

The audit committee journey continues to a higher-functioning committee

Executive summary

Over the past decade, audit committees have expanded their oversight from a review of the financial statements to also overseeing a broad array of accounting, compliance, risk and reporting matters. Board members and external stakeholders view the audit committee as the undisputed workhorse of the board.

Yet, audit chairs worry whether their committees are truly effective. With continued pressures from regulators and investors to do more, and given the upcoming challenges of overseeing major forthcoming changes to US GAAP, many feel they need to find new ways to boost their effectiveness. Unfortunately, the annual review of performance, which typically involves checking the year's activities against the committee charter, offers little guidance. Does a good performance review really mean nothing can be improved? Few audit chairs believe they have exhausted the opportunity to add more value to their committee and to perform their duties more ably.

In that context, Tapestry Networks investigated what leading audit committees are doing to enhance their effectiveness. Tapestry Networks spoke with approximately 60 audit chairs of Fortune 500 companies and with a diverse range of 24 subject-matter professionals, including investors, analysts, legal counsel, internal and external audit executives, controllers, academic experts, standards setters and more. The result is the current issue of *InSights*, which also draws on research by Tapestry Networks on evolving practices in large-bank governance and risk management. (For a full list of the subject-matter professionals who participated, see the appendix, on page 16.)

Research participants reported they expect the pressures on audit committees to continue to increase. In addition to accounting changes and the ongoing effects of the financial crisis, there is the Dodd-Frank Wall Street Reform and Consumer Protection Act to contend with, as well as the new governance, fraud and disclosure requirements mandated by the U.S. Securities and Exchange Commission (SEC). (For more detail, see pages 4-5).

Participants identified four factors that drive audit committee effectiveness and a range of leading practices within these areas that they believe generate higher performance:

1. Having the right mix of skills in the committee and in its support (pages 6-7)
2. Having a skilled, energetic and creative chair (pages 8)
3. Ensuring high-quality content and effective information flow (pages 9)
4. Instituting ongoing performance feedback, backed by high-quality committee evaluations (pages 10)

In addition, the participants identified emerging leading practices for key areas of audit committee work that are particularly important in today's environment:

- ▶ Accounting judgments (page 11)
- ▶ Financial communications with the market (page 12)
- ▶ Enterprise risk (page 13)
- ▶ Compliance and fraud prevention (page 14)

This issue of *InSights* does not purport to supply an exhaustive list of leading practices for audit committees. It does, however, highlight practices that research participants – including audit chairs – find effective. We believe it offers an invaluable resource to other audit chairs and committee members interested in enhancing their own committee's performance.





Sources of audit committee pressure

Audit committees have undergone a dramatic transformation over the past decade. Some research participants expressed amazement when thinking back to what the committee looked like prior to The Sarbanes-Oxley Act of 2002 (SOX), which dramatically changed the role and work of the audit committee.

Today, audit chairs and research participants describe much higher-functioning committees. An adviser said, "Audit committees ... are much healthier and better functioning than [in the past.] They are focused on the right areas, with high-quality directors [on the committee.]" An audit chair said, "[Today] there is more thought leadership on the audit committee. We are asking audit committee members to think, 'If we have an X, Y, Z event, how are we positioned to respond?'" An adviser added, "There is more of a monitoring function, less advisory. In practice, this means as opposed to giving the CEO advice, [board and audit committee members] are more active in oversight on decisions ... they need to help the company avoid disaster, and [they] get involved early ... the audit committee is the watchdog of the board."

Research participants all agreed that the pressure on audit committees is unlikely to let up. Thanks to the financial crisis, investors and regulators are even more stringent in their expectations for boards' and audit committees' oversight activities. Research participants pointed to four significant pressures audit committees will face during in 2011 and beyond.

Accounting standards change

The Financial Accounting Standards Board and the International Accounting Standards Board plan to complete their convergence projects by the end of 2011, and the SEC is in the process of deciding whether to convert to International Financial Reporting Standards (IFRS).¹ Given the focus that the accounting and auditing community has placed on conversion over the past several years, and the politicization surrounding the process, some audit chairs are feeling numb to the issue, and many doubt a full conversion to IFRS will ever take place.² However, an audit chair said, "Convergence is the biggest new topic that has occurred in recent times. I would say that the amount of time that companies will spend this year could be as much as 10%-15% [of audit committee meetings]. And if audit committees don't spend much time on it, they are going to have to play catch-up." Others noted that with accounting change comes an increased risk of misstatements and restatements: "The order of magnitude of these changes is mind-boggling – huge mistakes are possible." An adviser asked, "How do audit committees and companies make sure they have the right resources in place for the execution of standards convergence over the next few years? It seems like a tsunami to me."

