Audit Committee Leadership Summit

May 2018

VIEWPOINTS

Audit committee effectiveness

For members of the European and North American Audit Committee Leadership Networks (EACLN and ACLN), improving the effectiveness of their audit committees is a perennial challenge, driven by the need to address new and unfamiliar issues even as traditional audit committee concerns remain as demanding as ever. On April 16–17, 2018, the two networks met in London for their 13th annual summit, which included a session on audit committee effectiveness.

For list of participants, see Appendix 1, on page 11.

Executive summary

The audit chairs discussed good practices in three areas:

- **Assessing the audit committee and its chair** *(page 2)*

  Audit committees identify opportunities for improving effectiveness by assessing their performance on a regular basis. They use a range of approaches, including formal questionnaires and one-on-one conversations, and they gather input from management and their external auditors, as well as from their own members and other members of the board. Outside assistance with the process can add rigor and perspectives gleaned from other boards.

- **Keeping the audit committee up-to-date and informed** *(page 5)*

  To stay in sync with constantly changing regulations and standards, audit committees talk to people both inside and outside the company, often tracking new requirements from their earliest stages of development. Some committees have members of management gather and synthesize information, and most try to carve out time and even extra meetings for deep dives on key issues, including new and complicated areas of oversight (such as cybersecurity), as well as regulatory changes.

- **Onboarding new audit committee members** *(page 7)*

  Audit chairs noted that onboarding is crucial in helping new audit committee members become effective, and they highlighted the importance of quality interactions between incoming members and key executives, other board members, and the external auditor. One objective of these interactions is to ensure that new members fully understand the business of the company and the risks it faces.

For list of discussion questions for audit committees, see Appendix 2, on page 13.

Assessing the audit committee and its chair

The first step in improving effectiveness is identifying areas for improvement. Most boards conduct periodic, systematic assessments of their performance, including evaluations of individual committees of the board—an exercise that stock exchange listing requirements and corporate governance codes often require.[1] A 2017 Spencer Stuart governance survey found that 98% of boards in the S&P 500 had undertaken some kind of evaluation process, and a similar 2014 survey by Heidrick & Struggles found that around 70% of the top 400 listed companies in Europe performed an annual evaluation.[2]

Typically, evaluations include the performance of committees as well as of the full board. Many members said that their audit committee assessments were part of the board's overall evaluation process. But in some cases, the audit committee conducts its own, separate self-evaluation. *"The company should do it every year,"* a member noted.[3]

Collecting and analyzing information

EACLN and ACLN members described different methods of gathering data, identified several sources of input, and highlighted the benefits of third-party assistance.[4] Data-gathering methods included the following:

- **Questionnaires.** One member said in advance of the meeting, *"We rely on an excellent self-assessment questionnaire. I used it with the audit committee members and the management team to identify areas for improvement. It turned out to be helpful, normalizing expectations about what's good. We became more effective."* At the meeting, members also mentioned questionnaires,[5] though one warned against overly lengthy surveys: *"The biggest change we made a couple of years ago was to change to a simplified questionnaire, more general in nature. It focuses on what is done well and what needs to be improved. In addition, we added other topics, like the relevancy of the agenda. By doing long questionnaires, we found that we got questionnaire fatigue. It ends up not being useful."*

- **One-on-one conversations.** A member reported, *"We have a lot of one-on-one interviews and then a presentation and a judgment about whether there's room for improvement. We get the view of the full board on the audit committee, in an open and frank discussion."* Another member said, *"I call individual members of the committee by phone and ask them to give their thoughts on the meeting and what they'd do differently, asking for advice … My advice is to do it one-on-one so that you get genuine feedback."* One member saw such conversations as supplementary to surveys: *"I like to have a one-on-one discussion with each member. It's a matter of style. You take the result of the survey but then add the nuance from speaking directly."*

- **Informal discussions.** Members noted the value of supplementing the once-a-year approach with less formal assessments throughout the year. *"It's useful for an audit* *committee to reflect after a meeting on how it went. Ongoing feedback allows meetings to occur in a more efficient way,"* one member said in a pre-meeting conversation. Another elaborated at the meeting: *"Annual assessments are great, but you should be able to address issues as they appear. What do we need to put into the board agenda to make things better? You don't want to wait a year for the concerns to come out."*

Members noted that an assessment process should gather information from fellow board members, but also from other key stakeholders:

