What makes an audit committee effective, especially when corporations must navigate their way through difficult times?

Let me begin by sharing some insights from my own career. Several years ago, I was serving as the CEO of a company that was experiencing a number of severe challenges. I was brought in to carry out a complicated financial and operational restructuring.

Then an unexpected crisis arose.

A former employee came forward and presented documentation that seemed to prove that the computer system had been manipulated so that delinquencies in this company’s loan portfolio were not being reported correctly and, in fact, could not be tracked accurately. I immediately brought the matter to the audit committee’s attention.

At first, the audit committee was reluctant to commence a formal investigation. It did not hesitate because it was asleep at the switch, or incompetent, or in any way implicated in what might have been fraudulent behavior. But the committee was genuinely uncertain about how to proceed in a way that would be in the best interests of this company and its stakeholders. I understood that reaction. There were many problematic issues facing this company. Audit committee members were concerned that, if word of our suspicions leaked out, it might have an exaggerated effect in the outside world. If reports that later proved to be partly or fully unsubstantiated ended up causing creditors, customers, and others to lose faith, the company’s turnaround efforts might be impeded, reducing or eliminating its prospects for survival.

But what if the whole operation turned out to be fraudulent? There was no way to be certain without digging deeper. Imagine the situation that the audit committee faced: Even before this crisis arose, the company had embarked upon a difficult and extensive turnaround whose outcome was far from predictable. Now, the committee needed to consider taking a new and unexpected course of action in an environment riddled with risks and uncertainties. And it needed to make its decision quickly, since time was limited and the stakes were huge.

There weren’t any easy answers—in fact, there often are not when a company is experiencing some type of difficulty. This audit committee asked a lot of questions, however, and ultimately concluded that it was, indeed, essential to hire an outside expert to investigate the situation. How next to proceed?

In this case, the problem turned out to be a relatively contained one. Thanks to the audit committee’s careful yet decisive approach, we were able to take steps effectively to address it. We were fortunate. In recent years, other corporate situations have unfolded with far less favorable consequences. Certainly, some of the problems that have occurred might be laid at the feet of apparently asleep audit committees.

But that assessment is all too facile, given
the complexities that abound in the current corporate environment. One may argue that corporate accountants or attorneys have been asleep as well, since audit committees often have relied upon them for advice in situations that proved to be questionable or even fraudulent. But rather than apportioning blame based upon past inadequacies, I would argue that we need to broaden our definition of appropriate and desirable audit committee practices to help committee members be better prepared to meet future challenges.

During the past decade or so, the challenges facing audit committees have escalated to a degree once unimaginable. In large part, that is because technology in the financial markets has far outstripped the man on the street's ability to understand the financial risks that may be embedded in a company's financial statements. Off-balance-sheet accounting, developments in the derivatives market, and the lack of separation between a CEO's personal balance sheet and a company's balance sheet are all factors that conspire to make an audit committee's responsibilities more difficult to perform, yet more important than ever.

So, what makes an audit committee effective? The Sarbanes-Oxley Act of 2002 has underlined the responsibilities of audit committees, while making the consequences of not complying with the rules more draconian. But I am firmly convinced that the single most important ingredient in an effective audit committee is something that can neither be mandated nor legislated: the quality of engagement and attention that an audit committee member brings to his or her activities. Checklists can never be a substitute for a board member's active, intellectual engagement in a company's financial matters as well as the larger issues that affect its business.

It is scarcely an exaggeration to say that audit committees are the backbone of a system that assures confidence on the part of investors and other external constituents that a company's risks have been understood and controlled, while being reported fairly, accurately, and accessibly to the outside world. That is not an easy order. But when this role is performed well, it provides the public with the confidence that a company's numbers are reliable. But in the wake of Enron's collapse and other corporate scandals, some of this confidence has been eroded. Various audit committees have been criticized—at times quite harshly.

Today, there is a lot of fear on the part of audit committee members that they may be found to have done something wrong or that they may do something wrong in the future. Avoiding errors is an important goal, of course, but fear can produce negative consequences as well. It encourages audit committee members to view their role narrowly—to adhere to a checklist or yes/no box mentality—rather than to define their responsibilities in the broad terms necessary to ensure the best performance of this job.

Let me step back for a moment. I consider the mission of an audit committee to be not so much the detection of fraud, but more the creation of a corporate environment in which the risks that fraud can take place have been minimized. It's a preventive mechanism. While taking all the steps necessary to make certain that a company's financial results are presented fairly and accurately, a successful audit committee helps foster an environment in which no one will think about the possibility of pushing the edges of the envelope further and further. In part, that is because everyone knows that audit committee members are really paying attention, directing their best judgments to evaluating how the company's activities will further the achievement of its goals. When corporate practices don't seem to make sense, committee members will ask why, and when answers seem inadequate, they will keep probing.