The implications of the Dodd-Frank Act

The Dodd-Frank Act has been called the most sweeping change to financial regulation in the US since the Great Depression. It granted new powers to investors, such as say on pay, and it created specific requirements that affect the audit committee. One key concern for audit chairs is the impact of Section 922 of the Act, which deals with whistleblower tips and requires the SEC to provide a monetary award to individuals who provide the agency with "original information" that results in sanctions exceeding \$1 million. The SEC may then award 10%-30% of the total amount of the sanctions to the whistleblower.³ An executive said, "The whistleblower provision is a major problem. It will undermine everything [companies have done to encourage internal whistleblowing]. We've got a challenge on our hands ... [audit committees] will have to work harder on the value system and [will have to] ensure more checking and auditing."

New pressures for transparency

Both the SEC and the Dodd-Frank Act require new corporate governance disclosures designed to equip investors with more information. These disclosures include more on directors' biographies, decisions on assigning directors to the board and its committees, risk oversight and executive compensation. An adviser said, "Investors want more [information.] They say they are not hearing enough from management, and that gives the impression they don't trust management."

Some investors have even called for more information on the activities of the audit committee over the year, as seen in Canadian public company proxy circulars, or more detail on the external auditor's work. In response, the Public Company Accounting Oversight Board (PCAOB) announced that it will consider if auditors should make additional communications to shareholders, beyond the pass/fail opinion. It will issue a concept release offering a range of options, including the so-called "auditor discussion and analysis (AD&A)." The PCAOB's Acting Chairman, Daniel Goelzer, called this "one of our most important projects in 2011," noting "it is clear that there is considerable investor hunger for more insight into the audit and for more insight from the auditor into the company's financial reporting."⁴



An “auditor discussion and analysis” (AD&A)?

An analyst said, “It might make sense to have an auditor’s report, something like an auditor’s discussion and analysis, not to repeat the management discussion and analysis, but to identify issues such as where the company had to make accounting adjustments, changes in principles, how they were resolved, so that investors can understand how the audit committee is spending its time.” The so-called AD&A would offer a robust and substantive overview of the audit strategy, management’s significant assumptions used in critical accounting estimates that have a high degree of subjectivity, the significant risks identified by the auditor and through various other sources, the timing of the audit and the anticipated application of new accounting or regulator rules that may, upon adoption, have significant effect on the company’s financial reporting.⁵

However, many participants questioned the usefulness of an AD&A. One participant said, “My view is, investors wouldn’t want an auditor discussion and analysis. They have not pushed to have the management discussion and analysis attested, which they have a right to do per the AICPA standard, and since they didn’t want that, why would they want an auditor discussion and analysis?”

Calls for more formal communications with the external auditor

Recently, the PCAOB has proposed an auditing standard that would revise requirements for communication, including:

1. An agreement on the terms of the audit engagement, documented in an engagement letter;
2. An overview of the audit strategy, including a discussion of significant risks, the use of the internal audit function, as well as the roles, responsibilities and location of firms participating in the audit;
3. Communications of critical accounting policies, practices and estimates;
4. An evaluation of the company’s ability to continue as a going concern; and

5. Evaluation by the auditor of the adequacy of communications between the auditor and the audit committee.⁶

Research participants familiar with the standard believed the aim is to “ensure the audit committee is engaged in the tough decisions ... where judgment is applied, the close calls, the controversial decisions ... by airing the decisions in the committee, there is better dialogue and better decisions taken.” However, several audit chairs worried that the proposed standard might create a checklist mentality for something that should happen more “organically,” but others felt it “[wouldn’t] substantially alter current practice.”

These additional pressures will require the audit committee to remain mindful of the danger of taking on too many new responsibilities. They must stay focused on effectiveness throughout the year, and at year end, they must consider how best to improve their performance.

1. See American Institute of Certified Public Accountants, “IFRS Primer for Audit Committees,” *Audit Committee Brief*, June 2010.
2. See Audit Committee Leadership Summit, “The convergence of accounting standards,” *ViewPoints*, July 28, 2010.
3. Securities and Exchange Commission, “SEC Proposes New Whistleblower Program Under Dodd-Frank Act,” press release, November 3, 2010.
4. Daniel L. Goelzer, “Update on PCAOB Developments,” speech at the PCAOB SAG Meeting, Washington, DC, October 13, 2010.
5. Mary Hartman Morris, CalPERS Investment Office, letter to J. Gordon Seymour, general counsel and secretary of the Public Company Accounting Oversight Board, June 3, 2010, 4.
6. Public Company Accounting Oversight Board, “PCAOB proposes auditing standard on communications with audit committees, amendments to PCAOB interim standards,” press release, March 29, 2010.

Questions for audit committees

- ▶ Has the audit committee discussed how these, or other, external pressures are affecting the committee’s operations?
- ▶ Has the audit committee discussed how it might communicate its work more effectively to shareholders?
- ▶ Has the audit committee discussed the potential effect of the PCAOB’s proposed standard on communications with the external auditor?

Four factors that drive effectiveness

1 Having the right mix of skills in the committee and in its support

Audit chairs recognize that the expertise, leadership and commitment of people overseeing and managing the company's finance and reporting functions are critical to the audit committee's success. Research participants pointed to two important areas of focus:

Having the right mix of skills among the committee members

SOX's emphasis on the importance of having a financial expert on the audit committee has made recruitment of members that fit that profile a top priority. One audit chair noted, "The effectiveness of the audit committee will be totally dependent on the skills of the [financial experts]." Others recommended also having directors without deep technical knowledge, to ensure the broader questions get asked.

