

Increasing audit committee effectiveness

Introduction

On September 5, 2007, members of the Audit Committee Leadership Network (ACLN) met for the network's 15th stand-alone meeting. Members began the meeting by considering registrants' relationships with the Securities and Exchange Commission (SEC) in a dialogue with Mr. John White, Director of the Division of Corporation Finance.¹ Members then moved to their second topic: increasing audit committee effectiveness. For further information about the network, see "About this document" on page 10.

Members focused on three key questions during their discussion on audit committee effectiveness:

- **Does the committee have the right people and skills for the tasks at hand?**
- **How is the committee's agenda set?**
- **How can the committee use assessment processes to improve its performance?**

Audit chairs participating in the meeting included:

- Dick Harrington, Audit Committee Chair, Xerox
- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Laban Jackson, Audit Committee Chair, JPMorgan Chase
- Oscar Munoz, Audit Committee Chair, Continental Airlines
- Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Pam Patsley, Audit Committee Chair, Texas Instruments
- Sandy Warner, Audit Committee Chair, General Electric Company

The members listed above sit on the boards of over 30 large-, mid-, and small-cap public companies between them. Also attending the meeting and participating in the discussion were:

- Tom Flannery, Partner and Director, Audit Committee Communications, Ernst & Young
- Steve Howe, Americas Managing Partner, Ernst & Young

ViewPoints 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 before and during meetings are not attributed to individuals or corporations. Members' comments appear in italics.

¹ See Audit Committee Leadership Network, "Regulatory balance: a dialogue with John White" *ViewPoints*, October 19, 2007. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Oct07_View17.pdf.

Executive summary

In a speech given less than three months before Sarbanes–Oxley was signed, then SEC chief accountant Robert Herdman identified several ways audit committees could increase their effectiveness.² His final remark foreshadowed the current governance environment: “Many have asked, ‘who will want to be a member of an audit committee?’ and those who will consider additional rules will have to be mindful of the potential for overload.”³ During our discussion, members focused on people and skills, the agenda, and assessment as avenues for improving audit committee effectiveness:

- **Does the committee have the right people and skills for the tasks at hand?** *(Page 3)*

Members are concerned about the dwindling pool of qualified directors who are also willing to serve on the audit committee. To deal with this trend, some members have eliminated term limits and increased the mandatory retirement age. Members believe a current, sitting executive’s skill set and up-to-date knowledge is an enormous asset to a committee, but they also value diversity of experience among the committee’s membership. When considering the options for audit committee education, most members believe that plans that are tailored to individual committee members’ needs are best.

- **How is the committee’s agenda set?** *(Page 5)*

Despite the fact that compliance activities still take up to 75% of their agenda, members are finding ways to get back to the ‘business of the business.’ Many are using the company’s risk profile to help them determine where and when non-compliance issues fall on their agenda. Members also discussed how to ensure efficient information flow both out of and into the audit committee. *For additional tips for improving audit committee effectiveness, see the appendix on pages 9-10.*

- **How can the committee use assessment processes to improve its performance?** *(Page 7)*

Most members said their assessment processes are still evolving. Some have implemented formal procedures, including having the evaluation conducted by an independent third party. Members find the most valuable output of any assessment process is the resulting candid dialogue among the directors and, if applicable, a third party. *For examples of changes resulting from assessments, see box on page 8.*

² Robert K. Herdman, “Making Audit Committees More Effective.” Speech at the Tulane Corporate Law Institute, New Orleans, LA, March 7, 2002. Available at <http://www.sec.gov/news/speech/spch543.htm>.

³ Ibid.



Does the committee have the right people and skills for the tasks at hand?

In his book *Good to Great*, Jim Collins commented, “The executives who ignited the transformations from good to great did not first figure out where to drive the bus and then get people to take it there. No, they first got the *right* people on the bus (and the wrong people off the bus) and *then* figured out where to drive it.”⁴ Network members agree, believing it is of the utmost importance that audit committee members are qualified to be “on the bus.”

