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Audit Committee Realities

Insights from Europe's leading boards



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Contents

I. Introduction	1
II. Overview	3
III. Key takeaways	6
IV. Audit committee responsibilities required under the ARD	9
Reporting	9
Overseeing the external auditor	14
Leading the audit tender	23
Internal audit	37
V. Audit committee responsibilities derived from governance codes, company law, and practice	41
Risk management	41
Compliance	46
Cybersecurity	49
Tax strategy	53
Major transactions	55
Funding and liquidity	56
Investor engagement	57
VI. Managing the audit committee	59
VII. Appendix	68

I. Introduction

Audit committees play a critical role in contributing to the quality of statutory audits and in ensuring the integrity of the financial reporting process. High-performing audit committees provide confidence to market participants, who rely on financial reporting as they make investment decisions. In 2014, the European Union (EU) enacted a new Audit Regulation and a related Audit Directive—collectively referred to as the ARD—which became effective in 2016, expanding the role and mandatory responsibilities of audit committees.¹

Audit committees also spend a lot of time on activities that go beyond the oversight of the financial reporting process and the appointment and oversight of the external auditor. For example, audit committees often have important risk or compliance oversight responsibilities, as delegated by boards or as specified by laws or regulations.

Shareholders, regulators, and other stakeholders have increasingly focused on the performance of audit committees and how they discharge their duties. Recent financial scandals in the United Kingdom and elsewhere have further heightened public attention on the performance of audit committees. Nonetheless, many stakeholders are poorly informed about how audit committees actually carry out their important tasks. Because most of an audit committee's work is done in a confidential setting, it is not surprising that their work is not widely understood.

To help stakeholders better understand what audit committees do and how they do it, EY agreed to sponsor Tapestry Networks to undertake an independent research project to capture an inside look at the practices of the audit chairs and committees of Europe's largest listed companies. We hope that it provides new and distinctive information about what audit committees actually do, and thus informs the debate about corporate governance, public company audits, and the progress of audit reform in Europe.

Through one-on-one interviews, group discussions, and a quantitative survey, this report captures the insights of 55 audit chairs representing Europe's largest companies. *For the results of the quantitative survey, please see page 79.* Most of the audit chairs are current or former members of Tapestry Networks' European Audit Committee Leadership Network (EACLN). Since 2004, EACLN members have convened on more than 40 occasions to exchange

good practices and to engage in dialogue with regulators, investors, and other key stakeholders. The EACLN is one of several audit committee chair networks organized by Tapestry Networks in Europe and the United States. Tapestry Networks engages with several hundred audit committee chairs each year.

To provide an additional check on our findings, we established an advisory board of leading audit committee chairs, first to review the research plan and then to review findings before publication.

This report describes good practices of the audit committees of the largest European enterprises. It is not intended as a representation of what the average or typical audit committee does. Nor should it be read as a collection of “best practices” for audit committees. Each committee needs to assess and adapt the practices that are most appropriate for its board and company. Finally, it is not intended to recommend or advocate for change on audit policy or regulation.

EY has been a supporter and financial sponsor of the project from the start. We are grateful for their counsel and their vital support of this research. Tapestry Networks has been solely responsible for conducting the research and writing this report; EY had opportunities to comment on the research design and on the final product but did not exercise any editorial control over this report. Any errors are solely our own.

II. Overview

Audit committees at large, international, listed European companies perform a range of activities, many of them critically important to companies and their investors. Some of these are required by law or regulation, while others are included in audit committee charters or otherwise fall to audit committees because of members' skills and knowledge.

Audit committee responsibilities required under the ARD

The ARD specified new and enhanced responsibilities for audit committees which prompted audit committees to make important changes in how they fulfill their obligations in a more consistent manner.

Reporting

A core activity of audit committees is overseeing corporate reporting, including annual reports, interim reports, and other communications to investors and the public. Committees focus on accounting practices and on internal controls over financial reporting. They also discuss the reports themselves. In addition, audit committees review non-GAAP (generally accepted accounting principles) financial reporting and nonfinancial reporting, sometimes turning to the external auditor for assurance in these areas.

Overseeing the external auditor

Audit committees closely monitor their external auditors, conducting performance evaluations, partner rotations, and reviews of nonaudit services. They review the external auditor's audit plan and consider key audit risks, audit scope and coverage. They monitor oversight of the local audit teams and often meet with members of the local audit team when visiting local company offices. They review key judgments made by the external auditor such as impairment tests, and estimates for contingent liabilities. They look for proactive communication and independence on the part of the auditor, as well as proficiency in technical accounting principles and auditing standards. They inquire about internal audit quality findings and inspection reports from audit regulators. The partner rotation process is led by the audit chair with input from members of management and final approval by the audit committee and the board. Some audit chairs are reluctant to approve nonaudit services from the auditor, chiefly because of concerns about independence, while others more readily acknowledge the value of these services.

