

## Improving audit committee performance

On September 25, 2014, members of the Audit Committee Leadership Network (ACLN) convened in New York for their 28th stand-alone meeting. One of the sessions was a members-only discussion on how audit committees can improve their performance in the face of mounting challenges and demands from different stakeholders, including regulators who see audit committees as important gatekeepers for protecting investors and the public.

This *ViewPoints* presents a summary of the key points, along with background information and selected perspectives that members and subject matter experts shared before and after the meeting.<sup>1</sup> For further information on the network, see "About this document," on page 10. For a full list of participants, see Appendix 1, on page 11.

### Executive summary

The ACLN members touched on four main topics in their discussion of audit committee performance:

- **Audit committee focus of attention** (*page 2*)

An effective audit committee has to focus on the most critical issues, and these have expanded well beyond financial reporting. Audit chairs listed cybersecurity and risk management more generally as areas that have risen to the top of their agendas in recent years. Meanwhile, compliance with regulations, concerns about the quality of operations, and oversight of activities in remote locations continue to be a challenge. The broad range of issues that many audit committees oversee today means that they must always be ready for unexpected yet time-consuming situations, such as a serious cybersecurity breach or an investigation of compliance lapses.

- **Audit committee composition and education** (*page 4*)

Financial expertise continues to be essential on the audit committee, and having more than one financial expert is helpful. Yet members were unanimous in asserting that audit committees need more than financial expertise to deal with their current responsibilities. Qualifications such as strategic and operational experience, industry expertise, and geographical knowledge are also important, as is the ability to look at financial issues from a non-technical perspective. These requirements mean that a program of ongoing education and training for members is highly recommended.

- **Emerging good practices** (*page 6*)

Audit chairs mentioned a number of specific practices that can help boost the audit committee's performance. They can encourage engagement from other members of the committee by having them assume responsibility for areas in which they have expertise and by holding more executive sessions with only committee members present. Audit chairs also recommended ways of keeping committee meetings more focused, such as asking management to summarize and condense meeting materials and taking care

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<sup>1</sup> *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

of less critical issues in interim reports. To ensure good communications within the committee and with other relevant groups, audit chairs recommended frequent and open dialogue with management, internal audit and external audit, and broad outreach within companies to understand what is going on.

▪ **Evaluation of audit committee performance** (page 9)

Most audit committees conduct annual evaluations, which can be led by the audit chair or by the lead director as part of an overall board evaluation. Some members said that bringing in outside parties can be helpful, while others were skeptical. Evaluation tools often include surveys, but members underscored that frank discussions are the most helpful, and input should be solicited from management and the auditor. Members were open to the idea of disclosing the process used for evaluations (though not the results), as recently requested by the Council of Institutional Investors.

For a list of discussion questions for audit committees, see Appendix 2, on page 12.

### Audit committee focus of attention

Today's audit committees face pressures from many quarters. The Securities and Exchange Commission (SEC) has highlighted the importance of boards as gatekeepers whom investors and the SEC rely on to protect their interests and help defend securities laws. At the same time, the scope of the audit committee's functions has expanded significantly in the last several years. For many ACLN members, the risk of overload makes effective committee operation absolutely critical as the committee strives to meet the needs of its stakeholders.

ACLN members noted that to be effective, the audit committee must focus on the issues that have or will have the most impact on the company. As one member put it, *"The most important thing audit committees can do is to set the agenda and not let others do it."* Members described a range of issues that their audit committees are currently targeting for deeper analysis, issues that go well beyond oversight of financial reporting, which is the core of the committee's activity. They described a systematic approach to addressing them: *"We have a rolling three-year map in terms of deep dives. Some are annual, some are less often. We report on them to the full board."* These items include both perennial concerns and issues that have emerged in the last several years:

- **Cybersecurity.** Several members said that among the many risks they worry about, those centered in cyberspace are the most urgent and the most challenging. The SEC has also raised the issue, holding a roundtable in March 2014.<sup>2</sup> One member said, *"The biggest thing is cybersecurity. How do you know you've done enough? It's the hot topic. Risks from third parties, for example, are front and center."* Another member commented, *"It often seems event oriented, but it's not an event. There's always something to be learned. I was adamant regarding [recent attacks] – it can happen to anyone."* For one member, the issue of cybersecurity raised not only the issue of controls but also the question of talent and experience within the company: *"For example, do we have former FBI [Federal Bureau of Investigation] agents on staff?"*

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<sup>2</sup> For more information, visit [Cybersecurity Roundtable](#).