- **Members of management.** One member said, *"I have regular discussions with the CFO [chief financial officer], so I hear about issues."* Another had only recently approached management, but found it useful: *"I have always done assessments to understand what's working well, but for the first time, I formally asked management what they thought about the audit committee and its effectiveness, and it was nice to get the feedback. Management first thought it was a test! I had to reassure them that it wasn't and that we genuinely wanted the feedback."*
- **The external auditor.** Audit chairs see their external auditors as helpful sources of insight about committee effectiveness. A member said, *"I talk to the external auditor—if you have a good relationship, you can ask what they think."* Another added, *"I have frequent telephone calls with the external auditor. They also let me know when they see an issue."* Several members pointed out a key benefit of this feedback: *"Your auditor has experience across companies, so they can bring additional knowledge to your situation."* The external auditor can provide input on how well an audit committee interacts with management, for example, or how well the committee works together as a team.

Several members said that they receive third-party assistance with their evaluations, not necessarily every year but on a regular schedule, such as every third year. This assistance may be required in some corporate governance codes. For example, the UK Corporate Governance Code states that board evaluations at FTSE 350 companies "should be externally facilitated at least every three years," and the company's annual report should note any other connections between the external facilitator and the company.[6]

Members saw multiple benefits from third-party assistance. *"It brings in an outside perspective, but also more views. You get input from fellow committee members that you would not get if you did not have a third party,"* one member noted. Third parties can bring rigor to the process and, like the external auditor, can offer perspectives gleaned from working with other boards: *"It is helpful to have a proper and independent view,"* a member said, and another added, *"It helps us understand where we stand in comparison to other listed companies."*

Assessing the audit committee chair

Formal assessments of the performance of the audit committee chair are less common than assessments of the committee, members noted. One remarked, *"It's not something I do. We* *do regular assessments and look at how to improve, but do I do a strong self-assessment? It's hard to monitor your own performance unless you have metrics or benchmarks to measure against."*

More typically, this assessment is an element of the overall committee assessment. An ACLN member explained, *"We have a set of questions, and the corporate secretary speaks with audit committee members, key management, and the auditors. It includes feedback on the audit committee chair … It's integrated with the overall committee self-assessment."* Another member said, *"I do read self-critically the comments from the rest of the committee—I take them very seriously!"*

The evaluation is often supplemented by informal conversations. One member mentioned both a previous committee chair and the audit partner as helpful resources: *"For me, it's maybe a comparison to the prior audit chair, who is still on the committee. I do a lot of checks and balances with him to see if there are things I can do better … It's also helpful to work with the audit partner. We meet before and after the audit committee meeting. I ask him, How am I doing? What could I do differently? I think about this as an ongoing assessment instead of just a once-a-year evaluation."*

Experience on other boards is helpful for benchmarking performance, an EACLN member noted: *"It's fly-by-wire here, to tell the truth. I do what I think I need to do. I try to stay ahead of the curve and get feedback from the audit committee, since they also sit on other audit committees."*

In every case, members noted, encouraging honesty and openness is key. A member drew on experience as an executive: *"As a manager, feedback was crucial. I worked hard at creating an environment where people could tell me what they needed to tell me."*

Acting on the results

Members touched on how they implement what they learn from evaluations. One member said, *"From an evaluation, you identify issues and you track them like any internal audit issue, and down the road, you check on the progress. New issues can be added at any time."* Another added, *"There were some situations that came out of the audit committee self-evaluation, particularly regarding [enterprise risk management] and cyber. These were company specific, where we identified them and kept track of them and revisited them. But it's not always done with the same rigor everywhere."*

Several members remarked on the importance of assessing individual members as well as board processes and then following through with actions based on those assessments. One member said, *"Evaluation of board members, committee members, and the chairman is more important that what the audit committee does and how they do it. It's important to give good, constructive feedback. I have seen board members modify behavior and become more constructive members of the board. [I have also seen] boards where … they realize they need* *to change out the chair. There have been other times when the feedback didn't take and people left the board … If you have members who are not pulling their weight, you cannot keep them forever."*

Keeping the audit committee up-to-date and informed

EACLN and ACLN members raised two issues that fall under the heading of education: keeping up-to-date on new regulations and standards, and conducting deep dives on issues of particular complexity and importance.