Leading the audit tender

The ARD requires many European-based companies to tender more frequently than they once did. The audit committee owns and directs the process, while management supports it. The Big Four audit firms typically are the only candidates. In considering potential candidates, audit committees manage compliance with “cooling off” periods for audit firms currently providing non-audit services. Audit committees contend with complexities arising from mandatory rotation rules that are not consistent between countries. Audit committees distinguish between firms largely based on available quality, expertise, and audit technology, and they evaluate lead partners and engagement teams more subjectively.

Internal audit

The internal audit function and chief audit executive are important partners for an audit committee, which often spends substantial time and effort assessing and supporting the function. Areas of discussion include the audit plan, specific internal audit issues, risk management issues, the internal audit function’s performance and capabilities, relations with management, and relations with the external auditor.

Audit committee responsibilities derived from governance codes, company law, and practice

Risk management

Most boards delegate a substantial portion of the oversight of enterprise risk management to their audit committees. Committees review risks and mitigation plans at a high level, then allocate risk accountabilities within the board, keeping some for the audit committee itself.

Compliance

Audit chairs look for well-drafted, strict codes of conduct supported by effective training, controls, and assurance. Boards are under pressure to promote cultures of compliance, and audit committees increasingly assess corporate culture as part of their compliance oversight. Audit committees usually oversee management programs for employees to report misconduct, including “speak up” programs and whistleblower hotlines. When dealing with allegations of significant financial misconduct, or involving senior leaders, the audit committee may directly oversee the investigation itself.

Cybersecurity

By utilizing members' expertise and by developing techniques to evaluate company cybersecurity practices, audit committees help the full board oversee the company's cybersecurity.

Tax strategy

Audit committees often play a key role in the board's oversight of tax by balancing the pursuit of tax savings with countervailing regulatory and reputational risk considerations and by overseeing the tax function.

Major transactions

Audit committees often provide oversight in the diligence and posttransaction phases of major deals. They may also become involved at the start of transactions.

Funding and liquidity

Boards often rely on the financial expertise of their audit committees to oversee funding and liquidity. Audit committees routinely look at funding options and ability to manage debt. During crises, they may review the health of key business partners.

Investor engagement

Some investors say that they are interested in learning more about audit committee activities, but few audit chairs report having been contacted by investors and some have concerns about engaging directly with investors.

Managing the audit committee

Audit committees seek both financial and managerial experience in their members. Audit chairs thoroughly onboard new members and plan meeting schedules well in advance. Before meetings, management supplies the audit committee with preparatory materials, and audit chairs engage with key managers one on one. At meetings, audit committees conduct deep dives or use executive sessions to target issues.

III. Key takeaways

Audit chairs view the impact of ARD as mainly positive from their perspective.

Mandatory firm rotation has driven greater competition during the tendering process and audit chairs report more innovation from audit firms than they have seen in the past. Audit chairs who have changed audit firms report that they value the new perspectives provided by the new auditor. They have managed to overcome the potential challenges in transitioning to a new auditor, but they also recognize the real costs in doing so.

Audit committees and their chairs provide robust challenge to external auditors.

Challenge begins with an audit tender, where audit chairs play a leadership role, including the personal choice of the lead audit partner. It continues with the assessment of audit quality and the external audit team, including partner rotation. Audit chairs devote considerable effort to ensuring not only that their external auditors act independently, but also to communicating that independence.

Technological transformation poses ongoing challenges and opportunities for audit committees and their chairs.

Companies have been steadily increasing technology deployment, both in direct production roles (e.g., sourcing, production, distribution, customer service) and in support functions (e.g., finance and human resources). As a result, audit committees face an unrelenting cybersecurity challenge, not only in withstanding direct attacks but also via “information warfare” in the form of adversarial machine learning, disinformation campaigns, and other threats. External auditors are using technology, which is sometimes highly innovative, to transform audit operations. Audit chairs are optimistic that deployment of this technology will lead to an increase in audit quality and potentially improvements in efficiency as well. .

The increasing burden on audit committees often falls disproportionately on the committee chair.

Serving on an audit committee is different from chairing one. As audit committees take on incremental responsibilities, the bulk of this new work is often shouldered by the audit committee chair.

Much of it occurs between formal audit committee meetings as audit chairs engage with a growing number of internal stakeholders and provide guidance on new opportunities and risks. Demands on audit chairs increase as external pressures on audit committees mount. Some chairs report that the financial and nonfinancial rewards for their work no longer match the effort and personal risk that it requires of them.

