



Enhancing audit committee effectiveness in uncertain times

Introduction

The Pacific Southwest Audit Committee Network (PSWACN) held its 15th meeting on January 20, 2010, in Marina del Rey, CA. Network members, who sit on the boards of more than 25 large-, mid-, and small-cap companies between them, met to discuss their audit committees' 2010 agendas, and ways to enhance their committees' effectiveness in today's uncertain economic environment. This document reflects a summary of the key points raised during the meeting, along with selected perspectives that members shared before and after the meeting.¹ For a list of network participants, see Appendix 1, on page 10.

Executive summary

Although the worst of the financial crisis appears to have subsided, PSWACN members still have questions about the overall state of the US economy. Many members attributed improvements in recent corporate earnings to cost-cutting measures,² and are skeptical that profit upticks over the past quarter signal a long-term growth trend. One member said, "*Businesses are learning to operate with far fewer people.*" Therefore, audit committees will remain focused on the consequences of the uncertain economy this year. The meeting discussion covered three broad areas:

- **The 2010 audit committee agenda** (Page 2)

Members continue to think about the best ways to ensure the audit committee covers required responsibilities while leaving time to discuss more topical, discretionary issues. Overall, members expected their 2010 agendas would be similar in nature to their 2009 agendas, which reflected the immediate aftereffects of the financial crisis. During the course of 2010, audit committees expect to maintain a heightened focus on finance and liquidity, tax, and impending government regulation, among other issues.

- **Levers to enhance audit committee effectiveness** (Page 4)

PSWACN members said their audit committees rely on a variety of levers to enhance effectiveness. Members are ensuring that the right people are on their audit committees and setting aside more time for executive sessions. Audit committees are also taking advantage of a variety of education programs to stay abreast of company- and industry-specific accounting issues and general governance trends.

- **The chair's role in enhancing audit committee effectiveness** (Page 6)

Audit committee chairs are building and maintaining relationships with key members of management, internal audit, and the external auditor to help their committees best accomplish their oversight duties.

¹ 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. Quotes in italics are drawn directly from comments made by PSWACN members before, during, and after the January 20 meeting.

² For more on the effect of corporate cutbacks on profits, see Paul Vigna and John Shipman, "[The Shrinking Corporate World Around Us](#)," *The Wall Street Journal*, January 25, 2010.



PSWACN members said audit committee chairs should foster an environment of trust in all of these relationships. Members also suggested several tactical approaches that the chair can take to ensure that meetings are run efficiently and the committee is covering all of the right issues, including keeping fellow committee members focused during meetings and directing and managing the flow of information.

For selected questions audit committee members may ask about audit committee effectiveness, see Appendix 2 on page 11.

The 2010 audit committee agenda

Several members said the rapid rise of the US stock market³ since last March has masked the fact that business fundamentals may not be improving. Many agreed with one member who said, *“We don’t see the green shoots.”* Therefore, members said the issues that captured their audit committees’ attention during 2009 will largely remain on their agendas in 2010. Members said their audit committees will continue to dig deeper this year into issues related to the consequences of the uncertain economy, such as finance and liquidity and increasing regulatory scrutiny.

Audit committees are seeking the right balance between required and discretionary issues

An audit committee’s annual agenda reflects its committee charter, regulatory, legal and stock exchange listing requirements,⁴ and industry and company-specific issues. Most audit committees have an annual calendar mapping out the required issues that the committee must cover over the course of the year to address the elements of their charter. In addition, audit committees set meeting-specific agendas that both reflect these requirements and allow audit committees to adjust to shifting priorities throughout the year.

Most members said setting their audit committee agendas involves collaboration between the general counsel, the finance organization, internal audit, and the external auditor, with final approval by the audit committee chair. Other audit committee members also provide input into agenda items and how the committee allocates time during meetings. One member said it was important to know *“how comfortable the members on the committee are with how the time is being spent.”*

Most PSWACN members said their committees spend a majority of time on required items. Most agreed with one member, who said, *“We only devote 20% to items that are topical or discretionary.”* But members said that as a result of the economic turmoil, *“We are stressing that we need more time available for current topical matters.”*

Some members reported explicitly dividing their meeting agendas between required items and topical items. One said, *“We broke the agenda into two pieces: presentations and information. For the information section, we assume everyone has read the materials prior to the meeting. If they have questions about it, they can ask them. But we don’t discuss it.”* The presentation section is for those items that require deeper consideration and discussion.