What is the right mix of skills, and how does the audit committee ensure it has the right combination of members? Research participants suggest:

- ▶ **Including members with diverse backgrounds and expertise.** One adviser observed, "It's like building a sports team. You have strengths in defensive and offensive areas, and the audit committee works the same way. The best audit committees are those in which it's hard to find many similarities among individual resumes. They [should] all bring radically different perspectives on business to the table." Another adviser said, "One executive who ran an operations center and had no accounting background [was one of the best audit committee members I've seen.] She was never afraid to ask questions. The accountants might not have understood the issue either, but they didn't want to look stupid."
- ▶ **Casting a wide net when recruiting new members.** While some argued that younger, more energetic members are needed, others praised seasoned experts, saying their years of experience provide the insight needed, especially during a time of increased scrutiny of the audit committee. One adviser said, "I would try to recruit younger people from larger corporations and non-marquee people at smaller corporations ... there are a lot of smart people out there."
- ▶ **Rotating board members into the audit committee.** Some boards actively rotate members into the audit committee in order to get a fresh perspective on various topics and to allow other board members to get an in-depth view of the financials. An audit chair

said, "I look at [being on the audit committee] as a challenge. I am really interested in my companies, in their strategic and commercial [operations]. Being on the audit committee really allows you to see how the company makes money. Also, I am interested in helping to support good governance."

- ▶ **Having a succession plan for the audit chair.** An audit chair said, "You have to have quality and depth because you are left with a big hole if something unexpected happens."

Ensuring high-quality interaction between the audit committee and those who support it

An audit chair noted, "The importance of the people that aren't in the room can't be ignored." Research participants emphasized that the audit chair's role in working with management between meetings is critical; the audit chair has to get "immersed in the [work] of the finance team, the IT team and so on." But some audit chairs caution against a level of involvement that crosses the line from oversight into management.

Participants identified some of the key relationships and leading practices used to maximize these relationships.

The finance staff

- ▶ **Be involved in hiring and on-boarding the CFO.** An audit chair said, "Being part of the hiring process ... helps, because you are sure from the outset that this is the right person for the job. It sets the tone regarding the culture [the CFO] is coming into. It sends the message that the audit committee chair is important." Once a new CFO is in place, leading audit chairs suggest immediately holding private discussions to establish a relationship of candor and respect.
- ▶ **Aim for a close, supportive relationship with the CFO, but maintain objectivity.** Audit chairs said they must be able to constructively challenge the CFO, yet also support the CFO's decisions in conversations with the CEO as needed (for example, a decision to invest in certain areas, despite cost cutting). In

Participants identified skills and support, a superior chair, high-quality information, and meaningful evaluations and performance feedback as the most important drivers of effectiveness.

some cases, the audit chair may also act as a mentor. However, the mentoring relationship should not be allowed to compromise the audit chair's independence. One audit chair said, "Our job is to be skeptical, not to be the best friend of the CFO." Another added, "During audit committee meetings, it is important to be an objective steward of shareholders' interests, but between meetings, be a coach to financial management and help their development."

- ▶ **Gain insight into the bench strength of the finance staff below the CFO.** Audit chairs report more meetings with the tax director, controller, chief accounting officer, treasurer and executive overseeing pensions as risks in all these areas have increased. Approaches to meeting with these executives vary. One audit chair reported, "I attend the finance leadership team meetings. I listen, talk informally, attend dinners and discuss succession planning. I get a view of the quality of the people; [I] see how they perform under stress." Others advocate devoting a day around the board meeting to "management by walkabout," whereby informal, private conversations yield valuable information." Another said, "We added an extra day to our [audit committee] meeting to see the team beneath the team."

Internal audit

- ▶ **Use internal audit in an advisory role.** Several audit chairs highlighted that the head of internal audit has served as an adviser to the audit chair, particularly on issues such as enterprise risk and regulatory change. An audit chair said, "We've brought in [an internal audit executive] who brings a global mentality and has a good understanding of best practices. That really helps. Her idea is for her to lead an assessment in order to have the opportunity to comment on anything we could do better."
- ▶ **Leverage internal audit to help shape audit committee charters and agendas.** Several executives observed that internal audit is providing more input to and reviewing of audit committee agendas before finalizing those agendas with the audit chair. One

audit chair noted the exceptional work the head of internal audit did in analyzing competitor companies' audit committee charters for benchmarking purposes.

- ▶ **Have internal audit guide executives on how to present to the audit committee.** Given that internal audit executives attend audit committee meetings and work closely with audit chairs, several participants agreed that internal audit executives are well placed to provide guidance to their management colleagues. One executive recounted how the audit committee reacted negatively when an executive failed to follow guidance on how best to shape a presentation. Some internal audit executives oversee dry runs of their colleagues' presentations to avoid such situations.