The work of audit committees across Europe is more similar than different.

While differing legal requirements and structures affect the mandates and composition of European boards, there is a lot of overlap in what audit committees do. Factors including the mandatory requirements set forth in the ARD and the delegation of risk oversight to most audit committees lead to many similarities across audit committee agendas.

Audit committees have become “first stops” as new risks surface.

European audit committees and their chairs operate at the heart of corporate risk. Though it may not directly manage every risk that a company faces, an audit committee functions as the integrator of almost all risks. These include data privacy, compliance, cybersecurity, and culture-related issues. Even where a particular risk has been delegated to another committee, the audit committee will be well informed about that risk and its potential impact on reported results.

Audit committees have deep reach into finance functions.

In overseeing financial reporting, internal controls, and the finance function, an audit committee has contact with many finance function executives—not just the chief financial officer (CFO). In particular, audit committee chairs report working closely with chief accounting officers, controllers, treasurers, and other leaders. In many cases, the CFO is no longer a gatekeeper; audit committees have direct, unfettered access to these members of management.

Audit committees work with more and more executives outside finance functions.

It is not surprising that audit committees have a close relationship with heads of internal audit. But chief audit executives are just one of a growing list of leaders that audit committees interact with on a

regular basis. Their expanding oversight of risk and compliance drives audit chairs to spend more time with so-called second lines of defense, as well as with general counsel. Overseeing cybersecurity and general information technology (IT) risk brings committees into regular contact with chief information security officers and chief information officers. Their interaction is not limited to designated gatekeepers; in many cases, audit committees work directly with business leaders, who are the ultimate owners of key risks.

Audit committees are careful not to cross from oversight into management.

While each committee has to decide where the line lies, audit committees try to provide oversight without arrogating management's role. Some tasks, such as overseeing internal audit or leading an audit tender, require a more hands-on approach.

There are different ways to do the job well.

Not all audit committees can or should do things identically. Audit committee composition and frequency and length of meetings, for example, can vary dramatically. A company's industry and geographic footprint affect how it does business and reports to the audit committee. Each company is unique, and there is more than one right way to do the work.

IV. Audit committee responsibilities required under the ARD

Reporting

A core activity of an audit committee is overseeing corporate reporting: annual reports, interim reports, and other communications to investors and the public. Two important areas of focus are the company's accounting practices and its internal controls over financial reporting (ICFR), both of which underpin the integrity of financial statements. Audit committees also discuss the reports themselves, including both specific details and overall messaging. In addition, audit committees consider non-GAAP financial reporting and nonfinancial reporting. In recent years, environmental, social, and governance (ESG) reporting has been gaining traction and drawing increasing committee attention.

In recent years, new standards on revenue recognition, leases, and financial instruments have prompted deep dives by audit committees, with follow-up discussions at every meeting thereafter.

Overseeing financial reporting

Audit committees adhere to well-established routines as they review accounting practices. Audit chairs regularly discuss key accounting issues with their CFOs, internal and external auditors, and members of the accounting staffs. They focus on issues such as the implementation of new accounting standards and the handling of certain changes in the business or operations, and they look for red flags that could signal problems, such as disagreements between management and the external auditor.

One major area of focus is the impact of new accounting standards. In recent years, new standards on revenue recognition, leases, and financial instruments have prompted deep dives by audit committees, with follow-up discussions at every meeting thereafter. An audit chair noted that the full board takes little interest in these issues, so the audit committee must ensure that management is disciplined about how it implements changes.

Because of the substantial impact of new accounting standards, audit committees closely track their development by the International Accounting Standards Board and its US counterpart, the Financial Accounting Standards Board. Audit committees may also provide feedback to these organizations, as both have encouraged them to do. An audit chair noted that the external auditor can help educate the audit committee about new standards and their implementation.

Overseeing ICFR

The internal controls that are intended to ensure the accuracy and integrity of financial statements were thrust into prominence in the wake of the accounting scandals that occurred nearly 20 years ago. ICFR became the subject of important regulations, most notably the Sarbanes-Oxley Act of 2002 in the United States,² which was influential for companies on both sides of the Atlantic. As part of an overall effort to improve ICFR, audit committees ramped up their own oversight, focusing not only on potential deficiencies in specific controls but also on the overall “control environment,” which includes the attitudes and commitment of executives and staff to maintaining effective controls.