³ See, Standard & Poor’s, [S&P 500 Performance Data](#).

⁴ New York Stock Exchange, [“Final NYSE Corporate Governance Rules,”](#) (New York: NYSE Euronext, 2009), 303A.07(c)(iii)(D).



However, one member cautioned that *“some of the required items are substantive,”* reflecting the need for flexibility. That member said, *“some issues require you to spend five minutes, some [less] ... But some take longer. If you are doing a pre-call with the CFO, and he identifies a specific issue as being worrisome, you might want to spend 45 minutes on that.”*

The 2010 audit committee agenda reflects the uncertain economic environment

The New York Stock Exchange requires that audit committees “discuss guidelines and policies to govern the process by which [risk management] is handled.”⁵ While the financial crisis prompted many audit committees to drill down deeper into risk management at their companies, several members said that enterprise risk management (ERM) is now a full board item: *“We pushed risk up to the full board. Our audit committee said, ‘You don’t want three guys sitting around a table talking about enterprise risk.’”*

Since the full board is increasingly taking responsibility for ERM, this has created more flexibility on audit committee agendas. Members said their audit committees will devote more time to issues associated with an uncertain economy. These issues include:

- **Financing.** While a few members said that *“liquidity is a full board item,”* several members said their audit committees will continue to focus on financing issues, which became a major agenda item following the onset of the financial crisis. One member said, *“Bank lines, debt maturities, etc. ... were not on our agenda two years ago.”*
- **Regulation.** One member said, *“Government regulation is an agenda item now. It isn’t just banks that are being heavily regulated anymore.”* Another said, *“The government is such a major force now; if you get [in trouble] it is significant. If you are in a highly regulated industry, and you trip a wire, there might be an enterprise risk.”*
- **Tax strategy and tax risk.** An Ernst & Young study notes, “2009 saw many companies shift temporarily from an Effective Tax Rate strategy to a cash tax optimization strategy, carrying out wide ranging reviews to ensure that tax costs were at a minimum and that tax assets were being utilized to the highest degree.”⁶ One member said *“Tax has become a more important agenda item. There is so much more intensity on the part of the IRS related to ... tax strategy. Companies are becoming more aware of the importance of tax strategy to their overall business.”*
- **Asset impairment.** A member said, *“[Asset] impairment is a hard issue. The [Securities and Exchange Commission] and the accountants are all over this ... and they will be for a while in an economy that is depressed. Impairment is a standing agenda item now.”*
- **Litigation.** While litigation oversight has always been important, the financial crisis has caused boards to focus more intently on company and director liability. One member said, *“Litigation is now a big issue. We sit through presentations by various law firms. We also have our own in-house counsel. We are spending a lot of time understanding the litigation landscape.”*

⁵ *Ibid*, 10-11.

⁶ Ernst & Young, [“Lessons from change.”](#) (Ernst & Young Global Limited, 2009), 12.



- **Pensions.** One member said, *“We are spending a lot [more] time on pensions. This is not fundamentally where we have spent our time in the past.”*
- **Investments.** Prior to the meeting, a member said, *“Because of [Bernie] Madoff, there’s been added scrutiny around investment policies. This has been added to audit committee agendas. What ... instruments are being used by third-party organizations? The audit committee is used as a subgroup of the board to understand what is happening.”*

Levers to enhance audit committee effectiveness

Members said audit committees have already increased the amount of time spent and the number of meetings held since Sarbanes-Oxley,⁷ and they see only limited opportunity for further increases. Therefore, PSWACN members are relying on a variety of other levers to enhance their audit committees’ effectiveness. Audit committees are working to ensure that the right board members are on the committee, taking advantage of a variety of director education platforms, and setting aside more time for executive sessions.