Other members also mentioned how uneasy they are with the problem of cybersecurity. One remarked, *“After meeting with the FBI, you go to the CIO [chief information officer], who says things are under control. Then you go home praying there are no incidents.”* Another insisted, however, *“You have to keep going until you get the answer.”*

- **Risk management.** In addition to highlighting cybersecurity, many members discussed the importance of overseeing risks and risk management more broadly. A member noted, *“An appropriate trend of the audit committee is to spend time on big risks and what the company is doing about them. It’s the audit committee equivalent of the board spending time on strategy.”* Another member added, *“It’s about focusing on forward-looking risks, figuring out where logjams will be.”* One member suggested that the nature of the risks that have been emerging recently – such as the sudden rise of the Islamic State – raises the question of whether existing risk management systems are adequate: *“You can’t make up scenarios like this, so how do we deal with them?”*

Other members highlighted organizational issues relating to board oversight of risk, as multiple committees may oversee subsets of risk. One member remarked, *“The real question is, are audit committees and boards revisiting where certain risks need to reside and making sure all risks are appropriately assigned?”* Another member said, *“A challenge for the audit committee is to coordinate with the risk committee. We meet jointly once or twice a year, and we have at least two overlapping members.”* The member noted that the audit committee often retains overall responsibility for risk oversight and must take care that gaps do not emerge.

- **Compliance.** Overseeing compliance continues to be a challenge, as members emphasized both before and during the meeting. They mentioned the need to satisfy regulators in diverse government agencies such as the SEC, the Department of Justice, and the Department of Health and Human Services. A member said, *“An issue we are wrestling with is what regulators want from the audit committee and the level of detail required. How do you satisfy them but not drop the ball on other work? We try to prioritize what we’re doing, on a quarterly basis, so that we’re managing instead of reacting.”* Another member noted how significant a compliance failure can be: *“The regulators can put you out of business. Also, regulations are changing dramatically. There’s a lot of complexity. Regulations do have financial risks.”*

At the same time, some members reported that their audit committees are meeting the challenge of compliance successfully: *“The audit committee is spending less time on compliance because we have good processes in place. We understand what needs to be reported and how, so we don’t need to spend hours in the committee on it.”*

- **Operations, especially in remote locations.** A member explained the continuing importance of operations oversight: *“Audit committees also need to think about fundamental operations – changes in margins, inventories, and the like – because it helps you anticipate problems ... The focus of the audit committee should be to look at the quality and integrity of operations.”* Members noted that far-flung outposts of the company, such as overseas operations, may require extra attention: *“We worry about the*

*audit processes and structures within small, remote locations, which may not have huge financial impact but can have major reputational impact.”*

Members also mentioned the issue of litigation and the challenges of IT governance as key concerns. In a pre-meeting conversation, Don Zimmerman, an EY partner in assurance services, said that he and his colleagues have noticed many audit committees focusing on precisely the areas listed above, adding that they have also seen a strong interest in how internal audit is spending its time, how companies are managing their tax structure, and how the new revenue recognition standard should be implemented.

At the meeting, members noted that the audit committee needs to be ready to respond when new issues emerge or existing issues suddenly become urgent. One member said, *“There’s always room on the committee for the surprise. There hasn’t been a year when the audit committee hasn’t added a meeting.”* Another member reflected, *“You can’t predict when something will happen that requires a lot of time.”*

### **Audit committee composition and education**

ACLN members noted that the experience, skills, and temperament of audit committee members play a critical role in the committee’s effectiveness. In pre-meeting conversations and at the meeting, network members discussed a number of qualifications, beginning with financial expertise but going well beyond that to include several other types of knowledge and skills.

