

Enhancing audit committee effectiveness in a changing environment

Introduction

On 7–8 April 2010, members of the European Audit Committee Leadership Network (EACLN) met in Barcelona to discuss audit committee effectiveness and the relationships among the audit committee, the chief financial officer (CFO) and the wider finance organization.¹ *ViewPoints* contains a summary of the key points raised during the discussion on enhancing audit committee effectiveness, along with selected perspectives that members shared before and after the meeting.² For further information about the network, see “About this document,” on page 8. For a full list of participants, see Appendix 1, on page 9.

Executive summary

As the audit committee’s scope and agenda continues to evolve due to increased stakeholder pressure and the need to deal with changing accounting standards, audit chairs are faced with the challenge of improving audit committee effectiveness. At the 7-8 April meeting, members discussed the following topics which are described in more detail on the following pages:

§ **Defining and measuring audit committee effectiveness** (Page 2)

On one level, audit chairs define audit committee effectiveness as avoiding surprises and ensuring that there are no major problems in internal controls and financial reporting. They also recognize that meeting the objectives set out in their charter and engaging in in-depth discussions with management and the board on key issues are other important elements of success. Audit committees typically undertake annual self-evaluations as part of the broader board evaluation process, and audit chairs are interested in increasing the value of such evaluation beyond a tick-the-box exercise. Appendix 2, on page 10, includes a list of discussion questions for audit committees.

§ **Audit committee relationships are key to effectiveness** (Page 4):

Good relationships are at the heart of an effective audit committee. The audit chair must engage fellow audit committee members, work with the full board to ensure the board and audit committee have the right oversight structure and work with management to improve the quality of the information flowing to the committee. Audit chairs report spending significant time on the last of these activities. Methods of enhancing information include executive summaries of reading materials, specifications of how materials will be used and education sessions to provide more depth on complex topics.

§ **Maximizing the value of audit committee meetings** (Page 7):

Preparation by the audit chair in advance of audit committee meetings is essential to meeting effectiveness. It often entails one-to-one meetings with executives and the external auditor to gain greater clarity on particular issues and to refine the agenda. Given the increasing time pressure on the audit committee, audit chairs employ a variety of techniques to maximize the value of audit committee

¹ European Audit Committee Leadership Network, “The audit committee, the CFO and the finance organization.” *ViewPoints*, 30 April 2010.

² *ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and guests and their company affiliations are a matter of public record, but comments made before, during and after meetings are not attributed to individuals or corporations. All member quotes from the meeting and pre-meeting conversations appear in italics. Other subject matter experts’ quotes are not italicized.

meetings, including counseling management on how to present, using consent agendas and focusing on high-priority items first.

Defining and measuring audit committee effectiveness

Audit committees have experienced significant changes throughout the 2000s, including the United States' enactment of the Sarbanes-Oxley Act in 2002 and the European Union's adoption of the 8th Company Law Directive in 2006. The 8th Directive established basic requirements for audit committees across Europe, but the global financial crisis and its aftermath are causing many stakeholders to question whether audit committees should expand their agendas to address root causes of the crisis.³ Indeed, many EACLN members have seen their audit committee agendas expand to include oversight of risk, including risk associated with increased regulatory scrutiny.

The projected completion of the accounting convergence projects being undertaken by the International Accounting Standards Board and the Financial Accounting Standards Board is expected to bring another period of significant change that audit committees will need to oversee.⁴

Audit chairs want no surprises

In such a continuously changing environment, identifying the characteristics of an effective or successful audit committee is a challenging undertaking. At the EACLN meeting in Barcelona, several audit chairs agreed that a year without major problems in internal controls or financial reporting would constitute success. For one member, effectiveness is defined as *"a smooth audit."* Members were also quick to point out that success entails *"no exploding bombs,"* including no sudden resignations or dismissals of key financial staff. A member said, *"I hate surprises. We should not have surprises ... [We want] early warning from the organization."* Members also highlighted the critical role that external auditors play in preventing such surprises.

