



Navigating challenging situations

Introduction

The North Central Audit Committee Network¹ (NC ACN) met on June 5, 2007, to discuss how audit committees can ensure they effectively address the unexpected challenging situations that every audit committee confronts from time to time, whether allegations of fraud or the unexpected departure of a key finance executive. While network members agreed that preparing for challenging situations is difficult, they believe the insights gained by sharing their 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 16 large-, mid-, and small-cap public companies between them, were:

- Dave Dillon, Audit Committee Chair, Convergys Corporation
- Gordon Harnett, Audit Committee Chair, PolyOne Corporation
- Bill Lawrence, Audit Committee Chair, Ferro Corporation
- Mike Losh, Audit Committee Chair, TRW Automotive
- Dave McCammon, Audit Committee Chair, Pulte Homes
- Mike Monahan, Audit Committee Chair, CMS Energy
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Paul Smith, Audit Committee Chair, Constellation Brands
- Gary Valade, Audit Committee Chair, Wabtec Corporation

Other participants in the meeting included:

- Jay Young, Partner, Ernst & Young
- Al Paulus, Partner, 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.

¹ The North Central Audit Committee Network is a group of audit committee chairs drawn 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.

VantagePoint 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 *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, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.



Executive summary

Regardless of the amount of experience members have in dealing with challenging situations, they all agree that they cannot let “*naive optimism*” cloud their recognition that new challenging situations will inevitably arise, demanding significant time and resources.

- **Challenging situations are inevitable, yet planning for them is difficult** (page 2)

Members agreed that while audit committees need to be prepared to handle situations “*that aren’t business as usual*,” each situation is unique and requires a unique solution; there is little planning that boards or audit committees can do in advance. Instead, audit committees need to ensure that appropriate policies and protocols are in place to allow for speed and efficiency once a challenging situation occurs.

- **The board must determine what is an appropriate degree of independence** (page 3)

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. Similarly, the audit committee, and the audit committee chair specifically, often take the lead on the board, especially if the issue may impact financial reporting.

- **A rapid, serious response is essential to limit negative consequences** (page 4)

Members recognize the importance of being thorough when working toward resolution of challenging situations, but also emphasized the need to respond and act quickly with the appropriate earnestness to limit the potential impact.

- **Challenging situations can be opportunities to reinforce company policies** (page 6)

Boards can wring some benefit out of challenging situations by using the occurrence of such situations as an opportunity to assess company policies, bolstering them where necessary and reinforcing their importance to employees by clearly communicating how the challenge is being resolved.

Challenging situations are inevitable, yet planning for them is difficult

When asked to join a corporate board, members consider the “*culture of the corporation*” and the “*integrity of the [existing] board*” and management team. They note that they only serve on boards if they “*trust the tone at the top*.” Unfortunately, integrity does not inoculate a company against challenging situations, and therefore audit committees need to be ready to address them.

In some organizations, particularly in regulated companies, the process to follow may be pre-established, with clear roles and responsibilities enabling prompt and appropriate action.² NC ACN members emphasized, however, that being ready doesn’t necessarily mean having a formal plan in place. On the contrary, members generally agreed that because the “*facts and circumstances are so different*” in each situation, there is no “*cookie cutter*” plan they can implement in advance. One member said, “*We do not have a game plan, a prior arrangement with the audit committee and the board about how I’m going to*

² Southeast Audit Committee Network, “Preventing, detecting, investigating fraud: the audit committee’s role,” *VantagePoint*, February 22, 2007, 9.



proceed and in what time frame. I'm not sure how I'd bring [up how to deal with challenges] if there isn't something [specific to address]."

Nevertheless, audit committee chairs need to be ready to act quickly if something does come to their attention and past experience can suggest appropriate protocols to aid a timely response. Members noted that challenging situations are rarely solitary events; more often *"these things lead to each other."* Among the common types of situations boards may face are fraud or allegations of fraud, restatements, an unexpected change of external auditor, or litigation.