### **Financial expertise remains essential**

The New York Stock Exchange listing requirements state that all members of the audit committee must be financially literate and that at least one member must have recent and relevant financial experience.<sup>3</sup> ACLN members reaffirmed the importance of financial expertise, with one noting, *“Having a critical mass of people who have been intimately involved in disclosure preparation and execution is hugely important. Someone could sue us if we didn’t understand how financial statements are prepared.”* Another member said that having more than one financial expert is helpful because *“I have others who can understand what I’m talking about.”* Also, having multiple financial experts distributes the workload and provides a safeguard against the sudden loss of the only expert on the committee. A recent EY review of audit committee reports from Fortune 100 companies found that these companies’ audit committees had an average of 2.8 financial experts.<sup>4</sup>

Regarding more general financial knowledge, a member pointed out that a certain level of expertise is almost a given on the boards of large companies because of the type of people selected to serve on those boards: *“Former executives have a high level of financial experience. They have judgment. They can ask the right questions.”*

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<sup>3</sup> New York Stock Exchange, [“Audit Committee Additional Requirements,”](#) in *Listed Company Manual* (New York: NYSE Euronext, 2013), 303A.07.

<sup>4</sup> EY Center for Board Matters, [“Audit Committee Reporting to Shareholders: 2014 Proxy Season Update,”](#) *Let’s Talk: Governance*, no. 8 (August 2014), 3.

### Broader experience is also required

Nevertheless, ACLN members were almost unanimous in asserting that audit committees need more than financial expertise to deal with their current responsibilities. Members pointed to diversity of experience as helpful for the committee's oversight of risk, for example. One member said, *"Business elements are critical for understanding enterprise risk management, which has less to do with financial expertise but more with business judgment. Take third-party vendor risks: on the surface, financial metrics might seem reasonable, but do they really reflect other business aspects of these risks?"* Other members also mentioned some of the hard-to-quantify risks from third-party vendors, pointing to their role in recent cybersecurity breaches.

Members highlighted the following desired skills and qualifications:

- **Strategic and operational experience.** People with direct experience running a business are valuable. A member said, *"I look for a person who is collaborative but who has also dealt with difficult issues and has been in the C-suite, like CFOs. People who have put their money where their mouth is. People who have done a lot of acquisitions, since we're also trying to grow the business."* Other members pointed to operational experience: *"There's a tendency to have people with strong operating backgrounds in general."*
- **Industry expertise.** Several members mentioned the importance of expertise in the company's industry – often an issue raised by activist investors. A member said, *"A good audit committee is not composed only of accountants and people in finance – you have to have industry knowledge."*
- **Technical and geographical knowledge.** Members said that issues like cybersecurity have made technological expertise more attractive, and one member noted that the recent tribulations of some global companies have been due partially to a lack of understanding of major overseas markets and their regulatory environments: *"It helps to have people with real experience working in that country."*
- **Fresh eyes.** Several members suggested that a lack of financial expertise can even be an asset in some respects. A member said, *"One benefit of the non-financial person is that they will ask that simple wide-eyed question that the technical types will miss."* Another member was of the opinion that *"you shouldn't get brownie points for having more and more financial experts."*

### There are special qualifications for the audit chair

The audit chair, who often shoulders a larger share of the committee's burden, faces extra challenges. One member noted that the chair must have the flexibility to ignore other obligations when necessary: *"If someone can't call their own shots, it's a real problem. You have to be able to respond completely when you're needed."* The member suggested that an audit chair should preferably be someone who has retired from full-time work, and for audit chairs, even more than for other committee members, some members said the number of committees served on should be limited. The New York Stock Exchange listing

requirements state that if an audit committee member is on more than three audit committees, the board must determine and disclose that it is not impairing performance.<sup>5</sup>

Another member talked about the more involved role of the committee chair: *“The chair needs a deeper background. Good audit committee governance requires the audit committee chair to be intimately involved in conversations with the controller and CFO. It doesn’t have to play out in front of the audit committee ... The leadership of the audit committee provides the bridging.”*

### **Training and education should be ongoing**

Many ACLN members suggested that an important answer to the problem of expertise is not necessarily to find new members for the committee, but rather to help existing members acquire the knowledge needed. A member said, *“We try to calibrate where members are and where we need education.”* EY partner Don Zimmerman said that the external auditor is participating more in bringing new audit committee members up to speed, providing reviews on such topics as critical accounting matters, comment letters from the SEC, enterprise risk management, and other important areas.