Network members focused on three characteristics they value in a potential audit committee member:

- **Willingness and ability to serve on the audit committee.** Members expressed concern about finding “*qualified and willing board members who also happen to be suitable for and willing to serve on the audit committee.*” They recognized a disconcerting trend: “*There are conditions being put up by incoming board members about their unwillingness to serve on the audit committee. That’s a problem.*” One member’s board decided to eliminate term limits and increase the mandatory age of retirement because “*we were losing key people.*” Another member quipped, “*70 is the new 60*” and noted, “*There are 55-year-olds who shouldn’t be on boards, and there are 70-year-olds who I wouldn’t want off the board.*”
- **Experience as a CEO or CFO.** Members believe a current, sitting executive’s skill set and up-to-date knowledge are enormous assets to a committee. One member commented, “*There is a huge demand out there for someone who has current experience and understands the current issues.*” However, members also value former executives. Indeed, some members were concerned that current executives might suffer from “*divided loyalty.*” Members noted that many boards now deal with that problem by restricting their company’s CEO and CFO to service on, at most, one outside board. However, that policy cuts down even more on the pool of potential audit committee candidates.
- **Diverse experiences and skill sets.** At the Audit Committee Leadership Summit, audit chairs said that one key to a strong audit committee is diversity of expertise: “*If you have five accountants on the audit committee, you’re headed for disaster. You need different ways of looking at a company.*”⁵ Since many audit committee issues are business issues (rather than simply compliance ones), members believe it is essential to have a diversity of business experience, which will let the audit committee “*look at areas from different points of view.*”

⁴ Jim Collins, *Good to Great* (New York: HarperCollins, 2001), 42. The quoted excerpt, from chapter 3, is available at <http://www.jimcollins.com/lab/firstWho/p2.html>.

⁵ Audit Committee Leadership Summit, “Four Lessons for audit committees from high-profile accounting scandals,” *ViewPoints*, April 6, 2007, 4. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Summit_View2_Apr07.PDF.

Working with other committees to plan membership and succession

Managing the audit committee membership roster typically falls to the chairs of the audit and nominating/governance committees. While there is not often a *“formal arrangement between the committees,”* members said it was critical to have open lines of communication between the committees.

When asked if they have a succession plan for themselves, one member joked, *“Of course we do. It’s our only way out.”* One member described giving audit committee members the opportunity to demonstrate leadership by, for instance, leading a teleconference meeting in the chair’s absence. The member concluded, *“If I got hit by a bus on Fifth Avenue while leaving this meeting, the company knows who will take over for me as audit chair.”*

Members felt that an audit chair should remain in the role for at least five years. However, opinions vary on how long it should take to manage a successful transition of audit committee leadership:

- **Up to three years.** During his or her first two years, a new committee member is learning about the company and its issues. Supporters of a long transition felt *“there should at least be also one year of transition with [the current committee chair] before they can take over full time.”*
- **Within a few months.** Alternatively, some believe *“a good person won’t wait. These aren’t necessarily difficult skills to learn, but finding the time to spend on them is...”* The member said a short transition was possible if, *“there are meetings with the CFO, CEO, current chair of the audit committee, lawyers, internal audit, and the external auditor for a month prior [to the appointment].”*

Members are also anxious to get the wrong people off the bus. They tend to look to the nomination/governance committee and the CEO for assistance when a committee member is underperforming. One member described dealing with such a director: *“We had a non-performing director, and the chairman explained our concerns [to the director]. [The chairman] gave [the director] the option to either resign or shape up. I think [the director] was more effective in his last two years.”*

Audit committee education

According to Ernst & Young’s *Audit Committee Perspectives* survey, 63% of audit committee members whose boards offer formal continuing education spend 10 hours or less per year on it.⁶ Members do not feel education should be limited to one-size-fits all, formal training; many feel there is value in looking at the individual committee members’ strengths and weaknesses and devising customized education plans tailored to each member. One member explained, *“If you have an audit committee that is diverse, you should address each member’s needs. I say I need help with this [particular] area, and others do the same. We don’t assign the topics that should be covered.”*

⁶ Ernst & Young, *Audit Committee Perspectives: 2006 Audit Committee Survey and Industry Insights* (New York: Ernst & Young, 2007), 26. Available at [http://www.ey.com/global/download.nsf/Luxembourg_E/Audit_Committee_Perspectives_06/\\$file/EY_Audit_Committee_Perspectives%202006.pdf](http://www.ey.com/global/download.nsf/Luxembourg_E/Audit_Committee_Perspectives_06/$file/EY_Audit_Committee_Perspectives%202006.pdf).