Members discussed some of the issues their audit committees have faced:

- **Complaints through whistleblower mechanisms.** Several members said the most common situations they have dealt with involved *"employees or others telling on others in the company,"* often by contacting the audit committee or audit committee chair directly through letters or whistleblower lines, saying, *"Did you know? You should know: here are the facts."*
- **Ethics issues involving international subsidiaries.** Several members said they frequently deal with problems that involve practices that are common in some foreign countries, but questionable or prohibited under the Foreign Corrupt Practices Act, such as facilitating payments.
- **Unexpected departure of a key finance executive.** Several members have faced situations in which a CFO unexpectedly decided to retire early, but *"the company wasn't taking [the task of replacing the CFO] seriously enough."* Members emphasized the need to be sure there was nothing untoward behind a CFOs' decision to leave the company and also noted the audit committee chair's ability to advise and sometimes put pressure on management to deal with the departure with the appropriate urgency. The audit chair can also help to assure that management has considered succession plans for the future.
- **Acquisitions.** Many companies have changed the way they view acquisitions, now emphasizing the need for greater integration, especially regarding accounting systems and internal controls. One member said, *"One thing [Section 404] has changed is that [directors] are very inquisitive with acquisitions. You can't just let [the acquired company] run things the way they've been running them."*
- **Disagreement between auditors and management over accounting treatment.** When management and the company's external auditors disagree over accounting principles, it can cause problems. The audit committee can *"arbitrate"* between the two and help ensure that internal finance people aren't getting hung up on immaterial issues or *"getting adamant about small numbers"* to help the two sides reach agreement. Members also said it may be necessary to get an opinion from the external auditor's national office to ensure the local audit partner isn't mistaken.
- **Restatements.** One member reported dealing with a restatement process that *"included everything on the list of challenges [mentioned above] except a catastrophic event."* Multiple challenges can lead to a restatement, and multiple challenging consequences can result from a restatement.



The board determines the appropriate degree of independence for the investigation

When a potential problem emerges, the board must decide how independent it should be from management in order to deal with the problem effectively. Obviously any issue that directly involves senior executives demands independent – and direct – leadership from the board. However, directors are sensitive about crossing the bright line into management, and one member wondered, *“How do you address [an issue] without offending management by insinuating that [an allegation] is true, but [also] how do you make sure that the board feels it’s been fleshed out?”* Generally, the level of independence required by the board is *“determined by the facts”* of the matter at hand (see list of questions below). One member shared an example of accusations against an executive who was *“well thought of”* and *“a friend, a buddy”* of senior management. In this case, management actually requested that the board take the lead in investigating and resolving the issue to avoid a conflict of interest.

Key questions for determining what level of independence is required for the investigation

- How close is management to the issue and/or people who may be implicated?
- Is there the potential for criminal charges?
- Is there an accounting problem?
- Might the situation involve a regulatory inquiry?
- How systemic is the problem?

The audit committee’s role

Within the board, the audit committee often takes the leadership role in addressing challenging situations. One member said, *“If the integrity of the financial statements is in question, it is very important for the audit committee to jump on day one.”* Audit committees have oversight responsibilities not just for internal controls, financial reporting, and whistleblower mechanisms, but also often oversee ethics, so a wide range of challenging situations is likely to fall within the audit committee’s purview.

Depending on the scope and scale of the situation, the audit committee chair will likely have to make a substantial commitment of time and energy. Members described situations that demanded their full-time attention and in some cases took from six months to as long as two-and-a-half years to resolve. Given the time commitment that audit chairs must be prepared to make, their compensation may end up seeming rather meager. One member commented, *“When you agree to go on a board, you know you’re going to chair a committee. You get well compensated as a director, but when you’re the [audit committee] chair you say, ‘This is the least I’ve worked for since I was a co-op student.’”*

Managing external advisers

If the board determines that an independent inquiry is necessary, the audit committee will often seek help from outside advisers. The company’s general counsel can provide guidance and recommend outside firms, but relying solely on the general counsel *“is not good... [because] it will undermine the integrity of the*



investigation,” in the eyes of a regulator. Even the company’s outside legal counsel may not be sufficiently independent, although it too can be a source of recommendations.

The circumstances of each case will determine what skills outside advisers must possess, the key is that they have relevant experience and the appropriate skill set specific to the issue at hand. The audit committee chair often ends up *“playing quarterback,”* dealing directly with outside advisers and then informing the rest of the board and management about their progress.

The need to rely heavily on outside advisers can have a negative financial impact on the company as the cost of a lengthy investigation can be substantial. One member said his company spent \$19 million to resolve a problem that involved less than \$1 million.

