



## Shared responsibility: the audit committee and the board

### Introduction

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Pacific Southwest region of the United States. The network held its sixth meeting by telephone on March 7, 2007, to discuss the topic “Shared responsibility: the audit committee and the board.” This document is a synthesis of insights and comments from that meeting.

Members also participated in an unreported open session, during which they discussed other issues, including modifications to the audit committee report in the proxy, the inclusion of non-U.S. GAAP financial measures in securities disclosures and press releases, and whether or not their companies provided guidance.

Members who participated in meeting were:

- Ray Dittamore, Audit Committee Chair, Invitrogen Corporation
- George Farinsky, Audit Committee Chair, Broadcom Corporation
- Mike Fisher, Audit Committee Chair, Insight Enterprises
- Diana Laing, Audit Committee Chair, The Macerich Company
- Marty Melone, Audit Committee Chair, Countrywide Financial Corporation

Also participating were:

- Gary Birkenbeuel, Pacific Southwest Area AABS Managing Partner, Ernst & Young
- Peter Griffith, Pacific Southwest Area Managing Partner, Ernst & Young
- Doug Obenshain, Partner, Ernst & Young
- Bruce Stump, 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. Network members’ remarks appear in italicized quotes.

### Executive summary

The Pacific Southwest Audit Committee Network’s discussion focused primarily on ways in which the audit committee ensures the entire board is engaged with its work. The following important ideas were discussed:

- **Attention is shifting away from the audit committee** (*Page 2*)

Members believe the new executive compensation disclosure requirements instituted by the Securities and Exchange Commission (SEC) have shifted the focus of attention from the audit committee to the compensation committee. After several years in the spotlight, audit committees are now less often the subject of media and investor scrutiny.



• **Directors are better informed about and more interested in audit committee work** (Page 3)

Members believe that when Sarbanes-Oxley was enacted, few board directors had a deep understanding of the audit committee’s work. However, following several years of experience in implementing Section 404, members say that board directors are taking more interest in key audit committee issues. Members also report that board colleagues are more directly engaged in audit committee work, with many regularly attending audit committee meetings despite not being members. Other board members are content to delegate detailed, technical work to the audit committee.

• **The audit chair’s report should focus on key issues and avoid unnecessary detail** (Page 3)

Members noted that audit committees often need to delve into “esoteric” technical issues that are important to the committee, but not a good use of board time. Members said audit chairs should keep their report at a high level and stressed the importance of substance over style. Many audit committees are providing all board members with access to audit committee papers through secure websites.

• **Audit committees are seeking to improve their effectiveness** (Page 5)

Members see auditors and management as critical to their ongoing education, but are skeptical of the value others bring to board education. Members debated whether it was possible for audit committee members to dig too deeply into issues and concluded that despite the burden that detail-oriented committee members can impose on management, they should not be discouraged, as their care might save the audit committee from embarrassment.

## Attention is shifting away from the audit committee

Following the passage of the Sarbanes-Oxley Act, audit committee chairs were confronted with expanded roles and unclear expectations. However, most members say the increased attention audit committees received as a result of those changes is finally subsiding. Reflecting on the view that board dynamics are often cyclical, one member observed, “*The audit committee had its turn [as a fish] in the barrel with [Section] 404 compliance and [the challenge of] communicating with the board.*”

Members believe the SEC’s new executive compensation disclosure requirements have shifted some of the attention from the audit committee to the compensation committee, and “*the compensation committee is [now] going to see their heads up there in the [spot]light.*” Several members noted that their boards now have long discussions about executive compensation and observed that compensation committee reports to the board have become more robust.

In a recent edition of *InSights*, several audit committee chairs who also serve on compensation committees expressed the view that the audit committee’s experience reviewing detailed financial information meant it could support the compensation committee’s review of compensation discussion and analysis (CD&A) disclosures in the proxy. One *InSights* participant asserted, “The natural course of events will make the audit committees more involved in compensation reporting.”<sup>1</sup>

<sup>1</sup> Ernst & Young and Tapestry Networks, “Improving communication between audit and compensation committees,” *InSights*, December 22, 2006, 4.