Keeping up-to-date on regulations and standards

Audit committees need to stay abreast of new and changing standards, regulations, and guidance. These can come from governmental regulatory agencies like the Financial Reporting Council (FRC) or the Securities and Exchange Commission, but they also emerge regularly from non-governmental standards-setting bodies such as the International Accounting Standards Board. At times—such as after the 2008 financial crisis—these can strike companies as an avalanche of complex requirements to be analyzed and implemented, often under heavy time pressure.

What does it mean for an audit committee to stay on top of all these new requirements? An ACLN member noted in advance of the meeting, *"You need to know enough to discharge your oversight responsibilities. It's not the audit committee's job to be, for example, tax accounting experts, but we need to know enough to make sure it's being taken care of in the company."* At the meeting, a member added that the depth of the company's involvement in a particular issue is a factor in how deep the audit committee goes: *"Two companies of mine are relatively big in their space. They have taken leadership roles in interpreting the revenue recognition standard as it applies in their industry. It's important for bigger companies to step out with an active role in industry groups, and as audit committees, we need to keep up with them."*

EACLN and ACLN members speak with people inside and outside their firms as they seek to stay current with standards and regulations:

- **The head of reporting.** The head of reporting (or the controller or chief accounting officer) monitors and applies accounting standards and other financial reporting requirements and is therefore an obvious point person in this area. A member said, *"We have a regular session every quarter that the controller puts together on drafts, etc."*

- **General counsel.** The general counsel and the legal team are often responsible for compliance more broadly. A member said, *"I asked the general counsel to help me understand all the regulations we are subject to. I asked for a meeting with the lawyers involved with specific regulatory rules, and we went through them."* Another said, *"The legal department will at least once a year run through regulatory changes. I get a two- or three-page document."*

- **Line and functional leaders.** Operational managers may also be a resource, especially for industry-specific rules. A member said, *"I have a program to sit down with different department heads to get a flavor of what's going on, in order to translate that to the board."*
- **The external auditor.** Prominent among resources outside of the company is the external auditor. *"Audit firms do a good job of keeping you up to speed,"* a member said. Others added that auditors can draw upon the broad experience of their firms. One noted that representatives from a firm's national office can provide helpful presentations on particularly complex regulations or standards.
- **Regulators.** The regulators themselves sometimes provide direct input to audit committees: *"The FRC sends letters to audit chairs on what they found in their inspections and what they will focus on."*

Members said that it is important to gather information about important changes from different perspectives. One suggested asking everyone who presents to the audit committee to include an update on the regulations that are most relevant to their role: *"Get the head of tax, the head of treasury, the head of compliance—make sure that you're asking each management person to address regulatory changes. They can probably capture the main points."*

A combination of resources can help an audit committee track emerging standards and regulations as they develop—when they are still concept releases or exposure drafts—allowing the committee to exercise oversight all the way from initial analysis to final implementation. One member said of a new set of complex financial reporting requirements, *"We addressed it with a long lead time because we knew about it with a long lead time."* Another member's audit committee takes a similar approach: *"We get the white papers and green papers on European Union initiatives—I always ask the auditors to be very proactive. We have a detailed discussion when it's still at the legislative level, so we can be super prepared."*

One member described an unusual approach to integrating input from various sources: *"There's a lawyer who serves as the chief audit committee officer and spends 50% of his time supporting the audit committee. He interacts with the tax department, legal, CFO, and internal audit on behalf of the audit committee. He prepares the agenda and leads the process for getting materials together. Otherwise, the CFO or head of legal department would have to do it, and it would be difficult for them to prioritize this and find the time."* Another member reported, *"Our head of internal audit does a similar job for the audit committee. He helps consolidate information and thought leadership that the audit committee should know, including regulatory issues."*

Going deeper on key issues

Issues that are complex and difficult, requiring more attention and discussion, can be especially hard to squeeze into an audit committee's meeting agenda. Members mentioned topics that may be unfamiliar or technical in nature, yet potentially very strategic or associated with significant risks, citing blockchain and cybersecurity as examples.