External audit

- ▶ **Have a standing meeting with the external auditor before audit committee meetings.** An adviser noted, "A good practice is to have a standing meeting between the audit committee chair and the audit partner in the 24 hours before the audit committee meeting takes place. They can decide what to focus on ... look at the financials, the press release [to help avoid surprises.]"
- ▶ **Get external audit's view on the quality of key members of management.** External auditors are well positioned to provide an objective opinion of staff, along with benchmark information. An audit chair gave an example: "Whenever we have IT coming to report to the audit committee, we insist that [the external auditor] bring their IT partner. We quiz him or her on his views, versus what we heard from management."
- ▶ **Have a member of the external audit firm's leadership attend an audit committee meeting at least once yearly.** There was a strong consensus that having a member of the external audit firm's leadership attend at least one audit committee meeting a year is beneficial. One chair said it "enables access before you need it and provides the audit committee a view different from [that of] the lead partner. Also, it helps create a firm relationship, not just a partner relationship."

Questions for audit committees

- ▶ How does the audit committee recruit new members? How involved is the audit chair in determining the skills needed on the committee?
- ▶ What is the best mix of financial expertise and broader business experience for today's audit committee?
- ▶ What is the audit committee's succession plan for the audit chair's position?
- ▶ What executive relationships are most important for ensuring the audit committee's effectiveness? What can be done to maximize those relationships? Is there a good balance of constructive challenge and professional support?

2 Having a skilled, energetic and creative audit committee chair

Research participants agreed the audit chair plays a vital role in enhancing the effectiveness of the audit committee. Today, the “CEO of the audit committee” spends significantly more time than other members preparing for meetings and working with the internal auditor, external auditor, general counsel and often staff below this first level both within the company and on the external audit team. Noted one audit chair, “I would estimate the audit committee chair spends 50% to 100% more time than a typical audit committee member.”

Key ways in which the audit chair drives committee performance include:

- ▶ **Carefully crafting the agenda.** Many research participants agree with the audit chair who said, “I have found that it’s important to pay a lot of attention to how the agenda is organized so that the items that are going to take the most volume around them are discussed at the beginning of the meeting. Sometimes I have discussions with members ahead of time to see where they are. It’s important to get their views.” One adviser explained that in practice, “the real work is done in between meetings, when the chair is having a good dialogue [with various parties] on forming the [audit committee] agenda.”
- ▶ **Managing the meetings effectively.** In order to address policy approvals and other compliance items in a thorough but expeditious manner, some committees are making more frequent use of consent agendas or discussion by exception. One audit committee has added additional committee teleconference calls, scheduled between in-person meetings, to cover regulatory and compliance items so they need not be covered in meetings. Such tactics allow committees to set aside time for unplanned discussion in meetings, which is important because “if the agenda stays roughly the same every time, [meetings] ultimately will get sterile.” At one company, the audit committee chair and lead executive work through the meeting beforehand, then work together in the meeting to keep on time. Another audit chair holds a pre-meeting with committee members to talk through not just the agenda, but the substance of meeting content, so that all directors feel able to engage and ask questions.
- ▶ **Spicing it up.** Leading audit chairs meet the challenge of engaging members with a few creative strategies. One said, “As audit chair, I think we’ve got to make it interesting [for members]. I pick a subject matter that is of great interest and approach it at an angle that hasn’t been discussed. For example, profile a certain business line, even if nothing has gone wrong. Leaders from the business will come into a meeting and give some insights into the business, and it’s incredibly interesting. They have some great stories. It always raises governance, oversight and investment questions.”
- ▶ **Being a coach and advocate.** Members of management appreciate having audit chairs make time prior to meetings to discuss meeting presentation content. One internal audit expert suggested, “You should have prep time with the chair; it’s not a good idea to shoot cold. The chairman will give you a sense of balance on what to talk about during a meeting.” The chair’s role as advocate, mentioned earlier, includes backing up the CFO if the latter feels certain investments are necessary but the CEO is in a cost-cutting mode.

Questions for audit committees

- ▶ In what ways could the audit chair customize the agenda to maximize in-meeting and between-meeting time? What else could be done to enhance the efficiency of the committee meetings?
- ▶ How could the audit chair encourage more open dialogue in the meetings? How could the meetings be restructured to increase the amount of dialogue?

3 Ensuring high-quality content and effective information flow

Audit chairs emphasized the value of the right content being delivered at the right time. This is done by:

- ▶ **Sending committee members pre-reading materials in advance.** An executive said, "What I've seen that is most effective is to send members the pre-reading two weeks in advance and don't waste time in the meeting reading – members want to have dialogue."
- ▶ **Offering materials in reader-friendly formats.** Audit committee members often complain about the detail and length of committee materials. One director described the reports as "very elaborate – lots of tables with information." Another complained, "We get pages of numbers being presented to the board for approval." Participants recommended putting "more emphasis on trends – the board needs numbers, but they also need to understand the story behind the numbers and the patterns." Materials should also support more decision-oriented analysis: "The committee is most interested in what's behind [the data] and what management proposes we do about it." More transparency on assumptions would also be highly beneficial: executives should "share with the board what happens if our assumptions are wrong, and how much will it cost us."
- ▶ **Adopting a journalistic approach to reports.** Directors on bank boards and their risk executive colleagues have, as one would expect, spent a significant amount of time over the past 12 to 18 months redesigning their risk reporting to the board and risk committee. Audit committees may be able to draw on the risk organization's experiences to help improve audit committee reports. At one bank, for example, the risk report is "text heavy, with executive summaries at the top of each page ... we don't use [slides]." Some members of that bank's risk organization have taken writing courses to build skills in clear, concise prose and storytelling because "sometimes people who really know the facts can't write, and vice versa." Another company has a similar approach, making use of headers, footers and callout text to ensure the risk report is easy to navigate and communicates key messages clearly.
- ▶ **Having dry runs before meetings.** Some members of management take the lead on testing the audit committee agenda and meeting content. An executive said, "Three days before the meeting, I do a dry run of all presentations with the CFO, corporate secretary, controller, treasurer, myself and assistant secretary. We try to think of things from a board point of view. We ask, 'Does this help? What is right level of detail?'"
- ▶ **More routine updates.** Audit committee members know that it is challenging to keep up-to-date on their companies in between meetings. One participant advocated more executive updates: "Internal audit should send monthly reports on their work. The CFO should send the board monthly updates on the company's performance ... and on the 10 most significant issues management has told the board are 'on watch.'"
- ▶ **Using new technologies to facilitate information flow.** One executive suggested a new idea to deliver meeting materials to members in a timelier, more secure way: "There is [sometimes] a delay in getting the members [pre-reading material], so I'm planning to give them all iPads. With the portals some companies are using, they could get that report in a secure way immediately. If they are traveling, they can take the reading wherever they are going on the iPad."
- ▶ **Get external perspectives.** Several audit committees have adopted innovative approaches to get external input on key issues. One audit chair said on several of his boards, "the CFOs of various companies get together informally a couple of times a year to discuss challenges and share best practices ... it's helpful for the executives ... and provides useful insights for the audit chair and audit committee." Another chair has created an external "advisory committee" to provide independent perspectives to the audit committee on the company's investments (and may soon on litigation issues); the group meets three times a year via conference call and once over dinner with the audit committee. On risk, several chairs said the audit committee "should have external advisors on risk in the same way they have advisors on audit."

Questions for audit committees

- ▶ How can the company improve the quality and timeliness of information prepared for the audit committee? How can technology help?
- ▶ Where would improvements to the existing communications really make a positive difference to the audit committee's effectiveness?
- ▶ How does the audit chair provide feedback to members of management about the quality of information?
- ▶ How does the audit committee ensure it has access to perspectives on the views and communications presented from management?

4 Instituting ongoing performance feedback, backed by high-quality committee evaluations

Only a few audit chairs interviewed for this research viewed their annual committee evaluations as a mechanism to improve performance. In fact, many felt the current approach is insufficient and would likely agree with the audit chair who said, “In general, the committee assessments have become too rote. For example, we ask, ‘How’s the chair doing?’ Everyone just checks the boxes. There is an opportunity for the evaluations to be tied more into the core work.”

The challenge may be in part due to the difficulty in defining the characteristics of “an effective” audit committee. Audit chairs participating in this research agreed that a year without major problems in internal controls or financial reporting would constitute success. An audit chair said, “We’re all happy as long as there are no problems. You don’t want there to be any surprises.”

Nevertheless, audit chairs believe that if done well, performance feedback could provide a real opportunity for audit committees to improve. A good evaluation system would gather and share feedback on an ongoing basis – among the committee members and with management – and at year end.

There are several ways to do this:

- ▶ **Feedback during executive sessions.** An audit chair advocated having these executive sessions at the start of the audit committee meeting: “We do [the executive session] at the beginning [of the audit committee meeting] ... it’s a great way to stay plugged in.” One executive said, “External and internal audit provide feedback on [audit committee] effectiveness in executive session, not on the annual survey. The results are discussed ... in the room.” Some audit chairs fill in the CFO, other finance executives and the external auditor on relevant aspects of the discussion that occurs in the executive sessions.

- ▶ **One-on-ones between the key parties (audit chair, committee members, executives and the external auditor).** One chair explained his open-door policy regarding the feedback loop: “I am very open. Anyone can talk to me any time that I am awake.” An adviser added, “[Feedback] needs trust. [It] is done in the spirit of continuous improvement.” An audit chair said, “[Honest feedback has] always been the elephant in the room” and added that giving feedback is necessary to ensure the committee and individuals improve.
- ▶ **Other evaluation methods.** Many audit chairs reported using detailed, written surveys or checklists to evaluate their committees’ performance at the end of the year. However, some have found candid conversation more effective. One audit chair said, “We’ve got to determine if we’ve got the right people in the [committee] ... most are offended [when such feedback is provided] ... but you have to talk to management teams.” Another audit chair stated that “doing an M&A-style ‘postmortem’ at the end of every year was the best way to evaluate performance and make difficult changes about how to improve.” Some audit committees engage outside consultants: “[We conduct] a specific audit committee evaluation every three to four years with an external consultant.”

