CANADIAN
AUDIT COMMITTEE NETWORK
VantagePoint

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Navigating challenging situations

Introduction

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading Canadian companies. 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 evolving audit environment.

The fourth meeting of the network was held in Toronto on July 10, 2007. Discussion focused on the unanticipated, challenging situations every audit committee confronts from time to time.

This document reflects a synthesis of the key issues that emerged from the meeting. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues such as these. Anyone who receives this publication may share it with those in their own network. The more broadly we can disseminate this information to board directors, management executives, and their advisers, the greater the value created for all.

Between them, the members of the network who participated in the meeting sit on the boards of over 30 large-, mid-, and small-cap public companies. Those members participating in the meeting were:

- Bill Anderson, Audit Committee Chair, TransAlta
- John Caldwell, Audit Committee Chair, Cognos
- Gary Colter, Audit Committee Chair, CIBC
- Denis Desautels, Audit Committee Chair, Alcan
- Don Fullerton, Audit Committee Chair, Husky Energy
- Kerry Hawkins, Audit Committee Chair, NOVA Chemicals and Shell Canada
- Bob Luba, Audit Committee Chair, MDS
- Eileen Mercier, Audit Committee Chair, CGI Group
- Ted Reevey, Audit Committee Chair, Aliant

Members attending the meeting from Ernst & Young were:

- Lou Pagnutti, Area Managing Partner; Chairman and Chief Executive Officer, Ernst & Young Canada
- Ross Pearman, Senior Client Service Partner and Leader, Asset Management Services

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. Quotes in italics are drawn directly from conversations with Canadian Audit Committee Network members; quotes drawn from discussions with other audit committee chairs are not italicized.

Executive summary

In candid conversation, members discussed the diverse challenges they have faced, the importance of responding to those challenges quickly and appropriately, and how to find closure and generate value from the experience.

- **Challenging situations take many forms** *(page 2)*

  Even with proactive, diligent audit committees, challenging situations inevitably arise. Members discussed challenges involving fraud, illegal payments, and litigation, among others. Human resources issues make up the largest portion of the whistleblower claims, but members noted that as audit committee chairs, they must be most attentive to financial issues. Some members recommended keeping a PR firm on retainer to avert the reputational damage that can come from dealing with protracted or unanticipated problems.

- **Committees must seek a quick, proportionate response** *(page 4)*

  Although members feel that audit committees must not underreact to challenging situations, overreaction can be damaging too, especially when allegations are eventually proven false. It can be difficult to determine the credibility of allegations when charges are made through anonymous whistleblower systems, which also make it difficult to confirm resolution of the problem.

- **It is helpful to find closure and identify key lessons learned** *(page 4)*

  Unfortunately, not all challenging situations are neatly resolved; members pointed out that in the case of securities investigations, the U.S. Securities and Exchange Commission (SEC) does not necessarily inform boards when an investigation is complete. Members disagreed over how common formal after-action reviews are, but all agreed that it was important to identify and address the root causes of problems so they do not arise again.

Challenging situations take many forms

Members define "challenging situations" in broad terms, but agree that one point of commonality is that they can *"come out of the blue"* and are often difficult to navigate, even with proactive, diligent audit committees. Incidents can have a devastating impact: one member remarked, *"Despite audit committee intervention, that [situation] hit us like a bomb."*

Members candidly described a wide range of situations they have experienced over the course of their careers, including allegations of fraud by employees, potential illegal payments, and significant litigation. Members said that while these situations were often time-consuming and unpleasant, they often resulted in valuable lessons that were useful in dealing with subsequent challenges. Additionally, members observed that the cost of investigating a problem was often high relative to the magnitude of the problem itself.

Several members mentioned the challenging situations that can arise in foreign subsidiaries. In many nations, referral payments or facilitation fees are common, but those fees may run afoul of the U.S. Foreign Corrupt

Practices Act. When discovered, they can be *"very interesting to the Securities and Exchange Commission and the [U.S.] Department of Justice."* Recalling a foreign charitable donation scam in one company, a member remarked that *"big surprises can come easily when you're working internationally."*

Monitoring litigation

Network members described a multitude of ways to monitor corporate litigation. One member told us, *"We're given a quarterly report of all [litigation] above $100,000 [in potential damages]."* Other members agreed that such reports can be useful: *"You can monitor issues over time, track their progress. You can see something that doesn't look right."*

Members reported that their *"litigation reports are parsed into categories: human resources, class actions, etc."* One member noted that while it is important to understand what issues the company is dealing with, *"when you have 30,000 employees, trying to monitor all the details is insane."* However, several members questioned whether summary data would be adequate: *[Even though the full litigation report] is 50 pages long, the people on the board want it all."*

One member said, *"The vice president for human resources, the general counsel, and others deal with HR issues. But if any issue touches the books, [the audit committee is] in. You don't have a choice. You can be diplomatic about things, but you have to get to the bottom of the issue."* Another member agreed, *"You have to dig. How that's done, how that's monitored, and by whom, are the issues."* Generally, members believe that audit committees have to *"monitor risk in general"* and *"monitor the impact on the financial statements"* specifically.