Members said that they sometimes struggled to address issues that called for deeper dives. Finding the time, rather than the experts, is often the problem: *"If there is a topic that is seen as important, it just needs to be built into the agenda and experts brought in. It's not hard to bring them in, but it is hard to find the space in the agenda to do it."* A member described the same dilemma in a pre-meeting conversation: *"We have not been successful doing it at every meeting, but it's an objective. Usually, it's 30-minute bites. As we lay out the audit committee calendar, we try to set aside time for that. We might specify the topic, if possible."*

Carving out additional meetings is necessary in some cases, a member noted: *"We've got some topics where we need more understanding. On some boards, we've allocated time to look at issues outside the committee meeting itself, but that is exceptional. That happens if we need a couple of hours, rather than 45 minutes."* Another member mentioned two additional meetings per year in which deep dives are typically on the agenda: *"We have an annual strategy session for the audit committee, where we will review our agenda, charter, and one to three deep-dive topics. We also have an annual deep dive—a full day of deep-dive issues."* One member brought up a more structural solution that might be helpful for issues requiring ongoing attention: *"One way to find the space—rather than by crowding up the agenda—is to create a separate committee."*

Input from shareholders

Reflecting a general trend toward more engagement with shareholders, members said that shareholder input can be helpful on certain topics. A member noted, *"One thing I am starting to see more and more is interaction between board members and shareholders. It is a growing interaction with an important constituency. More often it is on governance questions or compensation questions."* Another member described one way of structuring the interaction: *"We have the non-executive chair, with the audit committee and compensation committee chairs, go meet with the top 10 shareholders every year without management. We are briefed on topics such as succession planning, compensation, governance, and sustainability. We have an active dialogue with our top investors."*

Onboarding new audit committee members

Members noted that onboarding is critical in preparing a board member for audit committee responsibilities. They cited several practices:

- **Arranging meetings with key executives.** A member said, *"Co-opt the head of [human resources] or whoever did the search. If management is involved, they will make sure the person knows the controller group, the treasurer, the tax person, etc."*
- **Assigning a colleague to help them ramp up.** A member explained, *"A new board member is assigned another board member. A year before they land on the audit committee, they start working with the shadow partner, spending time on the finance committee and the compensation committee."* Another member said the shadow partner could also be an executive: *"We call them a coach. [A coach] helps train someone as they are inducted to the board or a committee. These executives know the company perfectly, inside and out, much better than board members."*
- **Connecting them with the external auditor.** A member said, *"We also do some outside training with the external auditor so they can understand the key issues."* Spencer Stuart's 2017 board survey found that 87% of new directors met with the external auditor as part of their onboarding process.[7]

  One member described more extensive help from the external auditor: *"We've had the external auditor develop a training program. It helps new board members understand the business—how we build and sell products. Then they connect that to the accounting standards. This helps them understand the logic behind it, especially on complex issues like revenue recognition. This program was quite an effort by the company and the external auditor. They developed a software tutorial, and then they have an in-person meeting."*
- **Enlisting other external resources.** A member said, *"There are associations of board members that organize training, even for particular committees. We ask our members to participate in those sessions."*

A key theme in several members' comments was the importance of making sure that a new board member fully understands the business. A member noted, *"That education is essential, because often board members don't quite understand how the company runs."* Another member added, *"If you understand the business and the risks to the business, that's the way to run the audit committee. If you don't have a deep understanding of the business, you're really just highly paid editors of press releases."*

A member noted that the process obviously requires initiative on the part of the new member, especially if the newcomer aspires to be chair: *"There is time spent by the candidate doing prep work and raising questions."* A member recommended grooming a future chair well in advance of a transition: *"That is a resource you want to get lined up ahead of time. Two companies I am with have brought on active CFOs to get them ready to be audit committee chair. It takes two years or so for them to get to know the audit committee, the company, and the board."*

Bringing broader perspectives into the audit committee

The issue of onboarding led to some discussion of audit committee composition and specifically the question of how much financial or accounting expertise is needed on the committee. While members confirmed the obvious importance of this expertise, some of them also highlighted the role played by other kinds of experts. A member said, *"We brought a person from the military onto the audit committee. He felt out of his water for the first few meetings. While he is not someone who is adding to the detailed work of the audit committee, he loves being on audit committee because he is learning so much about the business. He is doing his homework and adding to the committee meetings by asking deep, pointed questions."*

Another member agreed: *"We had a similar scenario. The person asked questions that others were assuming the answers to. These questions opened the eyes of audit committee members who were not as familiar with company."* One member went so far as to say they *"couldn't imagine a worse audit committee than one with all accountants. You get a richer conversation by expanding the group's knowledge."*

Strengthening an audit committee

Audit committee effectiveness can be improved in many ways, and the audit chairs discussed several of them at the summit in London. They considered how audit committee assessments can identify problems and provide direction for improvements. They looked at how various kinds of educational efforts can keep the committee up-to-date on key issues and help new members of the committee ramp up. A common element emerged across these areas of activity: effective audit committees reach out to others for help, both inside and outside the company. Members of management, the external auditor, and various types of third parties can all provide critical knowledge and fresh perspectives, both on audit committee processes and techniques and on substantive issues facing the company.

