



Enhancing audit committee effectiveness

Introduction

The Mid-Atlantic Audit Committee Leadership Network¹ (MA ACN) met for the 12th time on October 15, 2007. Discussion focused on identifying ways to ensure audit committees are as effective as possible. Network members considered the continuing challenge of defining the scope of audit committee responsibility and the key elements that can assist audit committees in effectively fulfilling that responsibility.

The members of the network present at the meeting, who sit on the boards of 24 large-, mid-, and small-cap companies between them, were:

- Bill Albertini, Audit Committee Chair, Airgas
- Paula Cholmondeley, Audit Committee Chair, Dentsply
- Charlie Hopkins, Audit Committee Chair, Charming Shoppes
- Jay Morse, Audit Committee Chair, Host Hotels and Resorts
- Mike Ressler, Audit Committee Chair, Magellan Health Services
- John Schwieters, Audit Committee Chair, Smithfield Foods
- Paul Shapiro, Audit Committee Chair, Toll Brothers
- Jim Zug, Audit Committee Chair, Amkor Technology

Also participating in this meeting was:

- Mark Bartlett, Managing Partner, Ernst & Young

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 Mid-Atlantic Audit Committee Network is composed of audit committee chairs drawn from leading companies based in the Mid-Atlantic 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 Mid-Atlantic 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 begs the question “What does it mean to be effective?” MA ACN members agreed that the audit committee, like all other committees of the board, can assert that it is effective when it palpably helps the company to be successful. But given its many responsibilities, the audit committee must also be efficient: an inefficient audit committee will not have the time to be impactful in discretionary activities outside its statutory obligations.

- **Audit committees define their scope across a broad spectrum of risks and value diversity of experience for members** (pages 2-3)

Members varied greatly in what they thought was the audit committee’s fundamental scope of responsibilities. Some members’ committees focused almost exclusively on financial reporting risks, while others took responsibility for a range of key operational and strategic risks. Since every major risk can ultimately impact the financial statements, the audit committee chair has an opportunity for wider involvement in oversight. Members also noted that a diverse but stable committee membership facilitates committee effectiveness, regardless of choices about scope and focus.

- **The audit committee chair can implement efficient and effective procedures** (pages 4-6)

Audit committee chairs can do a lot to ensure the committee functions efficiently, so it gets essential work done both well and on schedule and has more time for the discretionary activities they and their board colleagues deem most relevant and beneficial to the company. Members shared a rich set of practical suggestions based on their personal experiences such as distributing audit committee materials to the full board and reducing time spent going over materials, such as auditor reports and management materials, that can be read before the meeting.

Audit committees define their scope across a broad spectrum of risks and value diversity of experience for members

As the oversight of Section 404 compliance becomes less time-consuming, many audit committees see an opportunity to reexamine how and where they focus their efforts beyond their core responsibilities. Members agree that shareholders benefit from the audit committee’s role in ensuring the integrity of the company’s financial statements and key internal controls. The question is whether an effective audit committee should seek to add value in other ways too. In a conversation prior to our meeting, one network member said, *“The audit committee’s client is the shareholder, not the SEC ... If shareholders saw our agendas, would they say we were spending our time on the right things?”*

Despite a full agenda, some network members see opportunities to streamline compliance oversight and push some responsibility back to the full board or other committees, which would free up audit committee time and allow the committee to focus on other, value-added, activities. Yet one member said, *“We do virtually all our work in committees ... and [the board has] only three committees.”* In other words, the audit committee often takes on additional work because there is no other logical place for it at the board level.



Audit committees often go beyond compliance and financial reporting

Members believe that audit committees can add value by going beyond “*checking boxes*” on required compliance activities, but say that they must work with their committee members, the full board, and management to determine what kind of scope is appropriate. The answer will vary depending on the risk profile of the business, the board committee structure, and the membership of the audit committee.