Questions for audit committees

- ▶ Does the audit committee conduct an independent evaluation of performance, separate from the overall board evaluation?
- ▶ Given that audit committees often define success as an absence of surprises or “hiccups,” what is assessed in this evaluation? How is effectiveness measured?
- ▶ In what ways could the audit committee evaluation be altered to yield more insightful feedback? From what internal or external stakeholders should evaluative input be sought?
- ▶ How effectively does the audit chair incorporate ongoing feedback from key stakeholders throughout the year?
- ▶ How well does the audit committee provide ongoing feedback to executives?

Leading practices of effective audit committees

Based on interviews with more than 80 research participants, including 60 audit chairs, Tapestry Networks compiled the following recommended practices for four of the most difficult areas of audit committee responsibility.

Accounting judgments

An audit chair said, “There is more risk in how the company forms judgments used in creating the earnings announcements than there is around the 10-Qs and 10-Ks ... because of SOX, for the Qs and Ks you have an army of lawyers and finance people and the external auditor reviewing disclosures. None of this process [for Qs and Ks] is protecting you in the earnings [announcements].” Audit chairs undertake several leading practices to get insight into how their companies apply accounting standards:

- ▶ **Understand where the company falls on a spectrum from conservative to aggressive accounting.** An executive said, “Benchmarking our accounting assumptions against our industry peers and [against companies in] other industries helps us think about where we are and ask why we are there. For example, we make assumptions on the lives of our assets and show that to the audit committee. We then show what we see in other companies in our industry. We can ask, ‘Why does our asset last longer than a competitor’s [asset]?’” An adviser said, “Audit committees should be able to understand the level [of aggressiveness].”
- ▶ **Examine accounting “close calls.”** Research participants saw value in reviewing near misses (such as control issues that were caught or discrepancies that were resolved), with one adviser suggesting, “Every year, identify one to three accounting close calls. Write them up and discuss them with relevant people in auditing and finance.”
- ▶ **Focus on critical issues related to the financial crisis.** Several participants recommended audit committees talk to their auditors and finance teams about areas the SEC and PCAOB believe were particularly problematic, in terms of properly applying auditing and accounting standards, as a result of the financial crisis. These include fair value measurements, goodwill impairments, indefinite-lived intangible assets and other long-lived assets, allowances for loan losses, off-balance-sheet structures, revenue recognition, inventory and income taxes.
- ▶ **Provide easily digestible summaries of accounting changes.** An executive said, “We send an accounting update to all the finance professionals in the company and the audit committee. It started five years ago. We sent one update, and [then] they asked for regular updates. We call it our Charlie-Browned accounting rules. It’s a way to make sure they know what’s going on.”
- ▶ **Hold education sessions on key accounting changes.** Many audit committees hold education sessions on an as-needed basis, led by executives and other experts. One executive said, “Our chair wants to make sure we have the right training for audit committee members. We recently had our external auditor conduct training on the convergence projects, such as lease accounting.”

Questions for audit committees

- ▶ Does the audit committee periodically discuss where the company is on the spectrum in terms of its accounting practices? Is it conservative or aggressive?
- ▶ Does the audit committee talk candidly about accounting close calls?
- ▶ How does the audit committee ensure management is on top of important accounting issues? How does it stay abreast of key accounting changes? How does it ensure management comments on relevant rule and standards proposals?

Leading practices of effective audit committees

Financial communications with the market

Over the past several years, the audit committee has taken on more responsibility for overseeing certain financial communications in addition to SEC filings. Research participants discussed leading practices for the following financial communications:⁷

- ▶ **Press releases.** Audit committees report paying special attention to press releases, which they review for language and tone, as well as for what is said in terms of guidance. An audit chair said, “We go through [the press release] line by line. Directors look at tone. I’m worried about statements like ‘We’ve had a great quarter, but the last month was very challenging.’”
- ▶ **Earnings guidance.** Audit committees are particularly sensitive to forward-looking earnings guidance. One audit chair said, “Generally, every quarter we get investor relations presentations. The audit committee is responsible for reviewing the press release every quarter, and we reaffirm guidance or change guidance based on that.”
- ▶ **Conversations with investors.** It is important to tap the “top of mind for investors.” One audit chair explained, “I couldn’t imagine being on the audit committee and not listening into earnings calls to hear all the investor concerns. That’s just good oversight.” One audit chair highlighted a practice of surveying investors as part of the company’s risk identification process. Occasionally, directors may attend annual investor days. One audit chair said, “I simply walk around the tables. It’s informative to hear the types of questions being asked, and our responses.”
- ▶ **Analyst presentations.** Some audit chairs provide feedback to management on analyst presentations. An audit chair said, “In two of my audit committees, we also look at the management presentation. We don’t approve it, but we look for the right tone, especially [during difficult economic times].”

⁷ For more information, see Tapestry Networks, “The financial communication challenge,” *InSights*, November 9, 2009.

