



Enhancing audit committee effectiveness

Introduction

The Midwest Audit Committee Leadership Network¹ (MW ACN) held its inaugural meeting on December 13, 2007. The discussion focused on how audit committee chairs can lead audit committees to realize their full potential, as well as the importance of defining the scope of audit committee responsibility within the context of corporate risk.

The members of the network present at the meeting, who sit on the boards of 30 large-, mid-, and small-cap companies between them, were:

- Brian Anderson, Audit Committee Chair, W. W. Grainger
- Dennis Chookaszian, Audit Committee Chair, CME Group
- Cheryl Francis, Audit Committee Chair, Morningstar
- David Landsittel, Audit Committee Chair, Molex
- Tom O'Neill, Audit Committee Chair, Archer Daniels Midland
- Rich Roedel, Audit Committee Chair, Brightpoint
- David Schwartz, Audit Committee Chair, Walgreen Company
- Dennis Van Mieghem, Audit Committee Chair, AEGON USA
- John White, Audit Committee Chair, Motorola

Ernst and Young members participating in the meeting included:

- Tony Anderson, Midwest Area Managing Partner
- Jim Logothetis, Partner and Chicago Market Leader

VantagePoint reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations.

¹ The Midwest Audit Committee Network is composed of audit committee chairs drawn from leading companies based in the Midwest region of the United States. 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 audit environment.

VantagePoint is a synthesis of some key issues arising from a facilitated discussion among members of the Midwest Audit Committee Network. It is intended to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, executives, and advisers who become systematically engaged in this dialogue, the more value will be created for all.



Executive summary

Any discussion of audit committee effectiveness raises the question “What does it mean to be effective?” Ultimately, members agreed that the audit committee’s effectiveness is measured by the company’s success. Members felt strongly that one of the audit committee’s significant contributions to the success of the company lies in its oversight of risk management.

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

- **Effective audit committees need effective leaders** (page 2)

Good leadership, members agreed, is essential for committee effectiveness. A good audit committee chair is an active leader who engages audit committee members and management, drives continuous improvement, and manages committee meetings well. Members identified a number of leadership practices that characterize the most effective audit committees.

- **Executive sessions make the committee more productive** (page 4)

Members agree that executive sessions significantly enhance audit committee effectiveness. Although members held different views on the ideal placement of executive sessions in the meeting agenda, they all agreed that private sessions allow for crucial candor and help to build open, trust-based relationships amongst committee members and with the committee’s key stakeholders.

- **Audit committees play a critical role in managing risk** (page 5)

Members are actively pursuing enterprise risk management (ERM). Members recognize that “one-size-fits-all” risk management techniques are impractical, and their committees oversee management’s effort to identify, prioritize, and monitor risk using a “*situational*” approach. Audit committee chairs unanimously agree that ERM will continue to be a major area of focus for audit committees in 2008.

Effective audit committees need effective leaders

In the course of discussion, members returned time and again to the central theme of leadership. As one member pointed out, “*We, as audit committee chairs, are held to such a high standard of accountability now that we can’t satisfy stockholders or the SEC by just saying, ‘we hit everything in the charter.’ I would like to hear from this group how other people make time for the candid conversations that the job requires.*”

Network members described seven ways audit committee chairs can be more effective leaders:

- **Manage meetings and meeting materials.** The audit committee chair is responsible for ensuring time is used productively: “*When meetings go too long, it is the audit committee chair’s problem. The buck stops at the top, and you’re the top.*” Another member remarked, “*The audit committee chair has to cut [off discussion] and know when to say, ‘That’s enough.’*” Members continuously stressed the importance of pre-meeting preparation and the use of data that is timely, relevant, and concise. Some members expressed frustration at the current state of their meeting material. One member joked, “*We have more PowerPoint slides [at our committee meetings] than anyone else... It’s unbelievable.*” Members say that the audit committee chair can improve the situation by filtering the material that is distributed to the board both



prior to and during the committee meeting. One member shared, *“I preview all of the material first, so it’s a focused presentation in the meeting. If the material is bad, it’s my fault.”*