Specific areas of focus will likely vary from one audit committee to the next. Some audit committees take explicit responsibility for operational risks, while others use the power of the audit committee to take on business risks not strictly inside their charter on an ad hoc basis on the grounds that those risks could have an adverse financial impact on the company. Network members agreed that they need not understand the intricacies of every risk area; as directors, the audit committee’s “*real obligation is to shareholders, to make sure management is doing what should be done.*” Audit committee members do not need specific expertise in order to question management’s decisions and they can also focus their attention on the rigor of the processes by which those decisions are made.

While several members felt the audit committee should have significant latitude in its activities, others said the audit committee exists for a very specific reason: to ensure the accuracy of financial statements and other required disclosures. One member pointed out the value of remaining true to the committee’s core purpose: “*The audit committee focuses on risk in financial reporting and disclosures. Isn’t oversight of that a value-added activity? ... Remember, this is an audit committee, not an operational improvement or business development committee.*” Another member agreed, “*Let’s not underestimate the value of ensuring financial reporting is accurate.*”

Audit committee membership should match the committee’s defined scope

Network members noted that as audit committees choose to, or are forced to, expand their scope of activity, they benefit all the more from members with a breadth of experience. Provided there is sufficient financial and accounting expertise on the audit committee, one member said, “*We look for a diversity of backgrounds. Different perspectives are enormously important.*”

Members noted that while new perspectives can be helpful, committees perform most effectively when membership is stable. For the most part, they agreed with one member who remarked, “*Audit committees tend to be pretty stable. There are no wholesale [membership] changes.*” That stability ensures institutional knowledge is retained. One member said, “*There’s a lot of background you pick up that helps you get through the agenda,*” and another said, “*We’ve been discussing [an evolving] issue for ten years. I’d hate to think about a bunch of new people coming on [to the audit committee].*” Consequently, audit committee chairs should work closely with the nominating and governance committee to be sure new audit committee candidates will complement existing members’ experience and temperament.



The audit committee chair can implement effective procedures to improve efficiency

Network members agreed that, *“the audit committee has the fullest agenda, so full of compliance that it’s hard to get to anything else.”* In a discussion prior to our meeting, one member said, *“Can we do it more efficiently? Is some percentage of the time we spend not useful, but simply part of the way we do things? ... Are we utilizing our time in the most effective way?”*

Members outlined a number of ways to keep audit committee agendas focused on the right topics:

- **Highlight key financial risks in SEC disclosures.** Members noted that a risk-based approach can help prioritize the agenda to maximize the committee’s effectiveness in light of time constraints. One member mentioned a relatively simple method for identifying which risk factors the audit committee should review: *“We take all of the risks in the 10-K, then go down and select which belong to the audit committee and which should go to the full board or other committees.”*
- **Review accounting judgments and forecasts.** One member said the audit committee had *“better be sure [it] understand[s] the levers on guidance given [in disclosures].”* Another member noted that standards such as AS5 and statements such as FAS 147, along with fair-value accounting, are making accounting more principles based. Audit committees must be increasingly mindful of the latitude management has in making judgments associated with financial reporting: *“Every quarter, companies have some judgment; where the audit committee helps [is by overseeing the suitability of] that judgment.”*
- **Solicit broad involvement in setting the agenda.** Many members distribute a draft agenda to all committee members prior to each meeting and ask for input. Even though the feedback is often limited, the process reminds members that they have a role to play in setting the agenda and keeps them engaged between meetings. One member said, *“Agenda setting is critical. Be sure the right people in management are touching it.”* While most committees work closely with the head of internal audit or the CFO in setting their agenda, members emphasized the importance of also involving the CEO, the chief accounting officer, and the general counsel. Another member said, *“The general counsel is critical to audit committees. They may see issues that may not be on the minds of finance people.”* One network member reflected on the *“power of the agenda”* to turn management’s attention toward areas that the audit committee deems worthy of review.
- **Engage in brainstorming.** Several members said their audit committees have annual sessions to discuss areas that may not be *“pre-ordained”* agenda items, but that stakeholders, including audit committee members and management (C-level executives, internal audit staff, etc.), want to review, or items about which management thinks the audit committee should be more deeply informed.
- **Ask the external auditor for input.** Though the external auditor is obligated to report areas of judgment that the audit committee must review, several members suggested the external auditor can also provide insight into other topics that the audit committee may want to include on their agenda, including reviewing specific company processes.