Questions for audit committees

- ▶ How engaged is the audit committee in how the company presents its financials to its shareholders? How does the committee get comfortable with that messaging?
- ▶ How, if at all, does the audit committee review press releases, analyst presentations and other investor-focused materials?

Leading practices of effective audit committees

Enterprise risk

With the increased threats in today's business environment, audit chairs reported varying degrees of ability to oversee risk. For many interviewed for this report, risk oversight is a work in progress. Some leading practices identified by audit chairs include:

- ▶ **Push the board to determine the right risk oversight approach.** Many companies are unclear on exactly who is responsible for the oversight of various types of existing and emerging risks. In one executive's audit committee charter analysis, which compared seven audit committee charters of firms from various industries, the risk oversight section of the charters stood out as having the most differences in wording and content. Some audit chairs have a formal discussion with their board to determine how best to handle risk oversight. One participant said "the audit committee needs to take risk on, or ensure another committee is properly overseeing it; it cannot fall between the cracks."
- ▶ **Prioritize risks.** Audit chairs are constantly exploring the leading ways to prioritize risks. Most say they prioritize risks based on an analysis of the risks' likelihood and the impact if they occur: "What is the impact? Eventually, it will come down to dollars and cents – the bottom line impact if the risk materializes." Some chairs say management might first apply a probability/impact analysis on all of the risks in the 10-K. However, others say the list of risks in the 10-K is often too comprehensive and should only be used as a reference: "The 10-K might give you a framework, but you can't [actively oversee] all of those risks."
- ▶ **Ensure risk reporting to the audit committee focuses on "gross risk."** Some audit chairs suggest boards should ensure they have an understanding of the total magnitude of each major risk (the gross risk) before factoring in management's assessment of the impact of its mitigation efforts (the "net risk").
- ▶ **Devote time to "deep dives" on key topics.** Some companies dedicate generous amounts of time, either within or outside of committee meetings, to focused discussions on risk topics. For example, one company holds sessions that are three to four hours in length between scheduled committee meetings, each devoted to a business area: "The stated objective is to understand the risk and controls in each division, which really means, get to know the business."
- ▶ **Ensure the right board members are present during discussions on risk.** Even if the audit committee "owns" risk at the board level, audit chairs recognize that the expertise of other board members may greatly enhance the committee's discussion of risk. These directors can be invited to participate. An audit chair described an interesting practice: "We have separated our audit committee meetings into two parts. The first is on traditional audit committee issues. [At] the second part, at which all board members are present, we discuss major risk and compliance issues." This enables a more robust discussion of non-financial risks.

Questions for audit committees

- ▶ How does the audit committee ensure it spends sufficient time on compliance and fraud matters?
- ▶ What are the most effective ways to evaluate "tone in the middle"?
- ▶ How does the audit committee keep abreast of the company's greatest compliance and fraud risks?

Leading practices of effective audit committees

Compliance and fraud prevention

A majority of audit committee charters state that the task of overseeing compliance with legal and regulatory requirements is a main responsibility. But how do audit committees ensure compliance with those requirements amidst so much change?

- ▶ **Keep up with compliance changes.** Research participants said the best way to keep abreast of regulatory and compliance change is to have a “knowledgeable team,” with one chair saying, “In the Foreign Corrupt Practices Act (FCPA) area, companies have challenges, and people come in and talk compliance and education. The audit committee chair needs to ask for more specific examples. There is an audit for FCPA violations. Is the internal audit team briefed for red flags? They have to be willing to ask specific questions about red flags on FCPA.”
- ▶ **Monitor “tone in the middle.”** Participants said it’s essential to consider the culture of the company when thinking about compliance and fraud. While all agreed that tone at the top is important, even more important is tone in the middle. “Tone at the top is easy ... tone in middle is what’s important. You’ve got to know heads of businesses ... the second or third auditor, the person who heads up financial for international. To monitor tone there, you have to try to build up some type of relationship.” With significant global operations, several audit chairs recommended having a lead foreign partner from the audit firm participate in audit committee meetings.
- ▶ **Deploy internal audit to do spot-checks throughout the company.** Many audit chairs see internal audit as being on the front lines in the battle against fraud at their companies. They recognize internal auditors “have relationships all over the company” and are well positioned to detect instances of fraud by talking to the all types of employees. Some chairs say sending internal audit to do spot-checks at unsuspecting places throughout the company can have a good signaling effect: “We send internal audit off the beaten path. They think, ‘Nobody goes there, so if the audit committee does, that’s a sign they take it seriously.’”
- ▶ **Have the external auditor brief the audit committee.** Audit chairs recognize that because external auditors have a much more detailed view of the company’s operations and interact with more company employees on a day-to-day basis, the audit committee can greatly improve its oversight of the company’s fraud risk through “regular check-ins with the external auditors. We get briefed regularly.” An audit chair said, “I am going to ask the auditors, ‘Do you see anything in the financials that might suggest something strange is going on?’”
- ▶ **Make sure there is clarity in the charter.** Some company charters explicitly state how often and with whom the audit committee must review compliance with new regulations.