Measures of audit committee effectiveness

In order to judge whether they are effective, audit committees first have to define effectiveness. Members said that external stakeholders, such as regulators and investors, judge audit committees based on whether there are any problems. One member said, *“People don’t want bad news ... if you don’t have any bad news at the end of the reporting cycle, you will be OK.”*

However, some members reported that their audit committees also set their own measures of success, which can only be judged in hindsight. One member said, *“Ask me in three years [whether our audit committee was successful]. You can’t judge success at the end of the year.”* Therefore, members say the best way to measure success in real time is to ensure that the audit committee is focused on the right issues and following the right processes: *“Make sure you are spending the right amount of time on the most important issues. Are you getting direct and honest input from management and the internal auditor?”*

Audit committee composition

Several members said audit committees are most effective when composed of the right board members. Members highlighted several characteristics of an effective audit committee:

- **A balance of skills and perspectives.** The New York Stock Exchange requires that “each member of the audit committee must be financially literate.”⁸ Indeed, the audit committee must have at least one accounting expert who can challenge the CFO and members of the finance organization. But PSWACN members said committees need not be dominated by accounting experts. Sometimes the most effective committee members are those with a less financially-oriented perspective. One member said audit committee members with limited financial expertise *“ask a lot of naïve questions ... Some of the best*

⁷ For further information on audit committee meeting length and frequency, see Spencer Stuart, [2009 Spencer Stuart Board Index](#) (Spencer Stuart, 2009), 9.

⁸ See, New York Stock Exchange, [Final NYSE Corporate Governance Rules](#) (New York: NYSE Euronext, 2009), 303A.07(c)(iii)(D), 10.



questions are the ones that highlight the things we take for granted: for example, ‘commercial paper is always going to roll over.’ Or, ‘There will always be a buyer for auction rate securities.’ These are [issues] that can stop the company, but we took [those assumptions] for granted.”

- **Engaged membership.** Members said that audit committee members should show up to meetings having read the advance materials and be prepared to ask questions. Members also said committee members should take time between meetings to meet with members of the finance organization, internal audit, and the external auditor. One member said, *“I value members who are always prepared and ask questions, and make an effort to really understand how the company does business.”*
- **Bench strength.** Some members said audit committees should consider a succession plan for the audit committee chair. One member said, *“You have to have quality in depth because you are left with a big hole if something unexpected happens.”*

Some members said their boards require all directors to begin their board service on the audit committee: *“Baptism by fire ... is a great way to get people up to speed.”* Members said this arrangement also benefits the audit committee because new directors often add a fresh perspective. However, they noted that these members have to quickly become familiar with complex technical issues. One member said, *“We have an orientation program for new directors, which includes presentations and sessions by the internal financial people and the general counsel. This runs for two to three hours before the committee meetings.”*

Audit committee education

Members emphasized the need for the audit committee to stay abreast of key governance trends, emerging financial issues, new and evolving accounting standards, and other regulatory developments. PSWACN members said that committee members typically meet these objectives through general director training and education on specific accounting rules.

- **General director education.** Members described a variety of conferences, workshops, or panels for general director education. However, one member said directors that regularly attended such sessions reported diminishing returns: *“We ... found that directors started to [tire of] it ... One session ... is [adequate].”*
- **Accounting education.** Several members said various committee-wide education sessions have proved valuable. One member’s company holds audit committee education sessions on one of the company’s critical accounting policies during each meeting: *“We take a look at all of [our] critical accounting policies [each year]. We take a really deep dive into how the math works.”* The member said these sessions have been valuable in helping the committee understand the process and formulas that the company has in place to apply these policies. Several other members were intrigued by this practice, saying they would adopt it for their own audit committees.

Members also said the external auditor typically provides the audit committee with updates on impending accounting changes likely to impact their companies. But the member added that the timing of these



briefings is important. The member said, *“We ask the external auditor to brief the committee on impending issues, but not those that are too far out to worry about.”*

Executive sessions

Members said their audit committees hold individual executive sessions with several key guests, including the CFO, chief accounting officer, internal audit, general counsel, and external auditor. Members said they use executive sessions to cover items that don’t fit on their traditional audit committee agendas. Executive sessions also afford audit committees the opportunity to learn more about the business and develop relationships with key people inside the organization, as well as the external auditor. One said, *“We block an hour for [executive sessions]. If the [meeting runs longer], we just hold the board up. We should actually block more time because they are so important.”*