Members also noted that the audit committee’s sources of education need to extend beyond the company and the auditor. One member suggested that what audit committees need, when it comes to the challenges they face, is broader perspectives and expertise. This member recommended that committees consult outside experts as needed: *“Audit committee members have to get a broader education, either on their own or by having consultants come in. Too often, we rely on management, but they have their noses to the grindstone focusing on the short term.”*

### **Emerging good practices**

In pre-meeting conversations and at the meeting, ACLN members mentioned a number of practices that they have found helpful in boosting the audit committee’s performance. These practices fall into several broad categories: encouraging engagement by the entire committee, summarizing materials and streamlining meetings, and fostering open communications and information flow.

Members’ comments on good practices echoed many of the points made in the guidance for audit committees published by the National Association of Corporate Directors,<sup>6</sup> as well as practices identified in research for a January 2011 *InSights* publication on audit committee performance, which provides considerable detail in several areas.<sup>7</sup>

### **Encouraging engagement by the entire committee**

ACLN members noted that a disproportionate load typically falls on the committee chair, and they highlighted the importance of engaging other members of the committee. *“It’s so different when you have the minds and the input from several smart, engaged people, versus having to try to figure it out on your*

<sup>5</sup> New York Stock Exchange, *“Audit Committee Additional Requirements,”* 303A.07.

<sup>6</sup> National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on the Audit Committee* (Washington, DC: National Association of Corporate Directors, 2010).

<sup>7</sup> Tapestry Networks, *The Audit Committee Journey Continues to a High-Functioning Committee*, InSights (London: EYGM Limited, 2011.)

own,” said one member. Members mentioned three techniques that audit chairs can use to encourage member engagement:

- **Meet with committee members to discuss their contributions.** Some members noted that the chair can meet individually with committee members to discuss their specific expertise and the responsibilities they might be able to assume in meeting the committee’s obligations. A member said, *“I asked a person who is more operational to go through the MD&A [management discussion and analysis], asking, does this make sense?”* Members also described having technology experts and compliance experts take the lead in their respective areas. *“We try to give everyone something they own as part of the committee,”* said one.
- **Have committee members run part of the meeting.** A member said, *“What I’ve also done is to cede my chair role to one of the members for some part of the meeting. By having them involved in running the meeting, it keeps everyone engaged. I’ll still coordinate an issue, but I’ll have them run things.”* Other members highlighted the importance of clearly conveying to members that their participation in the discussion is expected.
- **Take more time with only the audit committee present.** A member mentioned the benefits of members-only meetings for drawing people out: *“People are at ease to express concerns and disagreements.”* Several members said that it is useful to confer privately in advance of the main meeting. One said, *“I start the audit committee meeting with a brief executive session with just the committee. Is there something we need to spend more time on?”* Another took a similar approach: *“I meet with the directors a few minutes before each meeting. What is their take? I ask what else should be on the table.”*

### Summarizing materials and streamlining meetings

Many ACLN members said that the audit committee is drowning in the vast amount of information it receives. They said that several approaches are helpful for managing the volume and streamlining meetings:

- **Summarize the content.** Members said that documents can be structured to allow easier perusal. One member said, *“You always find in [the materials] the following: a one-page memo from the chief audit executive describing the objectives for the meeting and the actions needed by the audit committee; in each tab, a one-page memo with the actions required and comments, [plus] two sections, one for essential content and one for content that would be nice to read.”*
- **Reduce the volume.** A member also noted that management can cut down on the amount of material it sends: *“You can condense the material – it’s more work, but it can be done. The chair has to insist on it, and it requires involvement from the chair. The chair has to get the documents in advance and work with management.”*
- **Keep the meeting on track.** Members said that the meeting itself needs to be managed so that the discussion does not veer off into excessive detail or less relevant issues. A member said, *“You need to train management to go through the highlights.”* Another remarked, *“A lot of it is controlling the meeting – it can drift very easily.”*

