

## Audit committee charters and agendas

### Introduction

The European Audit Committee Leadership Network (EACLN) held its seventh meeting in Wiesbaden, Germany on 6 October 2006. Members discussed two topics: audit committee charters and agendas; and the future of accounting and the accounting profession.<sup>1</sup> For further information about the network, see "About this document" on page 7.

The members of the network participating in the meeting, or contributing through individual discussions beforehand, sit on the boards of about 75 large, mid and small cap public companies. Members attending the meeting included:

- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Prof Guido Ferrarini, Audit Committee Chair, Telecom Italia
- Sir Anthony Greener, former Audit Committee Chair, BT
- Mr Phil Hodkinson, Audit Committee Chair, BT
- Dr DeAnne Julius, Audit Committee Chair, Roche Holdings
- Mr Daniel Lebègue, Audit Committee Chair, Alcatel
- Mr Tom McGrath, Managing Partner, NEMIA Client Service and Accounts, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business, Ernst & Young
- Mr Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Sir Ian Prosser, Audit Committee Chair, BP
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services

Members who participated in individual discussions before the meeting were:

- Mr Jan Hommen, Audit Committee Chair, Royal Ahold
- Dr Ronaldo Schmitz, former Audit Committee Chair, GlaxoSmithKline
- Lord Sharman of Redlynch, Audit Committee Chair, ABN AMRO
- Mr Bernd Voss, Audit Committee Chair, ABB

*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. Comments described as being provided before the meeting were drawn from discussions with all those listed above.

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<sup>1</sup> European Audit Committee Leadership Network: "The future of accounting and the accounting profession", *ViewPoints* 11, 14 November 2006, available at: [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Euro\\_ACLN\\_Nov06\\_View11.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Nov06_View11.pdf)

## Executive summary

Audit committee charters and agendas are vital tools for audit committee chairs as they help establish the audit committee's priorities. The topics the audit committee chooses to address, the people they invite to participate in meetings and the questions raised, often reflect the interests of the company's stakeholders and send important signals to management about the audit committee's expectations.

The specific issues that network members found to be most important are highlighted below, with more detailed discussion on the following pages:

- **European audit committee charters are valuable, instructive and under-utilised** *(Page 2)*

Members agreed that audit committee charters and terms of reference don't get much attention from the board, management or capital markets. Rules for audit committee formulation have many inconsistencies across Europe but differ in some interesting ways. Even so, members do not see a need to force consistent standards on different regulatory regimes, preferring the market to determine convergence in this respect. Members agree that charters can be very useful in many situations, such as when the board is reorganised, or if there is confusion about board committee roles and responsibilities.

- **Audit committee chairs use a variety of sources to identify agenda items** *(Page 5)*

European audit committee chairs rely on a variety of resources to ensure that the proper topics appear on the committee's agendas. In general, audit chairs work closely with the CFO, the company secretary, the head of internal audit and other audit committee members. Using all of these sources helps ensure that agendas are relevant and address the concerns of management and shareholders.

- **Concise agendas can help maximise the audit committee's effectiveness** *(Page 6)*

Efficient audit committee meetings require a commitment to concise agendas. Highly relevant agendas must contain urgent 'hot-button' issues as they arise and be pruned of less important items such as routine regulatory updates. In addition, agendas should be structured to encourage the right balance of presentation and greater discussion among committee members – for which succinct pre-reading materials are important.

## European audit committee charters are valuable, instructive and under-utilised

Individual European countries set forth recommendations regarding corporate governance. While there tend to be subtle differences among these corporate governance guidelines, there are many core elements that are similar across national jurisdictions. In all cases, a principles-based approach coupled with, in most cases, a 'comply or explain' requirement provides companies with the opportunity to evaluate their national standards and other regulations within the context of their own needs.

The table overleaf summarises some of the key likenesses and small differences in the audit committee regulations of the seven European countries represented by the EACLN's current membership, together with the requirements for European SEC registrants listed on the New York Stock Exchange (NYSE).

