



## Audit committee composition

On 22 November 2013, members of the European Audit Committee Leadership Network (EACLN) met in Rome to discuss the issue of board and audit committee composition, among other topics.<sup>1</sup> For this session, members were joined by Dominic Schofield, Senior Client Partner, Korn/Ferry International. For a biography of Mr Schofield, see Appendix 1, on page 9.

This document summarizes key points that Mr Schofield and members raised in the discussion, along with background information and perspectives that Mr Schofield, members and other experts shared before the meeting.<sup>2</sup> For further information about the network, see "About this document," on page 8. For a list of participants, see Appendix 2, on page 10.

## Executive summary

As audit committees struggle to manage their evolving responsibilities in the shadow of the overarching issue of risk and its management, they are reassessing the skills and experience needed by the committee, and boards are adjusting their strategies for recruitment. Several themes emerged from the discussion in Rome:

- **Financial expertise remains fundamental** (page 2)

An increase in responsibilities for most audit committees has not reduced the need for financial expertise, which remains a core requirement. On boards that lack finance committees, a focus on both the risks and opportunities involving finance has created a need for broader knowledge of financial matters, including issues such as liquidity and capital structure. Mr Schofield and some members noted that having more than one financial expert on the committee helps drive discussion, and they said that ideally all members of the board should have a certain level of financial literacy.

- **Non-financial expertise and soft skills are increasingly important** (page 4)

Despite the continuing importance of financial expertise, the audit committee's new responsibilities are putting a premium on other skills and expertise as well. Deeper industry knowledge, combined with broad business experience, expertise in specific issue areas like technology, and soft skills such as the ability to challenge management in a constructive manner are all among the capabilities audit committees seek.

- **A tough environment for recruiting is driving new approaches** (page 5)

The challenges of the current recruiting environment include gender quotas and director compensation that varies across jurisdictions and has not grown to match increased workloads. To satisfy the expanding requirements for skills and experience in this environment, boards are relying on more systematic approaches that target specific skills using longer-term succession planning. Alternative pools of candidates are drawing interest, including younger candidates and candidates from other sectors and geographies.

<sup>1</sup> In another session, members discussed audit firm retender and rotation Professor Maurizio Dallocchio of SDA Bocconi School of Management and Dr. Maurizio Lauri, chair of the board of statutory auditors at UniCredit. See European Audit Committee Leadership Network, "[Audit firm retendering and rotation](#)," *ViewPoints*, 10 January 2014.

<sup>2</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.

For a list of discussion questions for audit committees, see Appendix 3, on page 11.

## Financial expertise remains fundamental

EACLN members began the discussion by outlining the evolving role of the audit committee. Echoing comments made by participants in research for an *InSights* report on audit committee composition,<sup>3</sup> they noted that audit committees have taken on many additional responsibilities, often in response to the overarching challenge of risk oversight. A member remarked, *“Ten years ago, all we did was review the financial statement and press release. Then we had scandals, recession and the resulting litigation. The audit committee is now focused on integrity and quality of operations, not just financial reporting.”* Members also mentioned areas of responsibility such as oversight of international operations, litigation and investigations, cybersecurity and the impact of political shocks.

Nevertheless, EACLN members and Mr Schofield made it clear that financial expertise remains a core requirement for audit committees. A member said, *“The assumption is that it is there. It is not the whole story, but it is essential.”* Another member said, *“I can’t imagine an audit committee without someone that has a financial background.”* As one member noted, *“Our core business is financial data.”*

## An intensified focus on finance

If anything, the financial crisis may have illuminated a need for broader financial expertise, going beyond auditing and accounting to encompass oversight of financial risks and opportunities. A member explained, *“We became very interested in risk management, liquidity and counterparty risks. There is a lot of activity on impairment. After the crisis, share buybacks and capital structure were on the agenda, so the question became, could the audit committee become the alter ego of the finance organization and challenge their ideas?”* While some boards have delegated this responsibility to a specialized finance committee, others have kept it in the audit committee: *“Some companies separate out financing, but it’s so entwined with risk management that it is better to put it in one box.”*

## Depth and breadth of knowledge

Some members emphasized depth of financial knowledge. One member said, *“You need one financial expert to have a level of detailed challenge to the financial organization.”* Another member remarked, *“In the audit committee, we get into the substance of the matter. In really complex judgments, I need audit committee members to take on discussion with the financial director and the lead audit partner. You need a higher level of skills.”*