Members had differing perspectives on the optimum time for the audit committee to hold executive sessions. Most members said they hold them at the end of the meeting. But one member’s audit committee holds executive sessions at the beginning of the meeting to ensure they receive the proper time and attention, since executive sessions can get “crowded out” otherwise. Another member advocated a more dynamic approach: *“You have got to keep your agendas alive. Sometimes I have executive sessions at the end of the meeting. Sometimes I have them at the beginning. Sometimes I will split up the meeting and have the executive session in the middle. You hold them when you think you have a good topic that you want to talk more about.”*

The chair’s role in enhancing audit committee effectiveness

PSWACN members said they rely on leadership skills honed with years of professional experience to make the best use of the audit committee’s talents and resources, as well as to develop and maintain relationships throughout the company and with the external auditor. The chair plays a critical role in fostering an environment of trust, and can employ several tactics to ensure that meetings run smoothly and that the committee is focused on the most important issues.

The chair fosters an environment of trust

Members said the audit committee chair must establish trusting relationships with fellow committee members, the management team, the internal audit, and the external auditor. Several cited the following practices to establish and maintain these relationships:

- **Set the right tone early.** *“When I first came on as [audit committee] chair, I set up lunch meetings with several executives to establish approachability. I try to establish relationships with people so they will feel comfortable being frank with me.”*
- **Seek input from others.** *“I have conversations with management members and audit committee members before the meeting to make sure I get their input and find out what is meaningful to them. This helps establish trust and a good working relationship.”*



- **Clarifying the role of the audit committee chair.** *“Sometimes when you are chair, other members think they are not equal. I say to them, ‘We are all equal. I am not the boss. I am just one of the directors. I am here to be the spokesperson [for the committee].’”* One member said, *“Rotating the chair helps with that.”*
- **Involve other committee members.** *“Delegating ... is a way to get members to own a particular item to try to stimulate their involvement.”*

The chair maintains key audit committee relationships

Audit committees benefit from the experience and perspective of management, internal audit, and the external auditor, and the chair typically owns these important relationships:

- **The full board.** One member said, *“The chair has to co-opt the board and engage them in the decision-making process. If the audit committee is struggling with something, it should be on the table for the full board.”* Members also said openly communicating with the full board and, in some cases, synching the audit committee’s agenda with the board’s, ensures that there are no overlaps or gaps in coverage of particular issues: *“We talk about overlaps ... with the full board.”*
- **The CEO.** The CEO helps the audit committee by setting and ensuring the right tone at the top throughout the organization. One member said that, in discussions with chief executives, *“The CEOs are always wondering what more [they] can do to ensure the right tone at the top.”* The CEO also represents the company to shareholders and analysts, and the audit committee depends on the CEO to provide these outside stakeholders with a candid description of the company’s strategy and financial performance.
- **The finance organization.** The audit committee depends on the CFO, treasurer, and controller for timely, accurate, comprehensive information about the finance organization. Audit committee chairs also depend on the finance organization to provide them with a better understanding of the complex issues that will be discussed at the meetings. One member cited the importance of ensuring the depth of talent in the finance organization: *“It is ... important for the audit committee chair to go out and meet the people behind the CFO. The quality of the entire organization is crucial.”*
- **The internal audit function.** Members said the audit committee relies on the internal auditor to identify potential problems well before they materialize. *“I meet with the internal auditor as part of an ongoing conversation so they will flag things that are early warning signs [and] so there’s no hesitancy if something emerges.”*
- **The external auditor.** One member said, *“The external auditors are truly independent. I think that relationship is truly valuable.”* Therefore, several members said it is critical for the chair to establish a high level of trust with the external auditor, in particular the lead partner. One member said, *“The key to making the relationship work is confidence – being able to talk in confidence. It is a disaster when you have a conversation and you [later] find out the [details of the] conversation goes beyond the two of you.”*



The chair focuses the committee on the right issues and maintains efficient meetings