- **Set longer-term priorities.** In addition to staying on top of the standard agenda, it is also important to set longer-term priorities. One member shared, *“We set two to three major priorities at the beginning of the year that are going to change the game and move us forward. Those priorities generally become internal audit’s job to keep up. An example of one of these priorities might be a change in mechanism for how the audit committee should be reported to, or another could be to establish a risk dashboard if you don’t already have one – those kinds of things.”*
- **Manage expectations.** Several members reported that they reach out to key players before the meeting in an effort to ensure that everyone is on the same page regarding the purpose and desired outcome of the meeting: *“I have what I refer to as ‘the call before the call.’ I talk to the external auditor, the internal auditor, the CEO, and the CFO a day before the meeting to make sure I understand everything. Audit committee meetings are no place for surprises.”*
- **Engage committee members.** Members agreed that while the audit committee chair shoulders primary responsibility for the audit committee’s smooth functioning, the committee members must be kept engaged. One audit chair said, *“I send the agenda between meetings and make sure [the committee members] feel important and engaged. I don’t want to be seen as a dictator. I want to make sure they know that they are key to the committee’s effectiveness.”* Members shared best practices regarding communication between the audit committee chair and committee members. One audit chair reported, *“I try to do a lot of emailing between meetings and [encourage emailing] amongst the audit committee.”* Another member shared, *“I make sure to remind audit committee members to tell me if they have additional items they want to discuss.”*
- **Drive continuous improvement through evaluations.** Members *“take the evaluation process very seriously”* and aren’t satisfied with merely covering the items on their charter. As one audit chair put it, *“I don’t advocate simply checking the boxes when it comes to evaluations. We get around a table once a year – internal audit, external audit, the general counsel, and any other relevant parties – and we evaluate what we’re doing. We ask ourselves, ‘Are we adding value? Is the plan in place being executed well?’ It’s an effective way of evaluating more [of what] we do as a committee in general.”* Indeed, several members reported the positive impact that the evaluation process has had on the effectiveness of their audit committees: *“We’re always focused on continuous improvement, and in our discussion of the audit committee’s performance with the CEO, he said, ‘You helped me see this business differently.’ So I take that as a helpful sign that we’re on the right track.”*
- **Ensure that committee members remain up-to-date.** Members feel that director education is a vital component in the continuous improvement of the audit committee. Regardless of committee members’ experience, they need to stay up-to-date on industry- and company-specific issues. Several network members said they *“have agenda time carved out specifically for education issues.”* However, the time spent on formal education is often limited. Ernst & Young’s *Audit Committee Perspectives* survey points out that 63% of audit committee members whose boards have a formal continuing education process spend



10 hours or less per year on this activity.² One member shared a best practice that underlines the importance of focused director education: *“We sat down with the CFO and decided what the audit committee needed to do as an audit committee and assigned all the people involved – audit committee members, the CEO, CFO, auditors – a specific subject to spearhead and learn best practices. Everyone took this on as an extracurricular where they would bring back their thinking. We ultimately decided that it was extraordinarily beneficial ... it got people engaged, and that was important.”*

- **Navigate the fine line between management and oversight roles.** Members describe the importance of motivating management, but caution that it is critical not to overstep the audit committee’s definitive oversight role. One member reflected, *“The thin line you walk with oversight and management is always a challenge for me. You can’t tell them what to do, but you want them to stay engaged.”* Another member, contemplating the subtleties of this dilemma, asked rhetorically, *“What is our role as an audit committee chair? How proactive should you be, and where do you finally draw the line between oversight and management?”*

Executive sessions make the committee more productive

Members agreed that anywhere from 12 to 25 people typically attend audit committee meetings. However, there was no consensus on the merits of greater inclusion. One member asserted, *“I think the more people that are in the room, the more engaged they are, and therefore the more effective the committee can be. We like to have the CFO, CEO, chief accounting officer, internal audit, three to four people from the external auditor, the general counsel, and the assistant general counsel. Sometimes we’ll even bring in [other key executives] to make presentations.”* In contrast, another audit chair remarked, *“There are only four people on the audit committee, but there are 25 people in the room.”*

Indeed, most members are quick to caution that it is important not to have too many people in the room because crowding adversely impacts meeting dynamics. As one member put it, *“There are certain people that are excellent to have in the room, but it comes to a point where you lose the effectiveness of interchange and candor.”*

Executive sessions provide an effective counterbalance to a more inclusive general session

Members agreed that executive sessions offer many benefits: *“I think it is amazing how valuable [executive sessions] are in terms of the interchange that can occur. It goes far beyond mere value add – it’s about building relationships and having that crucial candor.”*

Despite the benefits of executive sessions, members confess that they frequently struggle to carve out adequate time for them. One member lamented, *“I don’t like leaving executive sessions until the last five minute of the meeting, but oftentimes that is what it comes down to.”* Another member challenged that view: *“I have a problem when people say they run out of time – who’s in charge? I always leave one-third of the time for private sessions. If you say that in advance, then you won’t run out of time.”*

² 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/Canada/Audit_Committee_Survey_2006/\\$file/Audit_Committee_Perspectives_2006.pdf](http://www.ey.com/Global/download.nsf/Canada/Audit_Committee_Survey_2006/$file/Audit_Committee_Perspectives_2006.pdf).