Other members raised the question of how many members of the audit committee should be financial experts, an issue on which policymakers differ somewhat. See tint box on the next page. One member thought that all audit committee members should possess at least some financial expertise: *“I believe that financial expertise and basic knowledge is a must in every member. Seven out of 10 managers have a financial background, but you have to build on that to be a future board or audit committee member.”* In a separate meeting between members and investors that also took place in Rome, an investor suggested that more than one expert was necessary to have a full discussion: *“Our position is that there should be at least two financial experts on the committee so they could potentially debate one another.”* At the same time, some members

<sup>3</sup> Tapestry Networks and EY, [“Greater business challenges call for stronger audit committees.”](#) *InSights*, August 2013.

noted that an audit committee consisting of only three or four members is limited in how many of them can be specialists in financial matters, as other expertise is required as well.

A few members noted that financial knowledge is a requirement that extends beyond the audit committee: *“There is an expectation of a threshold level of financial expertise in any board member.”* Mr Schofield concurred, bringing in the perspective of a recruiter: *“You need to be financially skilled to be on a board. You need a high level of financial literacy. It is hard to select you if you don’t have it. It’s the language of boards, and if you can’t speak it, you can’t perform, given the speed of decision making.”*

### Examples of regulation and guidance regarding audit committee financial expertise

Regulations and corporate governance codes in the European Union and the United States typically specify that at least one member of the audit committee should have accounting, auditing or financial expertise, but some codes and proposed legislation go further:

- **EU Directive on statutory:** At least one member shall have competence in accounting and/or audit.<sup>4</sup>
- **European Commission proposal on audit policy:** One member should have expertise in audit and another should have expertise in accounting and/or audit. The committee members as a whole shall have competence relevant to the sector in which the audited entity is operating.<sup>5</sup>
- **UK Financial Reporting Council:** At least one member should have recent and relevant financial experience.<sup>6</sup>
- **Spanish Corporate Governance Code:** All members, particularly the chairman, shall be chosen with reference to their knowledge and background in accounting, auditing and risk management matters.<sup>7</sup>
- **German Corporate Governance Code:** The chair shall have specialist knowledge of accounting and internal control.<sup>8</sup>
- **New York Stock Exchange listing requirements:** All members should be financially literate, and at least one must have recent and relevant financial experience.<sup>9</sup>

<sup>4</sup> European Union, *“Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006.” Official Journal of the European Union*, 9 June 2006, page 103.

<sup>5</sup> European Commission, *Proposal for a Regulation of the European Parliament and of the Council on Specific Requirements Regarding Statutory Audit of Public-Interest Entities* (Brussels: European Commission, 2011), page 51.

<sup>6</sup> Financial Reporting Council, *Guidance on Audit Committees* (London: Financial Reporting Council, 2012), page 4.

<sup>7</sup> Comisión Nacional del Mercado de Valores, *Report of the Special Working Group on the Good Governance of Listed Companies* (Madrid: Comisión Nacional del Mercado de Valores, 2006), page 31.

<sup>8</sup> Commission on the German Corporate Governance Code, *German Corporate Governance Code* (Frankfurt am Main, Commission on the German Corporate Governance Code, 2012), page 10.

<sup>9</sup> New York Stock Exchange, *“Audit Committee Additional Requirements.”* in *Listed Company Manual* (New York: NYSE Euronext, 2013), 303A.07.

## Non-financial expertise and soft skills are increasingly important

Though EACLN members made a point of confirming that financial expertise remains a core requirement for audit committees, they also emphasized the importance of several other skills and areas of knowledge, which, like depth of financial expertise, have come to the fore due to heightened concern over a wide range of risks. As one member put it, *“The challenge is understanding the full spectrum of risks,”* which another member said *“requires a mosaic of competencies.”*

In pre-meeting conversations and at the meeting, members and Mr Schofield identified several competencies that are increasingly important:

- **Sector knowledge.** Several members emphasized the importance of understanding the business at a deep, industry-specific level. One member said, *“It’s not enough to have audit and accounting expertise; you also need operational expertise. We need people with specific industry expertise, and we also need that on the broader board level.”* One advantage of sector expertise that members mentioned was the ability to spot risks: *“We don’t need technicians, but people who can look forward. We need people steeped in operations, who can say, here’s a black swan – what have we done about it?”* Another member cited industry-specific compliance expertise: *“Compliance is very big now, so you need someone who understands compliance risks and not just financial risks.”*
- **Broad business experience.** At the same time, there were those who argued against relying too much on specialists in certain areas. One member said, *“We need to have people who can understand any of those issues, who can consult with experts and decide what’s right.”* Some members pointed to the board’s increasing responsibility for risks in general and said that breadth of knowledge is an advantage: *“It’s important to have a wide understanding of the risks to companies, which calls for a variety of experiences.”*
- **Technological expertise.** Noting the increasing importance of technology, a member said, *“You do need someone with a technical background.”* Another member added, *“There is a new world out there, which is critical to the success of our companies. We don’t pay enough attention to technology and big data.”*
- **Knowledge of specific issue areas.** Members brought up several other issues that benefit from expert input, such as international operations and legal matters. One member said, *“We need legal support in the audit committee. It is unbelievable how much we need lawyers around us.”* In pre-meeting conversations, a few members mentioned the impact of public policy on companies, not only in the area of compliance but more generally: *“You need someone attuned to the public issues of the day.”*
- **The ability to challenge constructively.** Members brought up several soft skills that are essential for board members. An EY partner saw parallels with the skills auditors need: *“The audit committee chair or member has the same challenge as the external auditor. You need courage, skepticism and the ability to challenge [management].”* A member concurred, but emphasized the need to be constructive in interactions with management: *“We are all on the same team, but with different roles. You need to be constructive and enquiring, have alternative perspectives and have the courage to guide them down an alternative path, working with management to get to the right answer. Style is important.”*
- **Other soft skills.** A member brought up the importance of teamwork on the board: *“The board is effective if people work together. They must debate, but they must also converge. Some brilliant people*

*are just diverters.” Another member said, “You have to have empathy to get information, to understand messages, to influence people.”*

Research for *InSights* identified many of these characteristics as well,<sup>10</sup> and a survey of board directors and CEOs conducted by the Korn/Ferry Institute in 2012 flagged several of them as important for board members in general, including breadth of experience, a deep understanding of the business, and technological expertise. This survey also identified traits such as independence, courage and the ability to receive feedback.<sup>11</sup> One member suggested that these non-financial skills and assets may be so important that someone without formal financial qualifications who possesses them may still be a valuable member of the audit committee: *“One of my audit committee members is the CEO of a major company. He is not an accountant or auditor – he would not tick that box. But he is a very valuable member.”*

## A tough environment for recruiting is driving new approaches

As EACLN members noted, boards must put together the portfolio of desired skills without making the board too large to be effective. Adding to this challenge are a number of difficulties around recruiting, which have resulted in changing – and varied – recruitment strategies.

### Workload and remuneration issues

Several EACLN members mentioned the challenges of recruiting qualified board members, especially audit committee members, given the increased workload entailed by the expanding responsibilities of the audit committee. One member noted, *“It’s getting onerous to be on a board, especially the audit committee.”* Another said, *“For the audit committee, the right capabilities are hard to find. There are older, retired auditors and younger finance directors. Because of the workload, the finance directors are not allowed to sit on more than one outside board, so the population is limited.”* Mr Schofield commented, *“After the great recession, the time commitment for directors has gone up. There is no shortage of people wanting to join boards, but they are only taking two or three [mandates].”*

Mr Schofield suggested that inadequate compensation may be adding to the problem, particularly for European boards interested in recruiting directors from the United States: *“Compensation levels have not gone up. They vary across Europe, with Switzerland and Spain at the top, the UK in the middle, and France and Netherlands at the bottom. The US has very different rewards with stock. That makes [recruiting] quite hard because there is a flow of interest in European, UK and Swiss boards to bring in US expertise. There is not much interest the other way, though. There are political issues, but compensation needs to be addressed.”* A survey of director remuneration across Europe in 2012 found that median basic board fees were €197,500 in Switzerland versus €20,000 in France.<sup>12</sup>

### The impact of quotas

Members touched on the impact of new diversity quotas, such as the requirement in several countries that women constitute a certain percentage of the board (for example, 40% in France by 2017, 30% in Italy by 2015, and 40% in Spain by 2015).<sup>13</sup> In pre-meeting conversations, several members reported positive

<sup>10</sup> Tapestry Networks and EY, *“Greater business challenges call for stronger audit committees.”* pp 5–8.

<sup>11</sup> The Korn/Ferry Institute, *What Makes an Exceptional Independent Non Executive Director?* (London: The Korn/Ferry Institute, 2012), pp 6, 10.

<sup>12</sup> Hay Group, *Non-executive directors in Europe: Pay practices, structures and diversity of leading European companies* (Philadelphia: Hay Group: February 2013).