For example, imagine a situation in which a company is contemplating some type of off-balance-sheet transaction. If you were serving on the audit committee, you might consult the firm's accountant or attorney or even an outside expert to make sure that the transaction complied with tax and accounting rules. And if they gave you the OK, you then might feel that you have done your duty.

But to me, other questions would be equally if not more important to ask as well. These include:

- How does this transaction further the objectives of the company?
- To what potential risks will it expose the company?
- Why should we take on those risks, and what will we be sacrificing if we decide not to take them on?

If you are not willing to ask those kinds of questions, and many more like them, you are not performing your duty fully as an audit committee member. Such lapses, upon rare occasions, may coincide with fraudulent behavior within a corporation. But they will exact a far greater toll elsewhere in the number of companies that fail to achieve their goals or long-term potential for lack of careful, thoughtful guidance from an actively engaged audit committee.
ASKING THE RIGHT QUESTIONS

With all the financial complexities that boards must deal with these days, there is some debate over whether the only people qualified to serve on audit committees are financial specialists—the kinds of people who really understand off-balance-sheet accounting or state-of-the-art derivatives deals. The thinking is that they would be likeliest to detect fraud and other improper activities because their expertise would make them difficult to deceive.

I do not believe a specialist’s knowledge is essential, however. An audit committee member must be financially literate, of course. One must be capable of understanding the business and financial plans of a company, to be capable, among other things, of evaluating how its activities are furthering or not furthering its core objectives. But a person could be an absolute derivatives genius and yet not necessarily be willing to ask the right questions. So his or her value on the committee would be limited at best.

What is the most essential quality that an audit committee member can have? A skeptical habit of mind. I often describe this as the “child mind”—a person’s willingness to ask questions and keep asking questions until she fundamentally understands the way things work.

It is easy for information to slip through the cracks, even when everyone has the best of intentions. We all recognize this from our own lives: It’s easy to think that you understand something when you really don’t. That is why audit committee members need to be rigorous in questioning management, as well the company’s external and internal auditors, on a wide variety of topics relating to the company’s business situation and financial matters. They should ask those questions from every possible direction and take nothing for granted.

The incentive to maintain such a probing mentality is really quite simple. Financial statements are supposed to be clear to investors. Yet how can audit committee members make certain that the financial reports they review are, indeed, simple, accessible, and accurate? The only way they can achieve such assurance is to make sure they really understand what is happening within the company. Then, and only then, can members evaluate whether financial reports fairly represent the company’s financial reality.

In some situations, hidden problems do exist within companies, whether because of complex marketplace downturns, management incompetence, or even fraudulent behavior. How quickly will those problems be detected, contained, disclosed, and remedied? That answer is correlated directly to the degree and quality of the audit committee’s engagement.

It will take a long time to fine-tune all the rules and regulations connected with Sarbanes-Oxley. But one thing that the new law already has accomplished is to give legitimacy and support to those audit committee members who keep asking questions. Once, these people might have been dismissed as squeaky wheels or impediments to a company’s forward momentum. But now, when questions are raised by audit committee members or others on the board, they must be taken seriously. It is important to note that the new regulation gives the audit committee explicit authority to engage independent counsel or other advisers, whenever that is deemed necessary to help get the answers it needs.

But there is only one way to begin this vital process: by asking questions. To take one example, rather than waiting for a company’s CEO to come to the board with a disclosure about a significant business risk, audit committee members should maintain a regular dialogue with management about a wide range of risk-related issues.

Good questions to ask may include:

• What processes are in place to help identify important business risks to the company?
• What business or financial-statement risks have been identified, and what procedures are being employed to monitor them?
• Are there subsidiaries, operating divisions, or corporate activities that are not subject to audit and offer unusual business or financial risks? If so, how is management responding?
• What issues or concerns exist that might adversely affect the future operations or financial condition of the company? Is there a plan in place to deal with them? What is that plan, specifically?

Similarly, there are plenty of good reasons to keep communications flowing between the audit committee and the company’s internal auditors. The passive approach would be basically to wait for problems to percolate, assuming that the chief financial officer would inform board members of any concerns that internal auditors may raise. But an engaged audit committee instead may choose to ask the internal auditors questions like these:

• What is the level of respect within the company for internal audit activity?
• What are management’s policies for responding to internal audit reports?
• Is this company following the same internal audit procedure that would be followed if you were CEO? If not, describe the differences.
• If you were serving on this audit committee, are there other questions that you believe we should have asked you, or management, or the external auditors?