About this document

The European Audit Committee Leadership Network (EACLN) and Audit Committee Leadership Network (ACLN) are groups of audit committee chairs drawn from leading European and North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are 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.

Appendix 1: Participants

North American and European Audit Committee Leadership Network members participating in all or part of the meeting sit on the boards of over 80 public companies:

Ron Allen, Coca-Cola Company

Mike Ashley, Barclays

Werner Brandt, Siemens

Julie Brown, Roche

Aldo Cardoso, ENGIE

Mary Anne Citrino, HP

Carlos Colomer, Abertis

Pam Daley, BlackRock

Dave Dillon, 3M and Union Pacific

Carolyn Dittmeier, Generali

Ángel Durández, Repsol

Eric Elzvik, Ericsson

Edgar Ernst, TUI

Renato Fassbind, Nestlé and Swiss Re

Byron Grote, Tesco, Akzo Nobel, and Anglo American

Siân Herbert-Jones, Air Liquide

Liz Hewitt, Novo Nordisk

Jean-Marc Huet, Heineken

Lou Hughes, ABB

Arne Karlsson, Maersk

Dagmar Kollmann, Deutsche Telekom

Mike Losh, Aon

Richard Meddings, Deutsche Bank

Nasser Munjee, Tata Motors

Chuck Noski, Microsoft

Appendix 1: Participants, continued

John Rishton, Unilever

Guylaine Saucier, Wendel

Erhard Schipporeit, SAP and RWE

Jim Turley, Citigroup

Steve West, Cisco Systems

Maggie Wilderotter, Hewlett Packard Enterprise

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

Andy Baldwin, EMEIA Area Managing Partner

Jean-Yves Jégourel, EMEIA Assurance Leader

Frank Mahoney, Americas Vice Chair of Assurance Services

Appendix 2: Discussion questions for audit committees

- ? How does your board and audit committee assess the audit committee? How is information gathered, and who provides it? What approaches are most useful?
- ? What kinds of evaluation criteria are used in the assessment? Which are most important?
- ? Is the audit committee evaluation a separate process from the board evaluation? What difference might that make?
- ? How is the audit committee chair evaluated? What do you find most helpful for improving your own performance?
- ? How are the results of assessments translated into actions? How is improvement in performance tracked? What kind of disclosures are made about these evaluations?
- ? Who provides updates and analysis to the audit committee about emerging standards and regulation? How is input gathered and presented to the audit committee?
- ? What kind of detail is sufficient for adequate oversight? How do you decide that you are comfortable with what you know about an impending standard or regulation and its implementation by management?
- ? What is the best way to do deep dives on key issues? How are the topics for these deep dives selected?
- ? What practices are helpful for onboarding new audit committee members?

Endnotes

[1] EY Center for Board Matters, *Accelerating Board Performance: The Importance of Assessments* (Ernst & Young LLP, 2015), 4.

[2] Spencer Stuart, *2017 Spencer Stuart U.S. Board Index* (Chicago: Spencer Stuart, 2017), 4; Heidrick & Struggles, *Towards Dynamic Governance 2014: European Corporate Governance Report* (Heidrick & Struggles, 2013), 31.

[3] This document 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.

[4] All of these approaches are elaborated on in the EY publication *Accelerating Board Performance: The Importance of Assessments*. This publication identifies helpful practices and lays out both the advantages and disadvantages of different techniques—see, for example, the table on page 14 that contrasts qualitative and quantitative methods.

[5] See, for example, EY, *Example Audit Committee Self-Assessment Tool* (Ernst & Yong LLP, 2014).

[6] Financial Reporting Council, *The UK Corporate Governance Code* (London: Financial Reporting Council, 2016), 14.

[7] Spencer Stuart, *2017 Spencer Stuart U.S. Board Index*, 15.