



## **Shared responsibility: the audit committee and the board**

### **Introduction**

The Southeast Audit Committee Network held its sixth meeting on February 8, 2007, to discuss how the audit committee and the board share responsibility for helping assure a company's financial reporting integrity. This document is a synthesis of insights and comments from that meeting.

In addition, members raised other matters, including the management and mandate of the internal audit function, the impact of possible changes in regulators' guidance on implementing Section 404 of the Sarbanes-Oxley Act, and the audit committee's role in enterprise risk management.

Collectively, members of the network sit on the boards of about 20 large-, mid-, and small-cap public companies. Members who attended the meeting were:

- Eddie Adair, Audit Committee Chair, Tech Data
- Denny Beresford, Audit Committee Chair, Kimberly-Clark and Legg Mason
- Brenda Gaines, Audit Committee Chair, Office Depot
- Sam Gibara, Audit Committee Chair, International Paper
- Sherrill Hudson, Audit Committee Chair, Standard Register and Publix Supermarkets
- John Rolls, Audit Committee Chair, Bowater
- Peter Wood, Audit Committee Chair, Eastman Chemical

Also attending all or part of the meeting were:

- Edwin Bennett, Southeast Area AABS Managing Partner, Ernst & Young
- Steve Konenkamp, 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. *VantagePoint* also includes select comments and perspectives that emerged from pre-meeting discussions with members.



## Executive summary

Members had a lively discussion about the board and the audit committee's shared responsibilities. The most important elements are highlighted below, with more detail in the following pages:

- **Sharing responsibility efficiently with the full board is difficult, but doable** (page 2)

Members agreed that sharing responsibility between audit committee members and non-members on the board can avoid situations where *“all [board members] are equal, but some are more responsible than others.”* But certain factors stand in the way of efficiently sharing responsibility, such as time constraints, relative financial expertise, and directors' pay differentials. To lessen the effects of these factors, audit chairs can insist on audit committee chair and member rotation, steer board recruiting efforts to identify both operational and leadership expertise for the audit committee in addition to financial expertise, and press the full board for more active participation in the 10-K approval process.

- **Reporting to the board is an art, not a science** (page 4)

The audit committee's report has to overcome a number of hurdles: it must contain those issues that are most important for a board director to know; it must engage the full board's interest as much as possible; and it must be easily accessible to non-financial experts. Members suggested a number of steps to overcome these hurdles, such as wearing a *“director hat”* when determining what to put in the report, asking management experts to present items directly, having the external auditor provide ad hoc director education on hot topics, and making the report as lively and engaging as possible.

- **Communication among board committees can be improved** (page 6)

Members agreed that communication among committees is satisfactory, but could more effectively support the sharing of responsibility among committees. Several ways to improve communication emerged, including cross-committee membership, joint committee meetings, and formal and informal communication among committee chairs. Members were particularly interested in coordination with the compensation committee, given the recent requirement to include compensation disclosures (the CD&A) in the annual proxy statement.

## Sharing responsibility efficiently with the full board is difficult, but doable

While network members agree that the full board and the audit committee share responsibility for many important tasks, including risk management and approval of securities disclosures, it is less clear exactly how those tasks should be divided. Most members say that it is not feasible to *“share all the [audit committee] details with the full board.”* The board needs a voice in some of the audit committee's decisions, but the situation should not be one where directors are left wondering, *“Why [should] we bother to have committees if the entire board is going to make all the decisions?”*



Determining how responsibility is shared is complicated by a number of issues, such as the amount of time directors have to devote to board tasks, director pay differentials, and legislated differences between directors (e.g., required finance and accounting expertise).

### **What is standing in the way of shared responsibility?**

Members cited many factors that inhibit the sharing of responsibility between the audit committee and the board. Board directors are generally busy people for whom *“time is a very real constraint.”* This is particularly true for working *“executives [who can’t accommodate] committee membership overlap.”* According to recent research, approximately 40% of audit committee members have full-time employment, and the average audit committee member spends more than 50 hours per year on committee-specific work in addition to over 80 hours on other board activities.<sup>1</sup>

Expertise is another obstacle to the sharing of responsibility with the full board. Members noted that recent legislation requiring audit committees to have at least one financial expert (or to disclose why they don’t) has resulted in audit committees with far more financial and accounting knowledge than the rest of the board. One member stated that *“these [skill-based] distinctions are artificial and due to regulation.”* This member felt that all board members can share in bearing certain responsibilities, regardless of expertise. Nonetheless, members agreed that situations arise in which the relative lack of expertise of some board members can cause them to be more restrained – in their questioning of the audit committee report, for instance – in order to avoid appearing uninformed.