Members shared two alternative approaches to the placement of executive sessions on the meeting agenda:

- **Executive sessions at the beginning of the meeting.** *“I’ve made the proposal of having executive sessions at the beginning of the meeting. The executive session with the external auditor will also be last, not first. Sometimes things happen where we would have talked about them in the meeting had we met beforehand, so we are going to try having the executive sessions first.”* One member who had already attempted this model cautioned, *“I’ve done executive sessions beforehand, and you can sometimes end up having the meeting before the meeting.”*
- **Executive sessions at the end of the meeting.** Most members said it is preferable to hold executive sessions at the end of the meeting, provided they are not cut short by time constraints. While members agreed that the order of the executive sessions makes a difference, they described different practices. Some committees prefer meet with the external auditor last, because it allows the audit committee to discuss issues that may affect the independent audit of financial statements. Other committees prefer to meet with the internal auditor last, *“because he is the one who works for us and we can give him directions.”*

Whatever the order, members agree with the audit committee chair who said, *“I always talk to the CEO, CFO, external audit, and internal audit alone, respectively. That’s a simple model, and it works.”*

Effective audit committee chairs establish and sustain open, trust-based relationships

Members agree that the relationships the audit committee builds with key stakeholders as a result of the executive sessions are what truly matters: *“I’m a big believer that the chairman and the audit committee [should] have a good relationship with both internal audit and external audit. I spend lots of time making sure that that communication happens.”* Another member added, *“I come in the night before the meeting so I can have dinner with the head of internal audit. I take it as an opportunity to tell them how important I think they are and how valuable they are to the organization.”*

Members emphasize that ongoing dialogue and good relationships make it easier to handle important tasks such as succession. One member noted, *“At my company, we decided to allocate time to talk about succession planning in the finance organization. Now that we’re going through a CFO succession, it is much easier because those relationships are already in place. I’m very glad we did that, because we’re all very comfortable with the players involved.”* Audit committee chairs demonstrate effective leadership by promoting good relationships, and those efforts ultimately enhance audit committee effectiveness.

Audit committees play a critical role in managing risk

As oversight of compliance with Sarbanes-Oxley’s Section 404 becomes less time-consuming, many audit committees see an opportunity to reexamine how and where they focus their efforts. One area that network members feel deserves more attention from the audit committee is enterprise risk management (ERM). One audit chair remarked, *“It seems to me the place where the audit committee can really contribute to the company is [in the area] ... of risk [management].”*

Indeed, members reported that risk management will be a key focus for their audit committees in 2008. One network member commented, *“We’ve started to work closely with management on ERM – that’s the new*



thing. We've had a lot of lip service to it in the past, and we're now finally addressing it." Another member shared, "We're going to take a serious look at ERM. We've only scratched the surface, so that will be an absolute focus for us this year, and we'll try to move the needle forward in that regard."

While members agree that risk management is an important focus, they caution that there is much work to do: *"Risk management, for the most part, is where companies need to play catch up."* Members acknowledge that establishing a solid ERM process is a challenge given that *"there are so many moving parts."* Furthermore, members noted that oversight of ERM risks turning into a bureaucratic exercise that yields diminishing returns. Members agreed with the audit committee chair who remarked, *"We want to make sure what we do with ERM is value add. We don't want to make unnecessary work for ourselves [or management]."* While members acknowledge the importance of identifying, prioritizing, and monitoring risk, they also say that there is no single best practice because *"risk is very different from company to company."*

Conclusion

Some observers paint a grim picture of audit committees in which the meetings are plagued by poor time management, the agenda is driven by *"checking the boxes,"* there are endless and unnecessary monotonous presentations, and meetings lack the candor and insight that is required for impact. Members of the Midwest Audit Committee Network reject this portrayal. They believe in effective audit committees guided by perceptive leaders. They advocate for audit committee chairs who will focus the committee's energy on the company's future, inspire candor, manage capably, and insist on high standards of board and management performance.

The views expressed in this document represent those of the Midwest Audit Committee 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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