Unfortunately, it is still too common for a company’s chief executive to dominate a board’s agenda, while the CFO presents the financial information to an audit committee and other board members who are largely passive. Audit committee members may tell themselves that they are doing enough if they receive reports, read them, attend meetings, and ask a few questions along the way. Yet I would argue that they need to transition into a more active and engaged pattern of behavior that will be in the best interests of the company and its investors.

How does one accomplish this? The answer goes back to due diligence, at every step of the way. If, for example, one has been asked by a company’s board to consider joining a company’s audit committee, there are important issues to investigate:

• Is there a written charter that describes what the audit committee is charged with doing, and what resources will be available to help it accomplish these goals?
• What is the composition of the audit committee and what kind of relationship has it maintained historically with the company’s management?

Meanwhile, although Sarbanes-Oxley does a lot to encourage audit committees to hire their own counsel when they feel in need of independent, expert advice, it is also a good idea to put that policy in writing. That can help defuse potentially explosive situations down the road. It should be simple to add such a clause at the time when a charter is being written, since presumably conditions within the company will be healthy at that time and no one will feel threatened by it.

Due diligence at this stage also should include reading all available public documents, internal management reports, monthly P&Ls, a description of accounting policies, and the risk-management protocol. Other good sources of information include newspaper and magazine articles and stock research reports. Prospective candidates should speak to management, of course, but also to other board members, outside counsel, internal and external auditors, and the company’s risk management adviser.

What to look for at this stage to satisfy oneself is hard to quantify, except to say that content and attitude both count. Candidates should ask themselves:

• How difficult is it to have these conversations? If the answer is “very,” that might be a red flag that suggests the company prefers to keep its board members passive.
• How open is the CEO to an audit committee that is truly, actively engaged, and what are the concrete indications of his attitudes?
• Are other members of the committee and the board as involved as the prospective candidate intends to be?

In this post-scandal era, one might assume that the types of companies for prospective candidates to avoid would be those that display signs of difficulty, such as deteriorating financial results or management confusion. But I have been involved with many troubled corporations, both as an audit committee member and as an independent crisis manager, and I can testify that those companies desperately need the support of strong, qualified board members who can help lead them in the right direction. So I would never preclude such engagements.

Instead, I would say that the situations to avoid are those in which a board seems locked into passive patterns of behavior, whether because of its own lack of initiative or management’s unwillingness to tolerate anything else. I myself would never want to serve on an audit committee where my questions were considered a distraction or a form of disloyalty.

ENCOURAGING INDEPENDENT THINKING

There’s a duality connected with serving on any board of directors. It is only natural to want to support the CEO; no board member wants to obstruct the company’s progress. On the other hand, there is an appropriate tension that should exist between the board and management. It develops when board members ask many questions, and when they challenge management to explain, justify, and explore various contingencies that may have been overlooked. A strong board helps management do its job better, and an effective audit committee is an essential component in this process.

Audit committees must learn how to act indepen-
dent if they are to be truly successful. Here is an example of what I mean by that: According to Sarbanes-Oxley, audit committees are directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the company. But what happens at many companies is that the CFO manages much of this process. He or she comes up with the recommended list of external auditors, hires and instructs whichever firm is chosen, receives the audit, and passes on significant findings to the audit committee.

In order to preserve the appropriate tension between the board and management, it is a good idea, instead, for the audit committee to manage all stages of the auditor relationship. That should include coming up with the candidates, signing the engagement letter, and actually listening to the auditor’s report.

I know that it is much simpler to sit back and let the CFO handle this relationship. But do any of us really want a situation in which the external auditor feels he or she is working for management and therefore is under some constraint, because the same person being audited is his or her client? Just imagine how different the flow of information might be if the audit committee is the one managing this relationship. The external auditor would much more likely be candid, because it will understand that the committee is the boss. Contrast that with the situation in which the external auditor knows that the CFO has recommended all the candidates, the CEO is running the show, and the CFO will be filtering all the information to the audit committee.

When dealing with external auditors, the best approach for an audit committee is—yet again—to ask plenty of questions. Don’t overlook these:

- To what extent can the planned audit be relied upon to detect material errors, irregularities, and material weaknesses in internal controls?
- Has the audit identified any areas of serious concern relative to the overall corporate control environment, or to matters of integrity or honesty?
- What is your assessment of the internal audit function?
- Is the program adequate and responsive to risk?
- If you were an investor in this company, would you have received all the information necessary in order to have a proper understanding of its financial performance during the reporting period?