Members said the audit committee chair ensures that meetings run smoothly and efficiently, thereby allowing the committee to focus its energy on the most important and relevant issues at hand. One said, *“After Sarbanes-Oxley, there was a lot of boiling of the ocean going on. Now, [we cover] 80% [of] the same [issues] but we’ve improved our effectiveness. We have crisper meetings.”* Members said the following key tactics help ensure that their committees are covering all of the right issues in an efficient manner:

- **Managing a checklist of items.** One member uses a checklist of items to ensure that the audit committee is covering all of its requirements, and its charter is up-to-date: *“I have a checklist that [reflects] the charter. You are always going to need to add things and take things away from the agenda. This also tells you whether you need to update the charter. This has been useful in making sure we cover everything and helping us plot the distribution of time among our agenda items.”*
- **Managing and directing information flow.** The audit committee chair ensures that relevant materials are made available and what the committee receives is organized, summarized, and easy to digest. Members also said the audit committee chair plays an important role in directing information flow to the board. Most members ensure that appropriate documents (reports, minutes, agendas, etc.) are accessible to all board members, so directors can review them and ask follow-up questions.
- **Agreeing on when specific issues will be discussed.** Prior to the meeting, one member said, *“You have to make sure people are being heard from so they are not inserting their opinions at inappropriate times. What causes inefficiency is when members feel they are not being heard from.”*
- **Keeping members focused during the meetings.** One member said, *“There are [several] meeting-management tactics that the chair can do to make meetings more efficient, like overriding irrelevant discussion topics or cutting people off who are wasting meeting time.”*

Conclusion

Financial and economic uncertainty over the last two years has forced boards to revisit many long-held assumptions about the economy and the fundamentals of their businesses. In the wake of the financial crisis, regulators, investors, and other external stakeholders expect more of boards and audit committees, yet they often lack the tools and information to objectively evaluate board performance. For their part, many audit committees are questioning what it means to be effective, over both short and longer-term time horizons. Is it enough for audit committees to simply fulfill the responsibilities prescribed by law or committee charter, or are some other measures of effectiveness also appropriate?

Going forward, audit committees should remain alert to shifting stakeholder expectations, and consider changing people and practices as appropriate to ensure effective oversight given an uncertain economy and a rapidly changing corporate governance environment.



About this document

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading 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.

VantagePoint 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 *VantagePoint* lies in its power 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, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Participants at the network meeting

The members of the network who participated in the meeting were:

- Doug Ammerman, Audit Committee Chair, Quiksilver
- Frank Biondi, Audit Committee Chair, Amgen
- Henry DeNero, Audit Committee Chair, Western Digital
- David Engelman, Audit Committee Member, MGIC
- Bala Iyer, Audit Committee Chair, IHS
- Diana Laing, Audit Committee Chair, Macerich
- Marty Melone, Audit Committee Chair, Internet Brands
- Roger Molvar, Audit Committee Chair, CapitalSource Bank
- Stephen Page, Audit Committee Chair, Lowe's Companies
- Sue Redman, Audit Committee Chair, The Apollo Group

The following members took part in post-meeting discussions:

- Richard Dahl, Audit Committee Chair, DineEquity
- Lou Lavigne, Audit Committee Chair, BMC Software
- Mike Stein, Audit Committee Chair, AIMCO

Ernst & Young partners participating in the meeting included:

- Mark Borowski, Assurance Managing Partner, West sub-area
- Kay Matthews, Vice Chairman and Managing Partner, West sub-area



Appendix 2: Questions for audit committee members

- ?** How does your 2010 audit committee agenda compare with the 2009 agenda? How have priorities changed over the past year? What has been added? What may require less scrutiny?
- ?** To what extent might pending legislative and regulatory changes impact your audit committee's agenda?
- ?** What agenda items do you believe are discretionary? How much of your audit committee's time is devoted to discretionary items?
- ?** What techniques are used by your audit committee to ensure the most efficient use of time?
- ?** How does your audit committee ensure that members are sufficiently informed to ask challenging questions and understand the answers?
- ?** How does the audit committee chair's leadership style impact the committee's effectiveness? How can the audit committee chair ensure candid dialogue in meetings?
- ?** How do you determine what information should be provided to your audit committee? How do you decide what should be shared with other committees or the full board?