- **Don't overlook current risk areas.** While it is important that companies be forward looking and consider potential future risk areas, one network member said it is essential that audit committees not lose sight of major current risks: *"Don't miss the Queen Mary as it goes sailing by."*

Maximizing committee efficiency and effectiveness

In addition to ensuring that the audit committee has the right membership and that its agenda has the right balance and focus, there are a variety of ways that audit chairs can maximize committee efficiency and effectiveness:

- **Take advantage of advance materials from management.** One member said, *"If you don't have good materials from management, and members don't read them, meetings are useless."* Members emphasized the importance of the right kind of materials from management, distributed well in advance to ensure that limited meeting time will be devoted to discussion and *"intelligent questions,"* rather than to repetitive presentations. Another member said, *"We have the advance materials – don't read to us. What are the key issues we need to discuss? You can get an extra 30 minutes out of the agenda that way."* Despite the problems that large numbers of attendees can cause for discussion, one member said involving more people from management in audit committee meetings is beneficial: *"I like to see a lot of people in the company make presentations to get exposure to them."*
- **Narrow the focus of auditor reports.** Auditors' reports to the audit committee can exceed 40 pages in length. As with management presentations, one member recommended that auditors *"highlight two to three pages and focus the discussion with the assumption that the rest of the report has been read and issues will be raised if necessary."*
- **Focus on changes when reviewing public disclosures.** Because much of the content in public disclosures is *"boilerplate text,"* at least one member asks management to *"redline"* changes from prior drafts to enable the audit committee to quickly focus on what's new.

Members also discussed the importance of communicating with the full board. Several members said that the entire board bears responsibility for ensuring the audit committee is working effectively. To keep board members informed of audit committee activities, some network members distribute the audit committee agenda and meeting materials to all board members prior to meetings. Broadly distributing the audit committee's agenda and other materials allows other directors to determine if there are issues they would like to learn more about and to make decisions regarding attending audit committee meetings.

Striving for continual improvement

As the business and regulatory environment evolves, audit committees need to ensure that they stay informed so they can continue to fulfill their oversight obligations effectively. Network members identified two methods for doing so: annual self-assessments and continuing education.

- **Maximizing the self-assessment process.** Members generally see limited value in formal, written annual assessments. One member said, *"[Written] self-assessments are contrived, just a form, and provide very little useful information."* Another put it more bluntly, *"The questionnaires are useless."*



Nevertheless, members agreed that the process of regularly reviewing their performance and effectiveness is beneficial. They said the benefit comes not from the formal written process but from discussions among committee members and executive sessions with the CEO. Members also noted that a written process can present legal risks because of the paper trail it leaves. In at least one case, the board asked a professor who is an expert in this area to review the board's assessment processes and make recommendations.

- **Continuing education.** One member asked, “*There are many programs on governance, but with FIN 48, FAS 147, etc., what do you do to anticipate so many things coming down the road?*” Many continuing-education options on governance issues are available for directors, but members agreed that programs customized for their companies and boards are far superior. One member said, “*The best [programs] are tailored to what may factor into the company’s strategy and decisions.*” Audit committees have unique education needs, and members said they often turn to members of management, often to people in the tier below C-suite, who may be more intimately involved in the work. Most also ask their external auditor for presentations and updates on topics of particular interest, such as changes in accounting standards or regulations.

Conclusion

Members agree that in order to be truly effective, an audit committee needs to have the right people, focused on the right things at the right time, with the right support.

The audit committee chair plays a critical leadership role in ensuring that the committee spends its scarce time not only on issues that are most urgent, but also on those that are most important, based on the company’s unique risk profile and governance structure. In a quest for continuous improvement, effective audit committee chairs are receptive to new and innovative practices that might enable the committee to better fulfill its responsibilities and deliver greater value to shareholders.

The views expressed in this document represent those of the Mid-Atlantic 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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