Finally, members noted that differences in compensation can create an artificial distinction between audit committee members and other board members if the differences are not managed and communicated properly. Audit committee chairs’ compensation is, on average, 21% greater than that of other committee members. Audit committee members’ compensation increased 20% in 2006, when median compensation reached \$120,000.<sup>2</sup> Member perspectives on pay differentials split evenly, with one member believing *“pay isn’t a problem ... all [my boards] pay the audit chair more, and everyone agrees this is right,”* and another stating that an audit chair pay differential *“creates two classes [of directors],”* which the member felt was a bad thing. Yet another member articulated both sides of the issue: *“I think everyone should get the same pay, but I haven’t exactly offered to return my extra compensation.”*

### **Practices to improve responsibility sharing**

Boards are overcoming barriers to shared responsibility in various ways. Members mentioned a number of steps they take to share the burden of certain audit committee responsibilities. The steps include:

- **Rotating committee chairs and membership.** On one network member’s board, *“[committee] chairs are required to rotate every four years.”* Another member agreed with this approach and said rotation *“should be for committee members as well.”*

<sup>1</sup> Ernst & Young, *Audit Committee Perspectives: 2006 Audit Committee Survey and Industry Insights* (New York: EYGM, 2007), 19, 35. 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)

<sup>2</sup> Ibid., 3.



- **Seeking diversity of expertise.** While financial expertise is a given on the audit committee and even required by law, an effective audit committee requires a broader skill set. One member remarked, *“It’s good to have manufacturing or operational experts on the audit committee. It’s important to [identify] risks [beyond] finance and accounting.”* Another member lamented the fact that *“the trend today is to have audit chairs be retired Big Four partners, not CEOs or CFOs.”* This member felt the trend contributes to the divide between the board and the audit committee, as former Big Four partners have such specialized and rare expertise. Furthermore, that expertise alone doesn’t necessarily make for an effective audit chair.
- **Valuing leadership abilities more than financial expertise in the audit chair.** Members do not think that the audit chair needs to be the committee’s financial expert: *“The key audit chair skill is leadership.”* One member recalled serving on a board whose audit chair was *“[financially] literate, but not an expert, and he was fantastic.”*
- **Developing effective processes for approving securities filings.** Approving the 10-K is a full-board responsibility, but one member said he has to use *“scare tactics”* to combat directors’ inclinations to leave the job for the audit committee. Another member described a 10-K approval process that the group admired for its orderliness: *“We have a discussion with the audit committee, then we bring in all the other directors. The first discussion is very technical, and the second is more focused on policy and compliance.”* Each discussion lasts about 45 minutes.

## Reporting to the board is an art, not a science

The network agreed with one member who said that *“what goes into the [audit committee] report is very arbitrary. As audit chair, I have to decide what is important, and what is ‘ministerial.’”* The challenge of reporting to the full board arises from the sheer volume of the audit committee’s deliberations, the disengagement of some board members, and a general lack of understanding of key financial and accounting issues on the full board. Members shared many ways to make the report as meaningful as possible for board members lacking time and expertise.

## Choosing what to present

The sheer number of details covered in a typical audit committee meeting makes deciding what to report to the board extremely difficult. While some audit chairs feel that those subjects getting the most “air time” in an audit committee meeting are the ones that should be discussed in the report, one member protested, *“You should forbid yourself from using [that method]. One thing we do on the audit committee is dig into internal audit details – it takes about 20% of our time. Then we do a legal review, which could take very little time in the audit committee but [is] extremely important to the full board. The audit chair has to put a director hat on to determine what to report to the board and ask, ‘what do I want [the other directors] to know?’”*



## Making the report accessible

The audit chair can go only so far in attempting to engage the full board. The gap in understanding between the audit committee and the rest of the board *“is an [ever-present] problem ... ignorance can be a problem anywhere [on the board].”* In general, engagement only comes *“if there’s interest in the subject [in the report]. If you report what’s important, you’ll get someone who’s interested.”*

Members elaborated on several practices they use to make board reports meaningful. Some of the most salient recommendations include:

- **Asking what directors would want to know and keeping an open mind.** One member explained that he asks himself, before reporting to the board, *“What would I be [upset] about if I didn’t hear about it in the audit chair’s report [and it came up later]?”* In order to do this, an audit chair *“can’t be prejudicial. You don’t know [before the meeting] what the big issues are going to be that the full board should know about.”*
- **Sending audit committee materials to everyone on the board in advance.** One member commented, *“Then they can dig into areas of interest, if they like.”* Most members find sending all the materials out preferable to trying to guess the exact interests of other board members. On one member’s board, *“if any board member wants information from the audit committee, they can get it, but we don’t push the information to them.”* One member agreed in spirit, but noted that *“if you force feed [the board] a little, that can be good.”*
- **Reporting in plain English.** During a busy, fact-filled board meeting, *“directors aren’t going to be interested in nitpicky stuff,”* especially if the details are full of jargon and technical terms. This is a particularly sensitive problem for new board members, who may be *“reluctant to ask questions,”* even though, ironically, their onboarding training often makes them more knowledgeable about accounting and finance issues than the directors who have served for a while.
- **Getting parts of the report straight from the source.** Instead of delivering talking points on subjects that management has just reported on to the board, one member asks management to address the board directly: *“I’d always rather have the board hear it from management than from me.”*
- **Bringing in outside experts for ad hoc education.** Members reported a diversity of practices for educating directors as needed, including quarterly *“20-minute presentations on important topics”* from the external auditor, full explanations in management reports of certain risk metrics, and a full walk-through of GAAP for new board members.
- **Enhancing report delivery.** While reporting to the board *“is a matter of personal style,”* making reports more lively can have a positive effect. One member tries to make the presentation a performance and aims 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!’”*



## Communication among board committees can be improved

Given the overlap between the compensation and audit committees' work, not to mention increased regulatory, investor, and media scrutiny of executive compensation, members' discussion of communication among board committees focused mainly on interaction between the audit and compensation committees.