Members went on to suggest other elements that contribute to audit committee effectiveness:

- § **Meeting the objectives set out in the audit committee charter.** In previous network discussions, members have said they review the audit committee charter yearly and put together the audit committee agenda for the year ahead based upon it.⁵ Audit committee charters typically set out the purpose and oversight role of the audit committee, membership, relationships that are important to the functioning of the audit committee (such as the relationship with the external auditor), the structure (such as the number of meetings) and the areas of focus. One audit chair suggested using the charter as a guide: *"You define what you mean [by success] and set your own objectives for what to achieve this year."*
- § **Ensuring that information supports in-depth discussion.** A member said, *"For me, [success is] if we improve our relationship with management [so that] we have the information we need to tackle the right issues ... [and] we allow time to discuss them."* Another member added, *"We need to address the right financial issues, understand them, [ensure] we are aligned on them and have a good ... discussion with the board. These are indicators that the audit committee plan is [well] executed."* The importance of improving information flow is discussed in more detail on page 5.

³ The network took up this issue at its November 2009 meeting. See European Audit Committee Leadership Network, ["The 2010 audit committee agenda,"](#) *ViewPoints*, 10 December 2009.

⁴ *Ibid.*, page 4.

⁵ European Audit Committee Leadership Network, ["Increasing audit committee effectiveness,"](#) *ViewPoints*, 21 April 2008.

Members also reflected upon how their own views of audit committee effectiveness differ from those of shareholders. Several agreed that most shareholders would view a “*silent running*” as success.

How do shareholders judge audit committee effectiveness?

While some members were skeptical that shareholders pay close attention to the functioning of the audit committee, research shows that investors need to be reassured that good governance procedures are in place.⁶ In some countries, new practices are addressing shareholder questions on board and audit committee effectiveness. In France, for example, the Association Française de la Gestion financière has provided new corporate governance recommendations that require that the committees of the board (including the audit committee) communicate detailed information about their work and conclusions with shareholders.⁷ A French audit chair said,

[The communication comprises] a public report that has one to two pages of information about the composition, functioning, agenda and work of the committees, including the audit committee. On the basis of the document, shareholders can ask questions before or during the general assembly, and the chairman of the board or the audit chair will answer. This may include questions about the functioning of the board [or audit committee.]

In other geographies, companies are experimenting with forums for major shareholders during which the audit committee can be asked questions. For example, the audit committee could be asked to describe the top three issues the committee faced during the year. While such meetings are not common among European companies today, some market observers are suggesting that they may become more so as the proportion of foreign shareholders of European companies increases.⁸

How do committees themselves measure their effectiveness?

Most EACLN members assess their committee’s effectiveness yearly as part of a broader board evaluation process, an activity many national corporate governance codes recommend.⁹ European companies listed on the New York Stock Exchange must undertake annual self-assessments.¹⁰

At the EACLN meeting in Barcelona, members reported a mix of annual self-evaluations by the board as well as periodic use of external consultants to provide an outside analysis of board performance. Several members agreed that a combination of questionnaires and informal feedback discussions are an effective means of self-evaluation. One member said, “*In the annual board evaluation, there is a rating by board members of their satisfaction with the work of the committees. There are also questions on how well each chairman chairs each committee.*” Another member suggested the board should focus its evaluation on the way each committee reports back to the board: “*They can be the hardest thing to do ... We should get feedback on enhancements and make them.*”

There were divergent views as to how useful board self-evaluation is for the audit committee:

⁶ Ernst & Young, unpublished research conducted in 2010 amongst global investors.

⁷ Association Française de la Gestion financière, *Recommendations on corporate governance* (Paris: Association Française de la Gestion financière, 2010), page 27.

⁸ Richard Milne, “*Europe: A meeting of minds.*” *Financial Times*, 28 February 2010.

⁹ Links to national corporate governance codes can be found at the [European Corporate Governance Institute](#).

¹⁰ New York Stock Exchange, *Section 303A: Corporate Governance Rules* (New York: NYSE Euronext, 2004), page 15.

- § **Not a valuable exercise.** One member suggested that current approaches are only cursory, not providing enough depth to be of use: *“How do we [as audit committees] evaluate our contribution to the firm? [It seems to me] we are checking boxes, not looking at value.”*
- § **Can create meaningful change.** One member commented, *“Our self-evaluation does produce useful changes.”* Another member reported that in response to an evaluation, the audit committee had decreased formal presentation time in audit committee meetings in order to increase time for discussion. A third reported that the evaluation process revealed that the audit committee should meet with executives deeper in the organization in order to gather more knowledge.