## An analysis of audit committee regulations

|                                    | Purpose and oversight  | Membership  | Areas of focus  |
|------------------------------------|--|---|---|
| <b>France<sup>2</sup></b>          | Inseparable from board of directors: approve corporate accounts and prepare consolidated accounts  | Two-thirds independent, no officers   | Accounts and control processes, auditor independence  |
| <b>Germany<sup>3</sup></b>         | Handle accounting and risk management, auditor independence, the issuing of the audit mandate and auditing focal points and fees   | Half represent shareholders, half represent employees; chair cannot be ex-management                    | Accounting, risk management, auditor independence and fees, internal controls   |
| <b>Italy<sup>4</sup></b>           | Evaluate internal control system, approve balance sheets and half yearly reports and ensure the external auditor is supported properly   | Three to five board members; majority independent   | Accounting principles, audit process, external auditor, risk management   |
| <b>The Netherlands<sup>5</sup></b> | Prepare the supervisory board to evaluate the management board, with respect to areas of focus   | Non-executive board members; one must be a financial expert   | Internal controls, financial reporting, internal audit, tax, external audit, IT   |
| <b>Sweden<sup>6</sup></b>          | Ensure financial reporting and control principles are followed; assure independence of external auditor  | At least three independent members  | Board preparation for financial statements; external audit relationship and fee negotiations  |
| <b>Switzerland<sup>7</sup></b>     | Provide independent judgement of the quality of the external auditors, internal controls and financial statements  | Financially literate and independent members  | External auditors, internal controls and reviewing financial statements with management   |
| <b>United Kingdom<sup>8</sup></b>  | Ensure implementation of financial reporting and internal control principles; maintain proper relationship with the company auditors   | Independent, non-executive board members; one financial expert  | Financial statements, internal controls, internal audit, external auditor independence  |
| <b>United States<sup>9</sup></b>   | Assist board oversight of financial statements, compliance, auditor independence and internal and external auditor performance; create audit committee report for annual proxy statement | At least three financially literate members; one must have financial or accounting management expertise | Internal quality control procedures, financial statements, earnings press releases, risk assessment and management, auditor independence, auditor hiring policies |

<sup>2</sup> The French Corporate Governance Code for listed companies is available at: [http://www.ecgi.org/codes/documents/cg\\_oct03\\_en.pdf](http://www.ecgi.org/codes/documents/cg_oct03_en.pdf)

<sup>3</sup> The German Corporate Governance Code is available at: [http://www.ecgi.org/codes/documents/corgov\\_endfassung\\_e.pdf](http://www.ecgi.org/codes/documents/corgov_endfassung_e.pdf)

<sup>4</sup> The Italian Corporate Governance Code is available at: [http://www.ecgi.org/codes/documents/codiceautodisciplina\\_en.pdf](http://www.ecgi.org/codes/documents/codiceautodisciplina_en.pdf)

<sup>5</sup> The Dutch Tabaksblatt Code is available at: <http://corgov.nl/page/downloads/CODE%20DEF%20ENGELS%20COMPLEET%20II.pdf>

<sup>6</sup> The Swedish Corporate Governance code is available at: [http://www.ecgi.org/codes/documents/swe\\_codes\\_group\\_en\\_mar2005.pdf](http://www.ecgi.org/codes/documents/swe_codes_group_en_mar2005.pdf)

<sup>7</sup> The Swiss Code of Best Practice for Corporate Governance is available at: [http://www.ecgi.org/codes/documents/swisscodeofbestpractice\\_english.pdf](http://www.ecgi.org/codes/documents/swisscodeofbestpractice_english.pdf)

<sup>8</sup> The Combined Code on Corporate Governance is available at: [http://www.ecgi.org/codes/documents/frc\\_combined\\_code\\_june2006.pdf](http://www.ecgi.org/codes/documents/frc_combined_code_june2006.pdf)