- **Use interim reports to minimize clutter.** A member noted that some issues can be dealt with outside the meetings: *“We do interim reports between meetings, in which management answers questions on certain issues so that they do not have to be raised in the meetings.”*

Participants in research for *InSights* mentioned similar approaches, noting that the agenda items that are going to require the most time should be discussed at the beginning of the meeting and adding that the use of consent agendas can help expedite policy approvals and other compliance items.<sup>8</sup> EY partner Don Zimmerman noted that more boards are using electronic board portals to help directors navigate materials and reduce the need for hard copy.

### Fostering open communications and information flow

Several members mentioned the importance of good communication within the audit committee itself and between the committee and other relevant groups. They suggested several ways to improve dialogue:

- **Maintain a policy of open dialogue with the company and the external auditor.** Several members stressed the importance of frequent and open dialogue between the audit committee and management, internal audit, and external audit. One member said, *“I meet with the audit partner six times a year and with internal audit six times a year. I meet the CFO three times a year. We discuss what we can do better.”*

One member described more extensive interactions with the external auditor: *“It used to be you had an executive session [with the auditor present] after the audit committee meeting. Now we have one before. If there is an issue around the disclosures, we have worked through it. It has made a huge difference.”*

- **Reach out broadly within the organization.** Members have also found it helpful to go deeper into the company hierarchy, meeting with people lower in the ranks to understand what is really going on. This tactic has entailed more travel to remote offices, including international travel. One member described going into detail on compliance to get a deeper understanding: *“We started a few years ago to take a month of violations and go through them with the ethics team, in order to understand the process.”*
- **Ensure that a member of management is accountable for each area of risk.** Members described being systematic about who would be responsible for and speak about key risks: *“We have three columns: what the risk is, who in the board is responsible, and who is accountable on the management side.”* ACLN members have previously noted that this approach allows the audit committee to pose questions to management without all the questions having to be answered by the CEO or CFO.

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<sup>8</sup> *Ibid.*, 8.

## Evaluation of audit committee performance

ACLN members were interested in discussing methods of evaluating the audit committee's performance, noting that standard methods of evaluation have not been established yet. They discussed several aspects of their own evaluation programs, which usually take place on an annual basis:

- **Who conducts the evaluation?** Members described various approaches. Many said the audit committee itself conducts the evaluation, led by the chair. Some said the evaluation is conducted by the lead director as part of an evaluation of all the board's committees. Another said the nomination and governance committee leads a similar effort.

Some members have had positive experiences bringing in outside parties to conduct the evaluation: *"I've seen it work well, leading to constructive feedback and behavior change."* However, other members expressed reservations about this approach: *"I'm a firm believer that you need to do it yourself – it needs to be open and straightforward. I'm not a big fan of getting outside help. It gets to be more academic. We know what needs to get done."* A few members saw benefits under some circumstances: *"I have seen value in external review, but probably more at the board evaluation level. There can be a role for that, but it depends on the maturation stage of the board. For a board that is less comfortable with each other, external reviews can play a role."*

- **What techniques are used?** Members described using both formal questionnaires and more informal conversations, often in combination. A member mentioned using standard questions year to year for comparability, but added that *"there's also the opportunity to offer comment, which is more enlightening."* Others stressed the need for dialogue: *"If you have collegiality and good relationships around the table, the best approach is to have a really good discussion on what could be improved and what can be done differently."* One member added, *"You need the opportunity to say things privately. Conversation is as important as written evaluations."*

One member described an approach that is effective both for engaging and assessing committee members: *"Every year we sit down with people at the company and go through detailed questions and answers about the business. It really reveals that everyone is engaged – it's very embarrassing not to be."*

- **Whose input is solicited?** Evaluations rely on input from committee members, but they may also involve others on the board and beyond. One member said, *"You need input from management as well as the external auditor."* Another member noted that the external auditor can help benchmark performance: *"I meet with the audit partner on the account to look at audit committee best practices and where we stand compared to others."* Others mentioned input from the internal auditor.
- **To whom are the results communicated?** Members said the results of evaluations are not disclosed beyond the board. A member said, *"Results are shared with the committee and shared with the full board. We would not disclose them [to anyone else]."* Another member said, *"We have a board meeting to discuss the evaluations of all the committees."* However, members were open to the idea of

disclosing the process used for the evaluations (though not the results), as recently requested by the Council of Institutional Investors.<sup>9</sup>