One way in which a more in-depth evaluation may be achieved is via an audit committee-specific evaluation (in addition to the broader board evaluation process). One member said that one particular audit committee benefits from *“a specific audit committee evaluation every three to four years with an external consultant. That includes face-to-face conversations with the CEO, CFO and external auditor.”*

Members emphasized the importance of the external auditor’s opinion of the effectiveness of the audit committee. Most members described gathering feedback from the external auditor in an informal way, via conversations held throughout the year. An Ernst & Young partner at the meeting said, *“We are not asked for formal input very often. It is usually informal.”* This partner noted that requests for formal feedback were more common in some countries and companies than others. Another Ernst & Young partner noted, *“It needs trust. [Feedback] is done in the spirit of continuous improvement,”* and that requests for formal feedback are expected to become more common as companies continue to become more international. Members agreed that a *“candid and transparent”* dialogue on effectiveness between the audit committee and the external auditor is critical.

Audit committee relationships are key to effectiveness

At the EAACLN meeting, audit chairs highlighted how important good relationships are to the effectiveness of the audit committee. Audit chairs must work with the full board to ensure the right oversight structure, engage with fellow audit committee members and work with management to improve the quality of the information that flows to the committee.

Working with the full board to ensure the right oversight structure

Pressures from stakeholders to address the root causes of the financial crisis have resulted in several members’ boards discussing how to respond to the increased demands on audit committees. For instance, the financial crisis brought a greater focus on financing and capital structure as well as risk, and regulatory changes are increasingly driving a focus on compliance. Should these items be dealt with by the full board or other board committees instead of the audit committee? A member said, *“Our board took a view of the workload of the audit committee as being too big. It grew by evolution. We still have some way to go on the board discussion of this. We have a group in the chairman’s office to coordinate between the committees. The board meets once a year to review it all.”*

Optimal oversight of risk is one topic boards have been discussing intensively. Members reported a range of responses:

- § **Expanding the audit committee agenda to include risk oversight.** One member reported a new, broader role for one company’s audit committee: *“We now have an audit and risk committee. All board*

members attend the risk committee portion of the audit committee meeting. The report to the board can then be [very brief].”

§ **Allocating risk to other committees of the board.** Another member said, *“We have split the audit and risk [committees]. It was a good decision ... The audit chair sits on both committees.”* Other boards subdivide risk oversight based upon the type of risk; for example, financial risks would fall to the audit committee, while environmental or sustainability risks would fall to a dedicated committee.

§ **Handling risk oversight at the full board level.** Other members report that the board as a whole handles risk. For example, a member said, *“On our board, we only have two committees, so we don’t delegate.”* Another member noted, *“The audit committee has to be in charge of the risk oversight process – ensuring all risks are being managed. [Overseeing] all risks is not the role of the audit committee. We can cover some risks if we have time. The board oversees strategic risk, [and other committees can oversee other risks.] We don’t have the expertise or right to oversee all of them.”*

Engaging fellow audit committee members

Even if the audit committee has achieved the right composition (as defined by its national corporate governance code and other regulations), ensuring members are engaged can be a challenge.¹¹ A member remarked, *“I’m not getting enough engagement from other audit committee members. I’d rather they’d get more involved [by] asking questions.”* Members highlighted the importance of a robust discussion of issues in audit committee meetings: *“We probably have the skills, but how do you get a good conversation going?”*

One member described a practice of meeting with committee members privately prior to audit committee meetings to encourage participation: *“I talk to all audit committee members before each audit committee meeting. I try to from time to time have lunch with them. I want to see whether we have enough information and ... if there is anything they are not comfortable with. We have a very open relationship. I am confident if they feel anything is missing, they will tell me.”* Other practices that audit chairs may use to engage fellow members include providing candid feedback on members’ participation or lack thereof, scheduling executive sessions at the audit committee meeting in which members can talk directly to one another and scheduling technical education sessions with external audit partners.¹²

Working with management to improve the flow of information to the audit committee

For the audit committee to function effectively, it must receive relevant materials in a timely manner, and those materials must be well organized, summarized and easy to digest. Several members described significant efforts to improve the quality of information from management to the audit committee. One member said: *“I meet with the people who present the papers to instruct them how I want the papers to be structured. I fly to [meet with them] two weeks before our meetings to discuss this with them.”*

The volume of information sent to the audit committee is a particular challenge. One member mused, *“I am [currently] going through a one-meter-high pile of documents, which on one hand is too much, too long and too detailed, and on the other hand, I would say almost everything is important.”*

¹¹ The network took up this issue at its April 2008 meeting. See European Audit Committee Leadership Network, [“Increasing audit committee effectiveness.” ViewPoints](#), 21 April 2008.