<sup>9</sup> The New York Stock Exchange's Listed Company Manual is available at: <http://www.nyse.com/RegulationFrameset.html?nyseref=http%3A//www.nyse.com/LeftNav.html%3FFlashVarsID%3D1090921948122&displayPage=/listed/1022221393251.html>

Analysis of the different countries' recommendations resulted in some interesting findings. For example, German companies do not typically have individual audit committee charters. Instead, terms of reference are often part of the supervisory board's rules, which do not have to be disclosed. In addition to the supervisory board rules, German SEC registrants issue a statement of compliance with Sarbanes-Oxley and other NYSE regulations.

Italian companies do not typically have audit committees, but rather an internal controls committee. This committee's primary purpose is to evaluate and assess the internal controls programme, as well as undertake many of the tasks typically associated with audit committee work, such as ensuring that accounting policies have been applied correctly to the preparation of the consolidated accounts and evaluating the proposals and audit plans of the external auditor.

### **Is there a need for standardisation of audit committee charters?**

While there was some interest in standardising audit committee charters across Europe, members concurred that consistent regulatory reform across the EU, for example, would be incredibly difficult if not impossible. Before regulations governing audit committee charters could be reformed, governments would have to *"standardise across legal jurisdictions"*. This would be impractical and unattractive, in part because it *"would require a rules focus"* as opposed to the principles-based approach that is widely used in Europe.

Instead of aiming for regulatory reform, many members suggested there may be voluntary solutions that could begin the process of standardising documents governing the formation and operation of audit committees. One member suggested *"the European Corporate Governance Institute [might] compile a guide that could be very useful"* if companies wanted to amend their charters and wished to harmonise provisions with other European companies.

### **When the audit committee charter is particularly useful**

Members agreed that many situations can benefit from a clear and concise charter. The structure a well-written charter provides can clarify the role the audit committee should play in ambiguous situations, such as where lines of authority should be drawn, or when there is a board reorganisation.

One vexing problem for many audit committee chairs was voiced by one member: *"How do you draw the line between the audit committee and [other committees]?"*. One clear solution for this problem is a charter which can help delineate the roles and responsibilities of various board committees: *"[A good charter] helps determine who handles what"*. For those boards with a risk committee, this can be a key issue, as many risk management topics *"tend to come to the audit committee before they go to the full board ... risk management can be everything, so the audit committee chair can't lose sight of what the role of the audit committee is"*.

A charter with clear delegation of authority can also be a practical aid for accomplishing the board's work, because *"you can't really involve the full board on everything"*. For example, one member pointed out that *"quarterly reports are approved by the audit committee"* in the US, which frees up other members of the board to cover different issues. Another member voiced an opposite opinion about excess burdens on the audit committee, in line with the regulations governing its purpose: *"I'm concerned [that] we put too much responsibility on the committees. The committees should be doing preparatory work but all decisions should be taken by the full board"*.

In addition, audit committee charters can prove very helpful during a corporate reorganisation. One member commented that *“the time when [charters] are most useful is when things are restructured ... it helps determine who handles what”*.

## Using the charter to communicate the audit committee’s priorities

The charter encapsulates the focus and priorities of the audit committee and can send powerful signals to both investors and management. However, companies rarely think about the charter as a channel of communication with internal and external stakeholders.

In addition to the charter, members favoured two other alternative communication vehicles, especially for those companies whose regulatory environment doesn’t require a publicly disclosed charter:

- **Annual shareholders’ meeting.** In many countries it is in this forum that the audit committee *“report[s] directly to shareholders on our work”*.
- **Annual report and accounts.** These can contain a letter from the audit committee chair, which in one member company’s case, has to be updated to reflect the dynamic situation of the member’s audit committee.