One member noted that the evaluation process doesn't necessarily have to be the same from year to year: *"I try to change up the process. It gets stale otherwise."* Other members underscored that any problems exposed have to be dealt with swiftly. One member warned, *"If you don't get it fixed, it will rear its head at exactly the wrong time. You don't need a survey to figure that out."*

## Conclusion

The demands on today's audit committees have put a premium on performance, and audit committees are responding on several fronts. They are focusing their efforts on the most critical issues, such as cybersecurity, risk management more broadly, and compliance. In recruiting members, they are seeking strategic, operational, and industry-specific experience, while implementing training programs to enhance the knowledge of existing members. They are also implementing practices that ensure engagement by the whole committee and promote effective dialogue with management and the external auditor. Meeting materials are streamlined and summarized, and meetings are kept on point.

To continue to improve, audit committees are conducting regular self-assessments, using formal questionnaires that they supplement with *"heart-to-heart discussions on how we are doing."* Only through continual effort can audit committees satisfy a critical criterion of performance: *"Do we have the right people doing the right thing at the right time?"*

## About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

*ViewPoints* 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 *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. 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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<sup>9</sup> Council of Institutional Investors, *Best Disclosure: Board Evaluation* (Washington, DC: Council of Institutional Investors, 2014), 3.

## Appendix 1: Participants

Members participating in all or part of the meeting sit on the boards of 45 public companies:

- Les Brun, Audit Committee Chair, Merck
- Dick Harrington, Audit Committee Chair, Aetna and Xerox
- Michele Hooper, Audit Committee Chair, PPG Industries
- Labe Jackson, Audit Committee Chair, JPMorgan Chase
- Olivia Kirtley, Audit Committee Chair, U.S. Bancorp
- Marie Knowles, Audit Committee Chair, McKesson
- Mike Losh, Audit Committee Chair, Aon and TRW Automotive
- Blythe McGarvie, Audit Committee Chair, Viacom
- Heidi Miller, Audit Committee Chair, General Mills
- Chuck Noski, Audit Committee Chair, Microsoft
- Tom O'Neill, Former Audit Committee Chair, Archer Daniels Midland
- Bill Osborn, Audit Committee Chair, Caterpillar
- Guylaine Saucier, Audit Committee Chair, AREVA\*
- Tom Schoewe, Audit Committee Chair, General Motors
- Jack Tai, Audit Committee Chair, Royal Philips NV\*
- Chris Williams, Former Audit Committee Chair, Wal-Mart Stores

\* *Member of the European Audit Committee Leadership Network*

EY was represented in all or part of the meeting by:

- Steve Howe, Americas Managing Partner
- Frank Mahoney, Americas Vice Chair of Assurance Services



## Appendix 2: Discussion questions for audit committees

- ? What issues are currently at the top of your audit committee's agenda? How have the committee's priorities shifted in recent years? What is driving these changes?
- ? What are some of the specific challenges and dilemmas associated with these issues and the audit committee's oversight of them?
- ? What are the most important skills and experience needed on the audit committee? How are these changing?
- ? What are some of the trade-offs and challenges of putting together an effective audit committee?
- ? What qualifications are important in the audit committee chair?
- ? What practices have you implemented that have been helpful in improving performance?
- ? How does your committee absorb and process the information it receives? How does it ensure that it receives the right information?
- ? Are there notable practices around specific issues, like cybersecurity and compliance, which should be highlighted?
- ? Do you have additional ideas for what might be helpful regarding any of the committee's activities?
- ? What evaluation approaches seem to work best? What are the advantages and disadvantages of different approaches? Who provides input and in what ways is their input solicited?
- ? What is the impact of evaluations? When have your evaluations changed how the audit committee does things?
- ? To whom should the results of evaluations be communicated?