¹² See Northeast Audit Committee Network, [“Enhancing audit committee effectiveness in uncertain times.” VantagePoint](#), 2 February 2010.

Members have also said that getting specific information from management on issues of interest, even when it is requested, can sometimes be a challenge. One member pointed out that turnover amongst the financial staff that works closely with the audit committee offers an opportune time to enhance reporting.

Members may use the following tools or disciplines to improve the information flow to the audit committee:

- § **Executive summaries of pre-reading materials.** A member said, *“We [now require] a two-page summary on any document presented to the audit committee. It works, and it helps.”* Members emphasized the importance of high-quality executive summaries, which should be written for non-technical experts.
- § **A push for less volume, when possible.** A member said, *“The thicker the pack, the less people will read it. It’s the role of the audit chair to [push for] this discipline.”*
- § **Specification of how materials will be used.** A member said, *“We are increasingly requesting presenters to give one slide with discussion points that the audit committee should address.”* The Institute for Internal Auditors (IIA) Research Foundation also recommends referencing in briefing materials how the information will be discussed in the upcoming meeting, or what audit committee members are expected to do with the information.¹³
- § **Focused education sessions.** Members said interactive education sessions can deepen their knowledge of relevant accounting and business issues and should be used to keep audit committee members abreast of important accounting changes in advance of their implementation. Members said this is particularly true today, given the changes expected to reporting standards as convergence projects are completed.

Looking ahead: audit chairs are increasingly focused on emerging risks

Audit committees are allowing time to “look ahead” in order to understand new trends and what types of risks may have an impact on the health of the company. Members highlighted the following practices to ensure emerging risks are discussed:

- ∅ **Dedicated meetings.** A member said, *“One meeting a year is a non-numbers meeting. We review the risk register of emerging risk issues. It is a future-focused meeting.”* Another said, *“We are trying to convene side meetings with just the audit committee members, the CFO and a few of his deputies, and the CEO to have an open debate on the [risks]. We look at these issues and discuss [them] openly.”*
- ∅ **Structured follow-up with management on important risks.** *“We hold a brainstorm once every two audit committee meetings on emerging issues [with members of management]. We decide then if we want a paper from management [on a particular risk] for the audit committee to discuss at a future meeting.”*
- ∅ **A more detailed risk report from management.** *“We will work with the head of internal audit to get a meatier presentation to get a better view on what the [risks] are for the audit committee [to discuss].”*

¹³ The Institute of Internal Auditors Research Foundation, *Audit Committee Effectiveness – What Works Best*, 3rd ed. (Altamonte Springs, FL: Institute of Internal Auditors Research Foundation, 2005), page 93.

Maximizing the value of audit committee meetings

Preparation by the audit chair is essential for an effective audit committee meeting. Members cited several activities that they undertake to prepare for audit committee meetings, noting the significant amount of time they invest in doing so:

- § **One-on-one meetings with executives.** One member commented, *“I meet with [members of the] accounting group, treasury, internal audit and IT ... I spend time with them outside of [audit committee] meetings ... I like to be physically there. I’m always travelling because the chairman needs to be close.”*
- § **One-on-one meetings with the external auditor.** Most members report seeking the external auditor’s input on the audit committee agenda: *“The external auditor provides input, for example, by providing reports on the countries [in which we operate]. The impetus to discuss something often comes from internal or external audit.”* In addition, an audit expert described a type of mediation role the external auditor can play: *“The external auditor is sometimes a go-between. They are asked by the CFO to check with the audit committee chair if things are going okay. Our role can be to build trust among the participants.”*
- § **Customizing the agenda.** Although audit committee agendas tend to be created a year in advance, audit chairs report that preparation for each meeting entails vetting what goes onto that meeting’s agenda and deciding whether and how to leave sufficient white space for open discussion. However, this is not a universal practice. One audit chair said, *“We have a standard agenda ... If something is really urgent, then it changes the agenda, but that’s rare.”* Members reported working with the CFO as well as internal and external auditors to customize the agenda.¹⁴

Although comprehensive and efficient preparation can help make audit committee meetings more effective, that alone may not be enough. One European audit expert remarked, “I see more and more audit chairs fighting with the clock. Meetings are not very efficient.” EACLN members have mentioned the following techniques for improving audit committee meetings:

- § **Encourage management to articulate in advance the goal(s) for the discussion.** This helps to focus the speaker and sharpens the discussion.
- § **Allocate an appropriate amount of time for each agenda item.** Some audit chairs like to plan in advance how much time they will spend on particular agenda items. A member said, *“I allocate time. The presenters can’t use more than half for the presentation; the rest is for discussion.”*
- § **Focus attention on the most important issues or items.** A member said less important issues should be removed from the agenda so that *“you have time for the big issues and [do] not feel you are under pressure.”*
- § **Use consent agendas (or discussion by exception).** A member said, *“I have begun using consent agendas more. Audit committee members have to read their papers before meetings. I don’t go through [the papers] unless there are questions ... It’s a simple tool.”*
- § **Make good use of smaller, executive or private sessions.** Many audit committees meet alone in executive session and also have smaller, informal meetings with one or two members of management present: *“We have 20–25 people in our meetings, so we start with an informal meeting of the committee*

¹⁴ See European Audit Committee Leadership Network, [“The audit committee, the CFO and the finance organization.”](#) *ViewPoints*, 30 April 2010.

and the CFO.” Another member has executive sessions with the audit committee alone and then separate private meetings with the CFO, the CEO and the external auditor alone.

Conclusion

In a continuously changing environment, defining what it means to be an effective or successful audit committee is a complex undertaking. While most audit chairs would agree that avoiding major problems in internal controls or financial reporting represents real success, the audit committee could benefit from being more explicit about its contribution to the company. In this context, audit committees may want to reconsider their annual self-evaluation process. Is the audit committee evaluation a tick-the-box process or a real opportunity to assess performance and identify opportunities for improvement? After all, increased scrutiny from shareholders and other stakeholders is leading to specific questions about European board practices, and they are expecting thoughtful answers.

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European 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 committee 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. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European Audit Committee Leadership Network, a group of audit committee chairs drawn from Europe’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.

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Appendix 1: Meeting participants

The members of the network participating in the meeting sit on the boards of about 40 large-, mid- and small-capitalization public companies. Network members participating in all or part of the meeting included:

- § Mr Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- § Dr DeAnne Julius, Audit Committee Chair, Roche
- § Mr Daniel Lebègue, Audit Committee Chair, SCOR
- § Sir Ian Prosser, Audit Committee Chair, BP
- § Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- § Ms Guylaine Saucier, Audit Committee Chair, Areva and Danone
- § Mr Tom de Swaan, Audit Committee Chair, Ahold and GlaxoSmithKline
- § Mr Jack Tai, Audit Committee Chair, ING
- § Mr Lars Westerberg, Audit Committee Chair, Volvo
- § Mr Mario Zibetti, Audit Committee Chair, Fiat Group

Ernst & Young was represented by:

- § Mr Tom McGrath, Managing Partner, EMEIA Financial Services
- § Mr Christian Mouillon, Global Vice Chair, Assurance

Appendix 2: Questions for boards and audit committees

- ? How does your board and audit committee define success for the audit committee? Over what period is that judged? What are the key metrics of performance on which the audit committee should be evaluated?
- ? How satisfied are you with your current evaluation process? Should individual members be evaluated? Does feedback from the audit committee assessment lead to changes in behavior, process or both? How can the external auditor add the most value to your assessment process?
- ? What pressures is your audit committee under from various stakeholders? How is this affecting your audit committee agenda and how you approach your work? Have we reached a point where audit committee overreach is itself a risk?
- ? How does your board allocate responsibilities to the audit committee and other committees of the board? Have there been any major changes in allocation between committees or between a committee and the full board?
- ? What makes for an effective and engaged audit committee member? What role can the audit chair play in making sure committee members stay engaged?
- ? How do you determine what information should be provided to the audit committee? Who else is involved in that decision? How do you work with management to refine materials for the audit committee? What is the most effective way to deliver audit committee technical education?
- ? As audit committee chair, how much additional time do you spend on committee business compared with other audit committee members? How do you coordinate with internal and external audit, members of the finance organization or other board members in advance of audit committee meetings?
- ? Is it necessary to visit the company in person to prepare effectively? How can other audit committee members help? How can the external auditor help?
- ? Do you have the right people in the room for audit committee meetings? What corporate functions are regularly represented? Can meeting attendance be rationalized in some way?
- ? What techniques do you find most useful for chairing efficient audit committee meetings? What is a good balance between presentation and discussion? How can you create space for more discussion of topical issues?
- ? Could the techniques used to improve the effectiveness of the audit committee have any negative impact on the effective functioning of management?