<sup>13</sup> Russell Reynolds Associates, *“European Board Composition: A Time of Change.” In Touch with the Board, 2013.*

experiences in working toward these quotas. One member said, *“We have found some very good women, which we would have missed without the quota.”* A few members were dismayed by what they had seen so far: *“Lots of appointments are purely cosmetic, not helping boards become more cohesive and better.”*

However, most members saw the effort to recruit women as adding to the difficulty of getting good board members. While there are highly qualified women, they are sought after by many companies: *“These women, once identified as effective, are in very high demand.”* A member pointed out that the pipeline for board directors does not have enough women: *“The real problem is the lack of depth in the executive pool of women: the glass ceiling – there aren’t enough women in the executive ranks.”*

This challenge will continue to grow over the coming years, as gender quotas proliferate. Shortly after the meeting in Rome, the European Parliament approved a directive that would require listed companies (with at least 250 employees) in the European Union to meet a 40% quota for women on their boards by 2020 (2018 for companies with public-entity ownership). The proposal passed in a 459 to 148 vote, though it must still be approved by the Council of Ministers.<sup>14</sup>

### **A more systematic, longer-term succession planning process**

A few members noted that their boards do not recruit for specific committees, preferring instead to find board directors who are capable of sitting on any committee. However, given the challenging recruiting environment and the need for increasingly specific skills, other directors, including directors interviewed for *InSights*, said their boards refer to a matrix of skills, aiming to target gaps as they select candidates. Based on the matrix, the nomination and governance committee draws up a short list of the board’s needs.

Mr Schofield also brought up the value of a skills matrix, and noted that a systematic, proactive approach was becoming more common in his work with boards: *“Our relationship with boards has changed. Ten years ago we did one-off rather than repeating assignments. Now we work with boards over multiple years on succession with the nominating committee. We can look at the whole suite of skills that are going to be needed.”*

Planning ahead is important when appointing an audit committee chair, because as a member remarked, *“It’s a risky venture to go into a company and chair the audit committee on the first day.”* Mr Schofield described a common practice: *“If someone has never chaired an audit committee or is a first time non-executive director, it is now the norm to have them join with a view to becoming audit committee chair in six to 18 months ... The ideal is to plan the succession.”*

### **Casting the net wider**

Boards are also beginning to look beyond their traditional networks and pools of candidates to find qualified directors. Mr Schofield commented on the recruiting process: *“Whether it’s search firms or the boards themselves, boards have to look far and wide at the beginning. Go way beyond. It does take time, so plan ahead.”* In pre-meeting conversations and at the meeting, EACLN members and Mr Schofield mentioned several alternative pools of candidates:

- **Younger, less experienced people.** A member said, *“There is an effort to cast the net wider, so boards are more receptive to less experienced, younger people. For example, it might be the number two person in finance.”* Mr Schofield concurred: *“If there’s a strong push for diversity, there’s increasing*

<sup>14</sup> Roberta Holland, [“European Parliament Backs Quotas for Women in Non-Executive Board Seats.”](#) *Compliance Week*, November 26, 2013.

*pressure to go below the executive and board level, to controllers, for example, and others one level below financial directors.” A survey of large European companies found that the average age on appointment is lower for female directors.<sup>15</sup> One member, however, mentioned going to the other end of the age spectrum: “Where are we going to find [a wider range of skills and experience]? In older people who have the experience, so we need to raise the limit on board ages.”*

- **Other industries and sectors.** A person lacking experience in the industry may be a viable candidate, but there are limitations. Mr Schofield said, *“Someone with very strong functional experience can move between sectors because they bring along a technical skill. But you are unlikely to go from retail to mining, for example.”* A member agreed: *“It could work for some enterprises.”*
- **Other geographies.** Recruiting board directors from other countries can bring challenges of distance and language, but members also saw advantages: *“Someone coming from another geography could be a good addition – these people add a lot to the discussion.”* Surveys indicate that the percentage of foreign nationals on boards is increasing significantly in some European countries, but less so in others. For example, Switzerland saw a rise from 47% in 2009 to 61% in 2012, while Belgium went from 35% to 36% during the same period.<sup>16</sup>

Have emerging technologies such as social media eased the challenges of finding the right people? In a pre-meeting conversation, one member remarked, *“It doesn’t change the fundamentals at all.”* Mr Schofield elaborated: *“There is disintermediation [as boards use social media rather than recruiters], but it is not likely to arrive at the top level. We need to assess emotional intelligence, learning agility – [candidates] need to display the wisdom needed to deal with change. This needs to be measured. It’s a very intimate process.”*