Pacific Southwest Audit Committee Network members felt it was *“too early to know”* how the CD&A might impact the audit committee, but said that the new disclosure requirements had not yet increased audit committee workload. Members said that both internal and external audit had been asked to review but not to audit the draft CD&A sections of the proxy, and they agreed that this was a sensible practice.

### **Directors are better informed about and more interested in audit committee work**

In the past, the audit committee was often the place where difficult, dangerous, or overly detailed items were relegated, and getting board directors who were not on the audit committee to share responsibility for those items was a challenge. When Sarbanes-Oxley was enacted, *“[board] members didn't know what [Section 404] was, but they were concerned.”*

But things have changed. One member commented that audit committees *“really tried to make sure the rest of the board [understood] the process the audit committee goes through, [including] the audit, the quarterly review, [oversight of] internal audit, [and] compliance.”* As a consequence, members agreed that *“[board members'] level of knowledge [about audit committee issues] has really come up significantly.”*

Members also agreed that fellow board directors can best understand the audit committee's work through direct involvement in audit committee meetings. Several audit chairs reported that a significant number of board directors who do not officially sit on the audit committee regularly attend audit committee meetings. As one member said, *“Everybody's interested in everything.”*

Ultimately, members wondered how far to extend the idea of shared responsibility. Everybody may be interested in everything, but it is not possible for the board meeting to deal with items at the level of detail that committees can. It is precisely because they are expected to go into more detail that board committees require technical expertise, and it is natural that non-committee members will lack that expertise. As one member put it, *“I can't get into the depth of what they do [on other board committees], and their issues [are as important to] the company as the audit committee[']s issues.”* Recognizing human limitations, members do not feel it is necessary for board members that do not serve on the audit committee to delve deeply into specific accounting or technical issues.

Members agreed it was important for the full board to understand the audit committee's work at a high level, but were *“not sure if it goes any further than that.”* Boards continue to be willing to delegate responsibility for accounting and internal controls to the audit committee, and they *“typically think you've taken care of those things for them.”*

### **The audit chair's report should focus on key issues and avoid unnecessary detail**

The New York Stock Exchange (NYSE) states in its revised listing requirements that audit committees must report regularly to the board of directors. According to the commentary published by the NYSE in November 2004, “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."<sup>2</sup>

One member said, *"The report is my opportunity to tell the rest of the board what I think is important."* Recognizing that the audit committees often spend time on complex, technical issues that are difficult for non-financial experts to understand, members agreed that audit committee chairs should *"try to articulate those principles in good, common business sense"* and should *"be careful not to include too much detail."*

Even though the audit committee may have spent significant time discussing highly technical, *"esoteric"* issues, members feel these discussions rarely warrant a significant amount of the board's time. One member noted that *"GAAP makes us spend time on things [even] investors don't care about."*<sup>3</sup> Furthermore, members agreed that while accurate accounting is important, minor technical accounting considerations should not unduly influence the full board's perspective on key strategic decisions.

### **Board discussion of audit committee issues**

Members said that in board meetings, the finance organization often leads a substantive discussion of the quarterly results. The audit committee report focuses primarily on committee process and unusual items. Members said 10 to 15 minutes is usually adequate for that purpose.

One member observed that the audit chair's report need not be a monologue and that it may lead to additional discussion or clarification: *"Sometimes [the chair's report] erupts into a full board discussion, but sometimes [it does] not."* Issues that might prompt further discussion include specific accounting policies, risk management, or related-party transactions. Another member noted that occasionally board engagement with the audit chair's report can be underwhelming: *"Sometimes you get discussion. Other times, you wonder why you didn't get discussion."* But members do not believe discussion is always required. As one member said, *"If I really felt I needed discussion, I'd just force it by planting some questions."*

Some audit committee chairs have commented on the importance of personal style when presenting the audit committee report. In a recent meeting of another network of audit committee chairs, a participant said he tried to "make the audit committee the highlight of the meeting ... I tell a joke ... I tell them, 'Now this is really big, you need to know this!'"<sup>4</sup> Members of the Pacific Southwest Audit Committee Network downplayed the need for humorous presentation; one member quipped, *"I never thought it was my job to entertain. If that's the case, we're in trouble."*

### **Sharing material with board colleagues**

Members agreed it was helpful to share presentations or other audit committee materials with their board colleagues. Several members said they do this through a secure website. One member said, *"Every board member has access [to the website]. If something is important, it would be in my report that members ought*

<sup>2</sup> NYSE Group, *Listed Company Manual* (New York: NYSE Group, 2007), 303A.07(c)(iii)(H). Available at <http://www.nyse.com/Frameset.html?nyserref=&displayPage=/lcm/1078416930900.html?archive=no>.