Members use a variety of methods to educate audit committee members

- **Computer-based learning.** One company has implemented a computer-based approach to learning. *"We had significant turnover on the committee, and we just wanted to make sure the [new] people were up to speed on the key issues. We worked with the external auditor and our finance team to put the system together."* The computer-based system is supplemented with classroom training, although *"teaching accounting to our diverse members isn't easy."*
- **Illustrating principles with company examples.** Audit chairs agree that all audit committee members must have a strong understanding of the key accounting principles driving the financials. In order to teach the principles, companies or their external auditors ground them in real business examples drawn from the company itself. For example, when dealing with something that is *"hugely complicated, like revenue recognition,"* committee members examine the impact of different accounting principles on the revenue of subsidiaries around the world. Another member reported, *"At my company, we spend time on the many regulatory changes. As opposed to looking at the details of each, we look at how the rules really impact our company. What do these changes mean to us?"*
- **Sessions on specific topics, with content provided by management or the external auditor.** Management is often the primary resource for the audit committee in gathering the information necessary to fulfill its mandate. *"The company has the arms and legs"* to chase down the details the audit committee needs in order to understand and evaluate the financial statements and internal controls. In one company, an executive session provides a key opportunity for audit committee members to *"look at the calendar and see what is going to happen next. Then we say to management if we need to a tutorial on the topic."* Members also look to the external auditor for education. One member asked the external auditor to put together a three-hour session on critical accounting policies that was then offered to audit committee members in one-hour sessions before three audit committee meetings.

How is the committee's agenda set?

Once the right people are on the audit committee bus, the audit chair needs to determine where to drive it. While many of the committee's responsibilities are prescribed by the Sarbanes-Oxley Act and the New York Stock Exchange (NYSE) listing standards, the way those responsibilities are fulfilled varies.

Before the meeting, a member noted that the audit committee's charter should list the items that the audit committee must address each year to help the full board fulfill its fiduciary responsibilities. This ideal was embodied in one member's statement: *"I look at the audit committee charter as the contract between the board, the audit committee, and the shareholders."*

Using risk to address business issues and prioritize the agenda

Even as the impact of Section 404 implementation recedes, members continue to be concerned about the amount of audit committee time still being spent on compliance activities at the expense of more pressing

issues at the core of the business. Members noted the compliance activities can take up to 75% of their agenda time; indeed, one commented, *“We try very hard to hold compliance to only 75% of our agenda.”*

One technique many audit chairs use to incorporate non-compliance activities into the agenda is to prioritize them according to their risk profile. Members agree that while there are different ways in which risk management is woven through the audit committee’s agenda, it *“seems to be the best way to ensure that nothing falls through the cracks.”*

Members identified two different ways to use the risk profile to clarify the audit committee agenda:

- **Board-initiated approach.** The full board of directors ranks the company’s risks and provides each committee with its mandate. One member commented, *“The audit committee is a delegated body of the full board of directors. At some point, the board has to [tell] us what [it] wants us to do. All of the committees get input on what the full board expects of us.”* Concern for personal liability is one factor driving the board-initiated approach. One member commented, *“I would be uncomfortable with the bottom-up approach. I do my work, as audit chair, at the pleasure of the full board. It needs to trickle down from them because when you go to look at something, you need to be assured the full board is aware of the issue.”*
- **Committee-initiated approach.** Most members said their audit committee identifies what items they want to cover so they can adequately fill their remit. Addressing the liability issue, a member commented, *“There is always a report back to the board about the priorities for the year, and they are aware of what we are doing.”*

Regardless of which approach they use, members agree that the only way to make sure everything is addressed is to keep the communication lines between the audit committee and the full board open. One member said, *“There are millions of things we could look at. We [as the board] rank risks, but there is still a vetting process at the committee level ... We choose what to do as a committee, then that gets adjusted with input from management and the full board, with the final product having input from all.”*

Managing information flow

The audit chair has an important role as a “clearinghouse for whether an issue goes more broadly.”⁷

Members are generally satisfied with the movement of information out of the committee. Most members ensure that materials that the audit committee generates (reports, minutes, agendas, etc.) are accessible to all board members, so directors can review them and ask follow-up questions as appropriate. ”

More challenging is ensuring that the necessary information flows into the committee. One member asked, *“How do we get [information] communicated to us consistently and efficiently without having to do it 365 days a year?”* Several members noted that the task is particularly difficult when the information flow in question is not embedded in a particular company function or department.