Directors interviewed for *InSights* noted that the need to tap the pool of less-experienced candidates has elevated the importance of training and support for new board members. Directors mentioned informal mentorships as well as formalized training programs. Commenting on this trend in a pre-meeting conversation, Mr Schofield remarked, *“It’s challenging, but there have been good examples of people growing into the role. It requires the chairman to support and mentor the person into that role.”*

## Conclusion

Today’s audit committees have taken on new responsibilities even as their core duties remain as important as ever. As a result, financial expertise remains a critical competency, but the skills and experience sought after by audit committees have also expanded to include such elements as sector experience and knowledge of specific issues like technology and international operations. Moreover, the soft skills that enable effective cooperation among committee members and with management and the external auditor remain important. To find these capabilities (and those required by other committees of the board) in a recruiting environment that includes gender quotas and compensation issues, boards and recruiters are approaching recruitment in a more systematic manner, using matrices of skills to plan for both current and future needs. They are also looking to new pools of candidates, mostly younger people and people in other industries and geographies.

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<sup>15</sup> Russell Reynolds Associates, [“European Board Composition: A Time of Change.”](#)

<sup>16</sup> [Ibid.](#)

## About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European 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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## Appendix 1: Biography of Dominic Schofield

Dominic Schofield is a senior client partner in Korn/Ferry Whitehead Mann's London office. He is a member of the board and CEO of the services practice.

Mr Schofield brings to the firm a decade's worth of executive search experience, having served as a consultant with another major international firm, focusing on boardroom and industrial appointments, prior to his current position. Previously, Mr Schofield worked for a leading British political party as a senior aide to the then party leader and as deputy head of research and policy.

Earlier in his career, Mr Schofield spent five years in the board practice of a boutique search firm. Additionally, he served as an adviser to the British home secretary (minister of the interior) between 1995 and 1997.

In the early 1990s, Mr Schofield lived and worked in Russia, where he was a journalist for a number of publications and media outlets. He has also lived in Kazakhstan and the Middle East.

Mr Schofield earned a master of arts degree in Russian and International relations from the University of St Andrews. He is also a graduate of the Chicago Booth School of Business Accelerated Development Program for senior executives.

He is fluent in Russian and has a strong working knowledge of Italian, Spanish and Arabic.

## Appendix 2: Participants

Members participating in all or parts of the meeting sit on the boards of nearly 40 large-, mid- and small-capitalization public companies:

- Mr Les Brun, Audit Committee Chair, Merck\*
- Mr Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- Mr Carlos Colomer, Audit Committee Chair, Telefónica
- Mr Ángel Durández Audit Committee Chair, Repsol
- Dr Byron Grote, Audit Committee Chair, Unilever
- Mr Lou Hughes, Audit Committee Chair, ABB
- Dame DeAnne Julius, Audit Committee Chair, Roche
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Mr Hans-Joerg Rudloff, former Audit Committee Chair, Rosneft
- Ms Guylaine Saucier, Audit Committee Chair, AREVA
- Mr Jakob Stausholm, Audit Committee Chair, Statoil
- Mr Jack Tai, Audit Committee Chair, Royal Philips Electronics
- Ms Martine Verluyten, Audit Committee Chair, STMicroelectronics and Thomas Cook
- Dr Bernd Voss, Audit Committee Chair, Continental AG
- Mr Mario Zibetti, former Chairman, Internal Control and Risk Committee, Fiat Group

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

- Mr Christian Mouillon, Global Risk Management Leader
- Mr Mark Otty, Area Managing Partner, EMEIA
- Mr Felice Persico, Global Vice Chair, Assurance

\* *Member of the Audit Committee Leadership Network of North America*

### Appendix 3: Discussion questions for audit committees

- ?** How much financial expertise does the audit committee need, and what kind? How does the committee's need for members with financial expertise differ from its need for financially literate members?
- ?** Are there differences between what a board needs and what an audit committee needs in terms of expertise and experience? How would you prioritize the needs of the audit committee?
- ?** How important is specific sector experience compared with broader senior-level business experience? How do you balance the requirements?
- ?** What are the most significant challenges your board faces in recruiting new audit committee members? Do the increasing demands on board directors generally, and audit committee members specifically, make it more difficult to recruit the best directors?
- ?** Should the "traditional" board recruitment process change? How is the pool of candidates for boards and audit committees changing?
- ?** How can the audit committee support new members?