<sup>3</sup> Another member noted wryly, *"GAAP is the space between accounting and reality."*

<sup>4</sup> Southeast Audit Committee Network, "Shared responsibility: the audit committee and the board," *VantagePoint*, March 2, 2007, 5.



*to look at it.”* Members said the ability to distribute material electronically between meetings allows for more timely feedback and helps to limit the size of audit committee or board meeting books.

From time to time, the audit committee will engage in an especially useful discussion that the audit committee chair believes should be held more broadly. As one member said, *“If the audit committee has a good presentation, then I’ll recommend that it be part of a full board discussion [at a future meeting].”*

### **Audit committees are seeking to improve their effectiveness**

Although much of the network meeting focused on responsibilities that the audit committee and the rest of the board share, members also reflected on some practices that enhance audit committee effectiveness and support audit committee members’ responsibility to one another.

#### **Education is best handled by management and auditors**

Members agreed that many audit committee members struggle with the technical demands of their role. One member asked, *“How does anyone who is not a CPA on a full-time basis keep up with all the changes in accounting rules?”* Another member retorted, *“It’s impossible,”* and stressed the audit committee’s reliance on finance staff and the external auditors.

One member said that the finance staff routinely sends a memo to the audit committee whenever there is a new technical accounting release. This memo is often reviewed and discussed briefly at audit committee meetings, but not shared with the whole board. Another member said that management and the external auditor hold information sessions during which they review new accounting issues that are immediately applicable, as well as issues that are likely to emerge in the future.

One member said that, over the course of the year, audit committee meetings include a *“trip through the balance sheet”* during which management and the external auditor educate audit committee members about the assumptions and accounting policies embedded in each line item. Another member said management used to hold educational sessions for directors the evening before committee or board meetings. The sessions ended for logistical reasons, but board members recently asked management to reinstate the practice.

If members generally value audit committee education delivered by management or external auditors, they are skeptical of the value independent consultants can offer. One member noted, *“Outsiders really don’t know how things fit in our business.”* Another member said that during recent audit committee education sessions led by a consultant, *“the directors educated the educators.”*

#### **Multiple modes of engagement have value**

During the meeting, members reflected on the fact that board directors engage with written material in different ways. Instead of valuing one approach over another, members broadly agreed that a blend of styles can be most effective.

As one member said, *“We have some deep readers and some surface readers.”* Surface readers look for key principles, while deep readers tend to probe the details. Members debated whether it was possible for the



audit committee to probe *too* deeply into issues. While some members felt a detail-oriented audit committee member might impose unnecessary demands on management and fail to see the forest for the trees, one member warned: *“Don’t discourage him. He may save your [skin] some day.”*

Ultimately, *“people are going to read the way they read,”* and members suggested that it was best to capitalize on members’ individual preferences and strengths. Some members suggested giving the *“deep drillers”* an early version of the proxy, so they had an opportunity to make substantive comments before the rest of the committee. The one thing members all agreed on was that *“you can never drill too deep for yourself. [If asked about your level of oversight], you never want to answer a question [with], ‘I held back.’”*

## Conclusion

For the last several years, audit committees have been placed in a difficult position. In the face of increased regulator and shareholder scrutiny, audit committees were expected to take on an expanded but often unclear oversight role. Moreover, audit committees reported back to board colleagues who understood little about the technical and organizational challenges confronting the committee.

Fortunately, there is reason to believe the tide is turning. Audit committee chairs report board colleagues are more engaged with the work of the audit committee. For many, the notion of shared responsibility is no longer merely an aspiration, but a reality.

*The views expressed in this document represent those of the Pacific Southwest 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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