## Audit committee chairs use a variety of sources to identify agenda items

The meeting agenda is fundamental to the audit committee’s work. With so many constituents to satisfy – from internal audit to the other audit committee members – audit committee chairs must construct the agenda with care. If new topics are regularly appearing on the agenda, audit chairs *“have to make sure to identify the less important issues, and focus time on the most important matters. You have to stand back from time to time [to make sure you’re covering the right things]”*.

Agendas consist of both regular items required by regulations or charters and additional topics or issues that have been brought to the audit committee’s attention. The amount of time devoted to each item depends on audit committee charters, on the processes used to get input to the agenda, and on the judgement of the audit committee chair. In general, members said: *“routine reports shouldn’t take up too much time in any meeting”*. This was particularly the case for one member, who is currently experimenting with the agenda development process because *“meetings were clogged with routine [updates] that really don’t change all that much”* from one meeting to the next.

### Members reported that more than two-thirds of the average agenda is made up of recurring items. The most common are:

- Quarterly financial reports
- Report from the internal audit function
- Report from the external auditor
- Legal briefing and overview of any fraud cases
- Financial and critical accounting policies, including IFRS interpretation
- Internal controls and/or Sarbanes-Oxley compliance

Members agreed that getting the proper feedback on what should go on the agenda is crucial to running a successful meeting. While the audit committee chairman has the final authority over agenda

items, one member stated that he would “*get into dangerous territory*” if he tried to create the agenda in isolation. Those involved in developing the agenda with the audit chair include:

- **CFO or finance director.** One member touched a chord in saying that “*management has much deeper insight*” into the issues that should concern the audit committee than most other sources. “*You have to have a good relationship with the CFO – they want the audit committee to [discuss certain] issues*”.
- **Company secretary.** Though the secretary is rarely a source of unique insight, he or she often provides a starting point for what should or must go on the agenda: “*the secretary creates the first draft of our agendas. He gets ideas from the previous meetings*”.
- **Head of internal audit.** One member relies on the internal audit team to put “*issues on our agenda and report on our list of hot issues at each meeting*”.
- **Legal/general counsel.** One member has an annual agenda item for legal review but “*they can ask for more time if they need it*” because there is a legal representative “*at every meeting*”.
- **Other audit committee members.** While members noted that other committee members “*generally have good ideas*”; there was also agreement that “*you can’t count on audit committee members to call you*” so audit committee chairs must solicit their input.

Regardless of the origin of agenda items, the audit committee chair has the final word: “*Once I finalise an agenda, no one adds or removes anything but me*”.

## Concise agendas can help maximise the audit committee’s effectiveness

Audit committee chairs are responsible for final versions of agendas at each meeting, as well as an overarching forward agenda that maps out the committee’s work for an entire year. The forward agenda can be a good device for focusing the audit committee’s efforts. As one member explained: “*We have a meeting at the beginning of the year about the forward agenda. It’s prepared by the secretary based on last years’ [agendas]. [The members] discuss ... what we need to look into. I encourage people to bring up ideas without any commitments – it’s a true brainstorming session*”.

To be relevant, each agenda must promote free discussion about concerns but time spent in discussions versus presentations varies among the membership. One member’s audit committee spends 80% of its meetings digesting presentations but admitted “*this is not a good balance*” and would like to allow “*more time for discussion among board members*”. Regular, routine reports to the audit committee can be another challenge to meeting agenda effectiveness, as well as new items that might best be discussed by the full board such as some aspects of risk management.

Good pre-reading material is key to an efficient audit committee agenda. However, not all pre-reading materials are equally effective: they must be succinct to encourage audit committee members both to digest them fully and ask questions at meetings. One member noted the “*dilemma between completeness and volume*” that management and the board must solve. “*Management wants to produce 60-page reports, not three-page ones ... but I review all the pre-reading and force them to dramatically reduce it.*” Since the audit committee needs less information than management, “*we can’t get pre-packaged management reports, because we’ll be overwhelmed [with the volume] and never ask questions*”. Members recommended that summaries of regular reports should be provided and that these should focus on what the audit committee needs to know.