Some members prefer to receive summaries rather than raw information. One member said, *“We are blessed with people setting the right tone, so we know we can trust their summaries of materials sent to us.”*

⁷ Ernst & Young and Tapestry Networks, “Audit committee agendas,” *Insights*, October 29, 2004, 6. Available at <http://www2.eycom.ch/publications/items/insights/200410/en.pdf>.

However, another member warned, *“Any time you have aggregation and someone with an agenda, that means you are at risk of not seeing stuff.”* This member uses internal audit to verify data: *“We would send in the internal auditor ... and have them opine on the issues. If they see that there is no data to back something up, they will say, ‘let’s get the data.’”* Members believe that when the committee is composed of people with diverse skill sets, information gaps are more likely to be identified.

How can the committee use self-assessment processes to improve its performance?

The NYSE listing requirements mandate annual self-assessments of public company boards of directors and their committees.⁸ *Directorship* notes that “a formal, thoughtful approach to board development permits clear connections among company strategy, board and management roles, board composition and skills, development priorities, action plans and year-over-year comparisons.”⁹

Members are aware that their individual performances are evaluated continuously by their fellow directors: *“It is obvious whether people are prepared for the meeting or not.”* Members also believe that annual board and committee evaluations are *“pretty useful mechanisms”* for improving performance. Assessment practices that network members use include:

- **Formal evaluation within the board and audit committee.** Some members’ companies have the general counsel, company secretary, or audit chair conduct either a written or verbal survey of directors. In one case, a member’s company also compares the results of the current assessment with previous years’ assessments.
- **360-degree review.** Other companies have a 360-degree review process, which lets *“the finance team, internal audit, and the external auditors provide the board and its committees with feedback.”* Even without a full 360-degree process, audit committees can develop *“two-way feedback with the external auditor ... It is a good way to see how we are performing on a yardstick [of how other audit committees are performing.]”*
- **Independent third-party reviews.** One way to ensure the objectivity of the assessment process is to have an independent third party conduct both a board- and committee-focused assessment. Third-party reviews, whether in the form of interviews or surveys, can be limited to board members or may be broader. Only one member reported using this approach with a high-profile business adviser interviewing all the directors and bringing the results back to the full board.

Members agree that the most important and significant outcome of any assessment process is the informal dialogue about the committee’s performance among directors and other participants in the process. One member said, *“While a third party can drive the candor of the directors and bring the board an outside perspective, if there isn’t a discussion among all of the parties, then it is still just a tick-the-box function.”* Members universally agreed that *“the informal-discussion aspects of the process are very useful.”* However,

⁸ For additional information, please see Section 303A (7) (c) (ii) of the listing standards, 15. Available at http://www.nyse.com/pdfs/section303A_final_rules.pdf.

⁹ David Anderson, “Using Board Evaluation to Develop Strength,” *Directorship*, June 2006. Available at http://www.directorship.com/publications/0606_evaluation.aspx.

several members questioned how long the process should remain informal and wondered when “*to start systemizing the informal aspects.*”

Examples of changes resulting from audit committee assessments

- Length and timing of the board meeting and those of its committees
- Composition and structure of the board and its committees
- Identification of new agenda items
- Changes in individual directors' behavior
- Improvement in the quality and timeliness of pre-meeting reading material
- Improved and increased communication between management, the board, and board committees

Conclusion

In light of the increasing complexity of the U.S. regulatory environment, audit committees should work to identify techniques that will allow them to increase their effectiveness. Members believe that although process improvements are useful, the quality of people on the committee is the key to effectiveness. As one member noted, “*This isn't difficult. It's all human stuff here,*” which is why open lines of communication in and among the committee and its key stakeholders is so critical to audit committee effectiveness.