A rapid, serious response is essential to limit negative consequences

Once an issue has risen to the attention of the board and the audit committee, a plan of action needs to be formulated quickly. The challenge is to respond quickly and appropriately without jumping to conclusions or limiting the scope of the investigation. One member highlighted the seemingly contradictory requirements of expeditious resolution and deliberate consideration, saying, *“You don’t know at the beginning where [an investigation] is going to lead. You don’t want to make more out of it than you hope it is, but you need to realize it could be a difficult, nasty thing.”*

A network member who joined a board following a large-scale problem at the company noted that one of the company’s missteps was that management and the board initially took the issue too lightly: *“The company, including the audit committee, was late getting in the game. It took months from when [the issue] was first raised to them taking it seriously. The audit committee needs to move very quickly to assess the problem, [otherwise] third-party interests start entering into it.”*

An effective way to find the appropriate balance between expeditiousness and careful deliberation may be to divide the process into tiers: *“Sometimes you need to do it in stages ... We had to do quick work, then down the road we did a more in-depth investigation.”* However, a tiered process may not work: *“Sometimes the gun goes off, the race starts.”* In those cases, the audit committee’s responsibility is to *“keep digging until you feel pretty comfortable, one way or another.”* Digging includes working with advisers, *“talk[ing] to a lot of people,”* and reviewing information to avoid *“the danger of accepting an answer that’s too quick.”*

In addition to being ready to respond quickly to challenges, boards must have effective means of detecting potential challenges as they arise. Members described two tools that can help identify those challenges:

- **Rotation of audit partners and internal finance personnel.** One network member said, *“Rotation of auditor [partners] matters. You get different eyes looking at the same circumstances.”* Other members said company rotations of finance people and internal auditors can produce similar results.
- **An appropriately scoped audit.** Network members noted that appropriately scoped internal and external audits can pick up issues in foreign subsidiaries that might otherwise go unnoticed: *“The biggest*



issues we've had have been with small, foreign subsidiaries.” While these kinds of issues don't necessarily rise to the level of a restatement, members pointed out that the audit committee can encourage the lead audit partner and executives in the finance function to travel to international locations and small subsidiaries to ensure local teams are providing the appropriate level of service and to change the audit scope to test whether controls are operating effectively. Members specifically noted the importance of setting high standards in emerging markets that may represent a *“platform for growth.”*

Challenging situations can be opportunities to reinforce company policies

Echoing John D. Rockefeller, who said, “I always tried to turn every disaster into an opportunity,” members said that challenging situations present important opportunities to assess company policies and controls and to bolster them where necessary. Challenging situations can also present an opportunity to communicate with employees regarding the situation at hand, company policies, and how the situation is being resolved.

The communication should make it clear that misdeeds are being punished appropriately: *“A public hanging [can] help reinforce [policy].”* One member said, *“To the extent that you've expended a lot of time, effort, and energy, [a challenging situation] is an opportunity to reinforce standards and guidelines.”* Another member said his audit committee highlights issues that come to the audit committee through whistleblower hotlines in order to emphasize to management the importance of such hotlines. A third member reported that in the wake of an issue at one of the member's companies, management and the board examined their ethics policy to be sure that it was clear and well understood.

Lessons for Navigating Challenging Situations

- Be forewarned: challenging situations will likely arise on the watch of every audit committee 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, but recognize that no significant advance planning for managing challenging situations is possible.
- 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.
- Recognize that outside counsel is often required to ensure independence and to provide specialized expertise.
- 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.



Conclusion

It may be impossible to develop a specific “*game plan*” for navigating challenging situations, but boards nevertheless must be prepared to address such situations because they will inevitably arise. Directors must be prepared to commit substantial time and effort to helping protect the company from the negative consequences of those situations. As one network member pointed out, “*It inevitably becomes your turn*” to chair a committee or act as lead director, and directors must be prepared to do their part.

Audit committees should have protocols in place that ensure they are able to respond quickly when a difficult situation emerges, and they should assist management by taking the lead when necessary to ensure appropriate independence. Audit committees can leverage 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 the company reduce the likelihood that similar challenges will arise in the future, and if they do, that they are handled in the most effective way possible.

The views expressed in this document represent those of the North Central 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.

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.