Members feel that discussion and interaction between committees (particularly audit and compensation) is generally satisfactory, but could be improved. Members want to make those improvements voluntarily and proactively, before regulators act.

### Methods of enhancing communication

In general, members agreed that there are at least three mechanisms for enhancing cross-committee communications that are worthy of adoption:

- **Cross-committee membership.** One member spoke specifically about the process of vetting the new compensation disclosures required by the SEC: *"We have cross-membership on the audit and compensation committees. Otherwise it's too cumbersome to define specific responsibilities on the compensation discussion and analysis [CD&A]."* Members believe the same approach could be taken for other committees with a lot of work in common with the audit committee, such as the finance, technology, and risk committees.
- **Joint meetings.** In another CD&A-related discussion, one member noted an effective use of a joint meeting: *"We take one hour from audit committee and compensation committee meetings to jointly discuss the CD&A."* The member noted that this process reduces the time needed to approve the disclosure and decreases the amount of duplicative work done by each committee.
- **Formal and informal communication between committee chairs.** One member voiced the common opinion that *"it's really up to the committee chairs to communicate with each other"* to assure effective collaboration and committee efficiency. Another member reported *"routinely exchang[ing] e-mails with the comp committee chair in between meetings."* Other members said that their boards' committee chairs hold executive sessions before board meetings to finalize the agenda.

### Involvement in the CD&A

Because this network meeting came just after the close of many members' fiscal years, most were actively involved with the CD&A, as it must be included in the proxy materials. While most members were interested in helping assure the accuracy and validity of the CD&A, one summed up the group's thinking well in saying, *"As audit committee chair, I have to trust the compensation committee chair's decision making."*

One member relied on input from the external auditor to get more comfortable with the CD&A: *"We have the external auditor [test] compensation [disclosures] for the CEO and the CFO. They give us an oral report at our meeting."* In this audit chair's view, *"the more people who look at the CD&A this year, the better."*



The need for collaboration with the compensation committee is not limited to the CD&A, however. Recent research has identified a broader agenda of issues requiring mutual consideration (see appendix overleaf).

### **Communication with other committees**

Though our discussion centered on communication between the audit and compensation committees, members acknowledged that communicating with other committees can be just as important. According to recent research, 18% of boards have risk committees,<sup>3</sup> which should, in the words of one member, be “*joined at the hip*” to the audit committee to ensure a seamless treatment of enterprise risk in financial disclosures. Other committees that can overlap with the audit committee include technology committees (with respect to technology risks and the control environment) and finance committees (especially with regard to mergers and acquisitions).

### **Conclusion**

Shared responsibility between the board and the audit committee is viewed by members as a key to fulfilling the board’s fiduciary obligation to shareholders. In order to provide the best corporate governance possible and to avoid putting an overwhelming burden on one committee, audit committee chairs must push their boards to share responsibility effectively. An engaging and thorough board report and effective communication between the board’s committees help make shared responsibility possible.

### **About this document**

The Southeast Audit Committee Network is a select group of audit committee chairs 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 or management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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<sup>3</sup> Ibid., 1.



## Appendix

### Important reasons to collaborate: thoughts from audit chairs who also sit on compensation committees<sup>4</sup>

- **Ensuring proper controls are in place.** “In theory, the [compensation] controls are being vetted because they are subject to [Section] 404 requirements.” Yet, “the audit committee will probably need more information from the comp committee about ... compensation, to be sure that controls are in place.”
- **Assessing the implications of compensation for financial reporting.** “On the audit committee, you need to understand the structure of [executive] compensation and where the sensitivities would be in regards to financial results ... [and other] potential implications of the comp structure.”
- **Anticipating the likely magnitude and timing of incentives.** “We need to know if [the incentive targets] are false goals. We have had to accrue and reverse big numbers. That is where compensation and audit need to be talking.”
- **Adjusting compensation to reflect extraordinary events.** “If performance is based on revenue growth or return on invested capital, someone has to oversee it to be sure that exogenous events haven't intervened to affect those measurements.”
- **Changing executive compensation practices.** “If the compensation committee is going to recommend a significant philosophical change in incentive comp, [it] should send a formal [proposal] to the audit committee, and the audit committee should provide a formal response.”
- **Stock option backdating.** “The compensation committee sets the [options grant] policy, and the audit committee has a responsibility for overseeing the control environment.”

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<sup>4</sup> Adapted from Ernst & Young and Tapestry Networks, “Improving communication between audit and compensation committees,” *InSights*, December 13, 2006. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Dec06\\_InSights\\_13.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_Dec06_InSights_13.pdf).