Management and the audit committee chair also have to set expectations for presenters to the committee so they know the “*difference between reporting to management and reporting to the board*” and to provide the audit committee with just the right level of detail to make the best use of their time.

For a concise list of actions recommended by audit committee chairs to improve agendas, please see Appendix 1 on pages 8-9.

## Conclusion

The audit committee charter can paint a public picture of the committee and its work. But European companies, with a few exceptions, don't fully utilise the charter to communicate externally with markets and internally with employees. Instead, the charter is mostly seen as a regulatory requirement. European companies have a unique opportunity to create value with the charter and should seize the moment to elevate the charter to a more strategic level.

Audit committee chairs have an equally valuable opportunity to improve their meetings by leveraging agendas to maximum effect. Agendas should be meticulously maintained so they contain only the most relevant items and provide adequate opportunities for audit committee members to discuss the questions that “*keep them up at night*”.

## About this document

The European Audit Committee Leadership Network is a select group of audit committee chairs 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 environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, their advisers and auditors, as they endeavour to fulfil their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from discussions among members of the European Audit Committee Leadership Network. 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, management, advisers and auditors 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 select group of audit committee chairs 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 organisation.*

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## Appendix 1: improving meeting effectiveness – advice from audit committee chairmen around the world

- **Set agendas in advance and prioritise later.** The audit chair maintains a one-year set of rolling agenda items and speaks to members before each meeting to prioritise the time spent on each item.<sup>10</sup>
- **Use consent agendas.** Committees may cover standard, non-controversial or self-explanatory items without formal discussion. In such cases, pre-meeting reading is distributed to committee members on the understanding that it will only be discussed on request.<sup>11</sup>
- **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 maximise the “completeness” and minimise the “volume” of pre-reading materials.
- **Cultivate the right mix of presentation vs discussion.** Allow ample room for discussion by limiting time for presentations in favour of discussion. Several members indicated that, on average, they spend about 60% of their meetings reviewing presentations, and 40% in free discussion. Inspirationally, at least one member felt that 20:80 was the best possible ratio.
- **Improve discussion by focusing on assumptions.** A member of the Audit Committee Leadership Network in North America 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”.<sup>12</sup>
- **Focus attention on the most important items.** 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 to put on 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”.<sup>13</sup>
- **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.
- **Uncover pan-organisational themes.** Require presenters to meet independently to discuss consistencies across their presentations, then report these consistencies back to the audit committee on a regular basis. One member reported “all the presenters had to identify

<sup>10</sup> Pacific Southwest Audit Committee Network: *The changing face of the audit committee*, *VantagePoint*, 4 October, 2005, page 5. Available at: [http://www.tapestrynetworks.com/documents/Tapestry\\_PacSouthwest\\_ACN\\_Oct05.pdf](http://www.tapestrynetworks.com/documents/Tapestry_PacSouthwest_ACN_Oct05.pdf)

<sup>11</sup> Southeast Audit Committee Network, pages 3-4.

<sup>12</sup> Tapestry Networks: *Call-For-Activism workshop for audit committees*, *ViewPoints*, 8-9 March, 2005, pages 5-6. Available at: [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Fortune\\_ACLN\\_Apr05.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_Fortune_ACLN_Apr05.pdf)

<sup>13</sup> Pacific Southwest Audit Committee Network, page 6.

*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". Over the course of a few years, this practice "has improved [audit committee] performance greatly" and enhanced cross-functional cooperation among management.*

- **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 "*identify the less important issues*" and remove those items from the agenda.
- **Issue interim reports between meetings.** 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.<sup>14</sup> In another example, the company prepares white papers on accounting issues that occurred in the quarter, or to explore particular risk items.<sup>15</sup>

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<sup>14</sup> Ernst & Young and Tapestry Networks, *Audit committee agendas, InSights*, 29 October, 2004, page 4.

<sup>15</sup> Pacific Southwest Audit Committee Network, page 5.