Remember what I suggested earlier: Don’t just ask questions but ask them from all directions. It is also a good idea to ask management and internal auditors about the external auditor, which may be a way of identifying hidden risks or problems. Useful questions might include:

- What is your overall evaluation of the external auditor’s performance?
- What seem to be the strengths and weaknesses of the key members of the audit team?
- Have your expectations of the external auditors been met and if not, why not?
- Do you have any concerns about the auditor’s independence?
- What are they and how can they be addressed?

It seems clear that this level of independent activity can help an audit committee perform its role more effectively. But anything that has the appearance of independence—or still worse, boardroom dissension—can seem threatening, at least in some corporate situations. Some people go out of their way to avoid it. They are the ones who think that a board meeting is going well if there are no questions. Orderliness may be important, but so is the opportunity for candid, active discussion.

There is nothing wrong, and maybe everything right, with the audit committee or other independent board members meeting without management being present. It is great when people can have these informal discussions and ask each other questions.

A fruitful dialogue may go something like this:

“What do you think about this strategy?”

“Are you worried about this? I am.”

“Oh really? What’s making you concerned? Do you think we could ask management for some more information about that?”

Many board members traditionally have viewed this as being disloyal. It is an interesting behavioral quirk. They do not want to meet without management being present, but they don’t realize that this might help create an environment in which board members would figure out how better to fulfill their responsibilities.

I was once on the audit committee of a distressed company whose independent board members consisted of two restructuring experts (I was one of them) and two former retailing CEOs. The former CEOs were nervous about anything that might look like “conspiracy” against this company’s management.

But once we started meeting by ourselves, it didn’t lead to anything nefarious. In fact, it helped us figure out how to handle a number of complicated business situa-
tions, including the need to file for bankruptcy protec-
tion. At one point, the chief executive came to us with
his suspicions about improper dealings on the part of a
board member who was also an insider.

We decided to hire an outside investigator because,
after all, these allegations may have been true, but the case
also may have been that the CEO was trying to get rid
of a board member he didn’t like. It was appropriate for
the audit committee to take this step, but one reason we
were able to act quickly and effectively was because we
had established a regular habit of meeting without the
chief executive being present. We were able to act with
true independence.

CONFRONTING PROBLEMS
WHEN THEY OCCUR

Creating an environment in which people will do
the right thing, whether because they want to or
because they believe their misdeeds will be detected,
should be a top priority for any audit committee. But
if that hasn’t worked, and fraudulent behavior occurs,
then it is up to the committee to deal with this problem
on a post hoc basis.

That means getting the best advice you can, as
quickly as possible. Consult the company’s auditors or
accountant, or its risk manager, or a specialist in infor-
mation systems. If a second auditor or other outside expert
seems necessary, bring in that person. As always, ask plenty
of questions.

The essential objective is to develop a well-informed
action plan quickly. The audit committee has an impor-
tant obligation to inform interested parties and the public
as a whole. That means investigating, measuring, con-
trolling, and reporting, while at the same time setting up
an enhanced system of checks and balances.

If what an audit committee member detects is not
fraud, but instead a set of business plans and actions that
raises doubt about management’s policies, then that
member must keep asking questions. Make sure that the
CEO provides information that details future probabili-
ties, risks, and contingency plans. Get everything quan-
tified. And ask for this often.

It is a tough challenge. You don’t want to frame
your questions so that you seem to be adding to the burden
of management. Instead, you are fulfilling the responsi-
bilities of your job by creating an awareness on the part of
management that it will need to explain and justify its
actions. I am not suggesting that the audit committee
continually reach for the help of an independent expert
as a knee-jerk reaction. But in a situation like this one, if
you think it will help to hear what an independent expert
has to say about management’s new plans and activities,
then by all means bring in someone.

There is one more problem worth considering: audit
committee members who are passive. Meeting privately
with such members may help motivate them to become
more engaged. If that doesn’t work, then you and the
other proactive members will need to compensate by
asking all relevant questions yourselves. Sarbanes-Oxley
will support you, even if some of your fellow audit com-
mite members prove to be less than enthusiastic.

To conclude, let me emphasize that there is great
satisfaction in doing this job well. I grew up on Wall
Street, working in the world’s most robust capital markets.
People from around the world have confidence in those
markets because they believe in the fair and reasonable
reporting of our corporations.

That confidence is our most important national trea-
sure and it has been eroded in recent years. There is no
more important job in the corporate world than helping
to restore it. Fortunately, that is what effective audit com-
mite members do best.

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