Appendix: Tips for improving audit committee effectiveness

Advice from audit committee chairs

- **Set agendas in advance and prioritize later.** The audit chair should maintain a one-year set of rolling agenda items and should speak to members before each meeting to prioritize the time spent on each item.¹⁰
- **Use consent agendas.** Committees may cover standard, non-controversial, or self-explanatory items without formal discussion. In such cases, pre-meeting reading should be distributed to committee members on the understanding that it will only be discussed on request.¹¹
- **Make sure pre-reading is concise and directly relevant to planned discussions.** While presenters may be tempted to use “*pre-packaged management reports*” as relevant pre-reading for their presentations, management’s information requirements are usually substantially larger than the board’s. Audit committee chairs should work to maximize the “*completeness*” and minimize the “*volume*” of pre-reading materials.
- **Cultivate the right mix of presentation and discussion.** Allow ample room for discussion by limiting time for presentations in favor of discussion. As a goal to aim for, at least one member felt that 20:80 was the best possible ratio.
- **Improve discussion by focusing on assumptions.** One ACLN member said, “*You can argue the analytics on the conclusions presented to you, but it is the core assumptions that get people into big trouble. [Questioning assumptions] also makes for a more interesting meeting.*”¹²
- **Focus attention on the most important items.** One ACLN member holds the executive session in the middle of the audit committee meeting so that it doesn’t get cut short at the end. Limit time devoted to routine reports that don’t change much from meeting to meeting. One member maintains an *annual slot* on the agenda for internal audit and general counsel for routine reports and encourages them to bring up important topical items for the agenda at any time.
- **Delegate important responsibilities to other audit committee members.** One audit chair said, “*I delegate portions of the agenda to a member of the committee who then must be the one to interact with management. This engages them more; they have more interest and ownership in their piece.*”¹³
- **Ensure the full committee brainstorms new agenda items at least annually.** Unstructured time to discuss what’s really worrying audit committee members can lead to new and important agenda items for both the forward agenda and individual meeting agendas.

¹⁰ Pacific Southwest Audit Committee Network, “The changing face of the audit committee,” *VantagePoint*, October 4, 2005, 5. Available at http://www.tapestrynetworks.com/documents/Tapestry_PacSouthwest_ACN_Oct05.pdf.

¹¹ Southeast Audit Committee Network, “The changing face of the audit committee,” *VantagePoint*, June 28, 2006, 3–4. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_SEast_ACN_Jun05_Van.pdf.

¹² Tapestry Networks, “Call-For-Activism workshop for audit committees,” *ViewPoints*, March 8–9, 2005, 6. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Fortune_ACLN_Apr05.pdf.

¹³ Pacific Southwest Audit Committee Network, “The changing face of the audit committee,” 6.

- **Uncover pan-organizational themes.** Require presenters to meet independently to discuss themes across their presentations, then report these themes back to the audit committee on a regular basis. One audit chair reported, “All the presenters [have] to identify thematic issues among them and distill [the issues] down to a two-page report. Then they have a pre-meeting with the audit committee chair on the themes.”¹⁴ Over the course of a few years, this practice “has improved [audit committee] performance greatly” and enhanced cross-functional cooperation with management.¹⁵
- **Don’t just add agenda items; remove less relevant ones, too.** Members reported that the audit committee often is expected to address new items that confront the board. Even though it’s natural to add items to the agenda, audit committee chairs must also “identify the less important issues” and remove those items from the agenda.¹⁶
- **Issue interim reports.** One audit chair asked management to distribute two-to-eight-page interim reports covering non-controversial, routine financial items. Six or seven such reports are generally issued between audit committee meetings. Another network member described white papers, commissioned up to four times a year by the audit committee, in which business units are asked to describe how they generate earnings.¹⁷ In another example, the company prepares white papers on accounting issues that arose in the quarter, or to explore particular risk items.¹⁸

About this document

The Audit Committee Leadership 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.

ViewPoints 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 *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

The views expressed in this document represent those of the Audit Committee Leadership 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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¹⁴ European Audit Committee Leadership Network, “Audit committee charter and agenda,” *ViewPoints*, November 14, 2006, 8-9. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Nov06_View10.pdf.

¹⁵ Ibid, 9.

¹⁶ Ibid.

¹⁷ Ernst & Young and Tapestry Networks, “Audit committee agendas,” 4.

¹⁸ Pacific Southwest Audit Committee Network, “The changing face of the audit committee,” 5.