Questions for audit committees

- ▶ How does the audit committee ensure it spends sufficient time on compliance and fraud matters?
- ▶ What are the most effective ways to evaluate “tone in the middle”?
- ▶ How does the audit committee keep abreast of the company’s greatest compliance and fraud risks?

Conclusion

Audit committees have been transformed over the last few years. Their workload has grown significantly, with a broader set of responsibilities, and much more diligence is required in every aspect of their work. In the few years following SOX, the solution to the problem was relatively simple: more and longer meetings.

But few audit committee members can commit much more time than they already are. They want to be more effective and efficient in their operations, and they look to the audit chair to make this happen. Audit chairs have taken this task to heart and some have introduced innovative new practices to make the best use of limited time.

The net effect has been positive. In the years of working through the implementation of SOX, the audit committee was commonly seen as the least desirable committee of the board. Why would anyone not interested in accounting want to be on the “compliance committee?” But now, with the broadest set of responsibilities of any committee and the opportunity to explore the business in more detail than any other committee – or the full board for that matter – the audit committee is both the board’s workhorse and the best learning opportunity for directors. Not surprisingly, some boards insist that new directors are appointed to the audit committee – not, as before, as some form of initiation – but because it is the best way to get to know the company, its key executives and the way the company represents itself to those the board represents: the shareholders.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm that brings leaders together to solve complex problems. Since 2002, networks convened by Tapestry Networks have tackled some of the most significant strategic challenges facing institutions and society through public-private collaboration, including raising standards in corporate governance in the United States, Canada and Europe and developing strategies for a more sustainable health care environment in Europe. Tapestry Networks convenes seven audit committee networks sponsored by Ernst & Young that collectively consist of nearly 150 individuals, who chair more than 200 audit committees and sit on over 300 boards at some of the world’s most admired companies. For more information, please visit www.tapestrynetworks.com.

About this document

InSights is produced by Tapestry Networks to provide assessments of key issues of interest to audit committee members in North America. It will be distributed by Ernst & Young and Tapestry Networks. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

The views expressed in this document represent those of the individuals who participated in the research. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks.



Appendix: Research participants

For this report, Tapestry Networks drew upon approximately 60 interviews with audit chairs of Fortune 500 companies who participate in Ernst & Young's audit networks. For more on these networks, see www.tapestrynetworks.com/networks/net_audit.html. It also drew on relevant research from Tapestry Networks' Bank Governance Leadership Network, www.tapestrynetworks.com/networks/net_bank.html.

In addition, Tapestry Networks interviewed a range of leading subject-matter professionals including:

- ▶ **Martin Baumann**, Chief Auditor and Director of Professional Standards, Public Company Accounting Oversight Board
- ▶ **Kenneth Bertsch**, Executive Director, Morgan Stanley Investment Management
- ▶ **Richard Chambers**, President and CEO, Institute of Internal Auditors
- ▶ **Andrew Cotton**, Partner, Ernst & Young, LLP
- ▶ **Julie Daum**, Practice Co-leader, North American Board, and, CEO Succession Practice, Spencer Stuart
- ▶ **Charles Elson, Edgar S. Woolard, Jr.**, Chair in Corporate Governance and Director of the John L. Weinberg Center for Corporate Governance, University of Delaware
- ▶ **Peggy Foran**, Chief Governance Officer, Vice President, and Corporate Secretary, Prudential Financial
- ▶ **Cindy Fornelli**, Executive Director, Center for Audit Quality
- ▶ **Stephen Frimpong**, Vice President, Internal Audit, Kimberly-Clark
- ▶ **Drew Hambly**, Vice President, Corporate Governance, State Street Global Advisors
- ▶ **Janice Harrissis**, Vice President and Director, Internal Audit, Texas Instruments
- ▶ **Mark Lundvall**, Vice President of Investment Proxy Research, Fidelity
- ▶ **Mary Morris**, Investment Officer, Corporate Governance of Global Equities, CalPERS
- ▶ **Al Paulus**, Partner, Director of Professional Practice – Auditing, Ernst & Young, LLP
- ▶ **Jeremy Perler**, Director of Research, ISS/CFRA, a division of MSCI
- ▶ **Chris Plath**, Vice President and Corporate Governance Analyst, Moody's
- ▶ **Kevin Reilly**, Partner, Director, National Professional Practice Group, Ernst & Young, LLP
- ▶ **Russell Ryan**, Partner, King & Spalding
- ▶ **Mal Salter**, James J. Hill Professor of Business Administration, Emeritus, Harvard Business School
- ▶ **Carolyn Sizemore**, Vice President and Controller, CSX Corporation
- ▶ **Marsch Smith**, Senior Vice President, Legal Affairs and General Counsel, 3M
- ▶ **Jim Traut**, Director of Enterprise Reputation and Risk Management, H.J. Heinz
- ▶ **Dominique Vincenti**, Vice President of Internal Audit and Financial Controls, Nordstrom
- ▶ **Don Zimmerman**, Partner, Ernst & Young, LLP

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