together, typically the day before the full board meeting. In some cases, coordination is provided by the board chairman, who sits in on all the committee meetings and shares highlights with the board over dinner.

Committees may involve the board even when formal board approval is not required

Just as it is important for the audit committee to report its decisions and thought processes to the board, there are times when committee members want to secure input or approval from their board colleagues.

When changing independent auditors, one member described a situation in which the audit committee’s recommendation was different from management’s. Even though the audit committee had the authority to make a final decision without board approval, the committee sought the full board’s endorsement of the decision. The board supported the audit committee’s judgment; the member admitted, *“I don’t know where we would have gone otherwise.”*

Members said board approval is also important when considering a financial restatement, especially if management’s opinion differs from that of the independent auditor. As one member said, restatement decisions should *“always go up [to the rest of the board].”*

Members agreed the audit committee needs to coordinate with the full board to ensure all enterprise-wide risks are being addressed. While some members saw a role for the audit committee in overseeing some aspects of the risk management activity, many believed it would be a mistake for the audit committee to take the lead. One member asserted it would be *“a disaster putting [enterprise-wide risk management] in the audit committee. This is a board function, not [a] committee function.”* Another member said, *“The CEO should be thinking about risk every day, and sharing [his thoughts] with the [full] board.”*

Audit committees should understand the details of executive compensation programs

Although the board compensation committee takes the lead role in overseeing executive compensation programs, members agree the audit committee must understand the triggers that drive incentive-based



compensation, since management may be tempted to manipulate the financial measures that impact these triggers. The audit committee also needs to understand these programs so they can feel comfortable that compensation plans and employee agreements are appropriately disclosed in the company's public filings.

Several members were concerned that interaction between the audit committee and the compensation committee was less formal than it should be. One member said most audit committee members have a high-level appreciation of compensation issues, but noted *"the compensation committee chair doesn't go into a lot of detail"* in board meetings. In order to investigate the complexities of the incentive programs, this member makes a point to carefully read all employment agreements. While this practice may lead to a deeper level of individual understanding, this member admitted, *"I am not as comfortable that we understand [the issues] as a committee."* Several members suggested that the compensation committee chair should make an annual presentation to the audit committee regarding executive compensation plans and employment agreements.

Cascading the tone at the top down through the organization

With audit committees responsible for overseeing corporate ethics hotlines (whistleblower hotlines), members are concerned not only with specific ethical violations but also with ensuring a corporate culture that encourages and supports ethical behavior. Even though a series of high-profile ethical lapses led to the sweeping Sarbanes-Oxley legislation, one member observed, *"[Sarbanes-Oxley] Section 404 does not deal with tone at the top."*

Members agreed there is no single way to investigate and manage ethical allegations, noting that while such allegations sometimes have merit, they may also be motivated by grudges and personality conflicts. The audit committee's challenge is to devote the right level of attention to each case. As one member said, *"The bigger risk is that the audit committee gets so fixated [on] penny-ante schemes they miss the forest for the trees."*

However, members agree it is important for audit committees to take all reasonable precautions, as *"you never want to look back and say, 'I wish I had [acted differently].'"* While some ethical breaches might appear to be isolated, one member said that audit committees need to investigate fully unless there is strong evidence to suggest the allegation is not systematic.

One member articulated three criteria for determining whether a full investigation is warranted and drew particular attention to the fact that *"the higher [the ethical breaches go] in the organization, the less you can rely on internal investigation."* This member set a relatively low hurdle for bringing in outside resources, saying there is potential for undue management interference when investigating even a division controller.

Ethics Hotline – Criteria to Guide the Depth of the Investigation

- Financial impact
- Frequency (i.e., has the alleged behavior happened repeatedly?)
- Position of the employee who is implicated



Be proactive in promoting ethical behavior, but recognize the value of a public hanging

Reflecting on the fact that in some cases ethical violations (e.g., kickbacks) are reported by vendors or other outside parties rather than through internal channels, one might reasonably ask whether it is just as troubling for an internal ethics hotline to receive few allegations as for it to receive many allegations. Members felt that, in some ways, receiving such reports from vendors or customers was evidence that the values of the organization had been articulated effectively, even to those on the outside.

The internal audit department or general counsel's office is typically on the front line identifying and investigating ethical violations. As such, members felt it was important for internal auditors to understand their role and the audit committee's expectations. One member described inviting the entire internal audit staff to a brown-bag lunch, hoping to enlist their support in upholding *"not just the letter of the law but also the spirit of the law."* This member posed a simple, yet challenging question: *"Who do you work for?"*

Rather than simply reacting to ethical violations, several members say they actively encourage an emphasis on ethical behavior. One member requires each key operating executive to report annually on the conduct policy in their business unit – what issues arose, and what they are doing about them – and described this technique as highly effective in signaling the audit committee's commitment to ethics. Another member said the CEO, the chair of audit committee, and the chair of the corporate responsibility and compliance committee send a joint letter to employees articulating the importance of ethical behavior and the ethics hotline and seeking employees' support. Members would also like to see their CEOs articulate ethical values regularly within the organization.

However, words are meaningless unless backed up with action, and members agree that sometimes a "public hanging" is the most effective way to demonstrate a commitment to ethics. Sometimes there is no better response to an ethics violation than *"somebody got fired."*

Improving the Art – Supporting an Ethical Tone at the Top

- Require each key operating executive to report annually on the conduct policy in their business unit: what issues arose, and what they are doing about them
- Encourage senior executives to articulate their values regularly
- Host informal dinners with senior executives, such as CFO, VP financial reporting, controller, finance director, and head of internal audit
- Hold brown-bag lunches with the entire internal audit staff
- Distribute a letter from the CEO, the chair of audit committee, and the chair of corporate responsibility and compliance committee to all employees, highlighting the importance of ethical behavior and the ethics hotline: *"We need your help"*

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 North Central ACN – but several of their additional ideas for “Improving the Art” seemed worth passing on in this *VantagePoint* document.

- Engage in a dialogue with the board, not a monologue; do not equate board silence during audit committee reports with understanding
- Agree together during the audit committee executive session which issues should be shared with the full board
- Work with auditors and other advisers to develop an effective program of continuing education; this should be tailored to the specific needs of the company and delivered “just in time”
- Ask the compensation committee chair or the head of human resources to present annually to the audit committee on the triggers for executive incentive compensation
- Place one member of the audit committee on the compensation committee

Final thoughts

In reflecting on the theme of the meeting – shared responsibility – one member wondered, “*Does shared responsibility really mean shared accountability? Is it really about getting others on the hook?*” This question echoes earlier discussions, when members have questioned whether “financial experts” on the audit committee might face greater legal exposure than their less financially experienced board colleagues.

Either way, members agree that all board directors benefit from a system in which committees probe deeply into specific issues, then share with the full board a meaningful synthesis of the discussions that underlie key activities and decisions. The notion of committee leadership as an art rather than a science resonates with members who have years of experience in corporate leadership. Most importantly, members recognize the benefits that accrue when audit committee chairs share this artistry with their peers.

About this document

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.

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.

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