Members brought up one very specific concern regarding litigation: *"Juries. If your fate is in the hands of a jury,"* one member remarked, *"it's a crap shoot."*

Class action lawsuits also present difficulties, because, as one member observed, *"If everyone else settles, and you don't, the jury [may] then [decide] against you jointly and severely.*" That is, the jury can find the party that does not settle responsible for the whole of the damages, regardless of its individual share of responsibility. At the same time, *"if you always settle, you become a magnet for class actions."*

Reputation risk

Members feel that one of the largest concerns for corporations, when dealing with challenges, is *"reputational risk. You have to manage the news. You have to mitigate damage and impact. This is usually handled by management, sometimes inappropriately."* Ongoing problems, even if the company is innocent of wrongdoing, *"become image issues after a while."*

One member described a crisis they dealt with during their career: *"We were receiving 30,000 phone calls a day. It was horrible. We hired a PR firm, but it was six weeks before they were up to speed. There was a horrible impact. [Once the PR firm] is in place, it's critical that they are able to manage the situation."* Another member remarked that in a similar situation, *"it was four weeks before the PR firm was in place."*

To lessen the potential damage, one member recommended having a PR firm *"on retainer. Have them keep up-to-speed on issues. [When there is a crisis, they] can be on site within 24 hours, with resources behind them backing them up. Plus, they know your culture."*

Committees must seek a swift, proportionate response

In dealing with challenging situations, directors need to ensure that their responses are timely and reasonable. Given a choice between overreacting and underreacting to a developing situation, members generally agreed that boards were obliged to respond aggressively. However, overreaction can be costly, both in terms of the legal and accounting work and in terms of the reputational impact on the people involved.

The risk of overreaction

Members noted that for many potential situations, specific plans of action are already in place. *"We have whistleblower plans now that are very specific. We have a special committee structure for when hostile bids come in. [Regarding] who is on the committee, how will it behave, will they be paid – these rules are usually in place."*

Unfortunately, *"you can't predict everything."* When challenging situations arise that current plans do not cover, boards and committees must come up with a course of action. Directors must make sure they are responding appropriately without overreacting. *"There's a big difference between staying cool and calling the [Royal Canadian Mounted Police],"* one member remarked. This is especially important if the investigation could have an impact on a person's reputation within the company. Several members described situations in which executives were investigated, only to have the allegation proven false. The accused isn't the only one who can be upset by false allegations: one member recalled that *"the internal auditor was incensed"* over a fraud investigation because it implied that people believed fraud could take place and not be discovered by internal audit.

The dilemma of anonymous reporting

Members noted that one complication of an anonymous reporting system is the difficulty of follow-up, either to ask clarifying questions or to confirm resolution of the issue. One member said, *"If the report is anonymous, it's hard to track back and figure out if it's smoke or fire."* Another member admitted, *"I'm more suspicious [about the validity of the complaint] if it's done anonymously."*

It is helpful to find closure and identify key lessons learned

Unfortunately, not all challenging situations are neatly resolved; it is not always easy to say that the case has been closed. As mentioned above, in anonymous whistleblower situations, it is not always possible to close the loop with the complainant. In some securities investigations, there may be no notification that the investigation has concluded. Audit committees must find ways to recognize when an issue has been resolved and then look at how it can be prevented in the future and what lessons can be learned from the experience.

Cross-border differences exist

Members who serve on boards in both the U.S. and Canada noted a significant difference between the two countries in the closure of securities investigations. In Canada, *"the Ontario Securities Commission says, 'Thank you, you're done.' [In contrast,] there seems to be no end point with a Securities and Exchange Commission [investigation]."*

What happens afterward?

One member remarked, *"We don't let the issue end until we know what actions management is taking. On all the committees I'm on, we ask that question. If we're satisfied with the answer, we'll then ask, 'What can we learn as a board and as a company?'"* Members liked this approach, which they felt was *"a great test of 'tone at the top.'"*

Members disagreed on how often formal after-action reviews[1] of challenging situations are undertaken. One member said that *"with SOX, a breakdown of internal controls forces [a review] now more than ever."* However, other members said that in their experience, reviews don't happen as often: *"They're very selective and rare. They're conducted at the board level, and we do it in a sensitive fashion. We focus on the present and the future and try not to get dragged down in the past."*

Members feel that identifying and eliminating the root cause of a problem is vital, regardless of the specific course of action taken to do so. *"You're negligent in your role if you don't fix the issue,"* one member stated. *"You have to identify the cause and fix it."* Fixing problems at the root level can also allow directors to reinforce the ethics and values of the business at a time when morale may be low.

Conclusion

One member closed out our discussion by sharing the maxim *"Good judgment comes from experience. Experience comes from bad judgment."* Although navigating challenging situations is difficult, it can improve directors' confidence in their ability to handle adversity and frequently leads to changes that improve future performance.

[1] The idea of an after-action review comes from the military. In a military context, an AAR "is a professional discussion of an event, focused on performance standards, that enables soldiers to discover for themselves what happened, why it happened, and how to sustain strengths and improve on weaknesses." Corporations may similarly benefit from a comprehensive review of how a problem occurred, why it occurred, and how management and the board addressed it as the process can help ensure the same mistakes are not repeated.