Tracking potential deficiencies

The attention to detail required to oversee ICFR—whether in a Sarbanes-Oxley-compliant company or otherwise—is a challenge for audit committees, who try to find the right balance between adequate scrutiny on the one hand, and excessive involvement and information overload on the other. Audit chairs noted that there may be many control deficiencies that have the potential to become significant deficiencies or even material weaknesses, so being involved in the details is necessary in order to spot problems early on.

Audit chairs mentioned a variety of practices that their audit committees use to monitor internal controls and ensure that the audit committee and the board as a whole receive adequate reporting on deficiencies:

- **Cooperating closely with management.** Audit chairs mentioned “*continuous and systematic discussion*” between the audit committee and those in management responsible for implementing and maintaining internal controls. One audit chair described a deep level of personal involvement, spending considerable time outside of meetings with the team.
- **Asking for more information from internal audit.** Audit chairs described extensive interactions with internal audit: “*We push them to explain failures to the organization ... An individual failure is not significant, but how widespread is it? What does it tell us about the company? How is it being fixed, and by when?*”³ One audit chair described asking the head of internal audit and the audit partner to select the key themes emerging from their audit findings to identify longer-term, strategic weaknesses in controls.
- **Asking for reports to be formatted for more clarity.** An audit chair said, “*Every report is circulated to the board and the audit*

Audit chairs mentioned “*continuous and systematic discussion*” between the audit committee and those in management responsible for implementing and maintaining internal controls.

committee with every deficiency highlighted. You see it if they reappear or become systemic, or where IT is deficient.” Other audit chairs said that they ask for a color-coded summary to be provided to the committee every quarter.

- **Asking for more frequent reports.** Audit chairs ensure that, if necessary, they get reports outside the usual reporting cycle. Reports are sent directly to the audit committee if something serious happens between the quarterly reports.

Monitoring the control environment

Despite the successes achieved through implementing Sarbanes-Oxley and improving internal controls, maintaining a good control environment continues to be a challenge. Worries over bribery and corruption contribute to this focus. The ethical culture of the organization is a key concern because culture is critical to success yet hard to change.

Audit chairs brought up the role of the CEO and other senior managers, noting that the audit committee should start with the tone at the top. Are the CEO and his or her direct reports communicating throughout the organization that they are serious about internal controls? One audit chair described a frank discussion at the board level, in which it was decided that the management team would comply with the spirit and letter of the law or be dismissed; the board made it a fundamental cultural priority for the organization. An audit chair remarked on the impact of a new CEO with a fresh approach: *“It was a turning point when the new CEO said that accounting and internal control systems are important. He did not want any surprises. That spread through the organization.”*

Audit chairs also emphasized the importance of assessing and shaping attitudes deeper down in the organization: *“We are having serious discussions with middle management, and we have a zero-tolerance culture. This is the only way. Even with zero tolerance, it’s difficult at the lower levels. You need a strong tone at the top and systematic procedures.”* For more on compliance and culture, see the section on compliance, on page 46.

Reviewing the reports

Boards also weigh in on other aspects of corporate reporting, such as how it aligns with company strategy and the general quality of the reports. One audit chair noted that boards can correct some of the biases to which management is prone: *“Management is so into the weeds that they lose sight of the key message. It’s important to remind them that reporting should be in alignment with the agreed-upon strategy. We can ask about the weighting of their message*

“Even with zero tolerance, it’s difficult at the lower levels. You need a strong tone at the top and systematic procedures.”

versus the strategy. It's very useful for the board to bring this extra perspective."

These issues are typically addressed by the full board, but audit chairs noted that their experience with reporting and investor relations makes them valuable contributors. *"Of course, there is an exchange of experiences and views on corporate reporting strategy between the audit committee and management,"* one chair said. Audit committees review reports and may make suggestions on content and even style.

More generally, though, audit committees focus on certain details. One audit chair noted that the audit committee is deeply involved in every quarterly report, but much of the discussion is about such issues as the notes in the financial statements, especially those on sensitive issues like legal disputes. Audit committees may conduct benchmarking against peers, and they may check for compliance with stock exchange rules.

Overseeing non-GAAP measures

Audit chairs are also interested in the use of non-GAAP financial metrics, also referred to as non-IFRS (International Financial Reporting Standards) financial measures. These metrics are widely used by companies today to supplement their GAAP (or IFRS) reporting. In a recent CFA Institute global member survey, 63.6% of respondents said they always or often use non-GAAP financial metrics,⁴ and several other surveys have found similar widespread investor use of such measures. This use has attracted the interest of regulators in both Europe and the United States, who are concerned that some of these measures may mislead, rather than help, investors.

Audit chairs see the value of these measures but acknowledge the need to assess their validity. One said, *"I actually support or encourage non-GAAP financial measures because that's the only way the reader can really know what's happening at the company. The audit committee has to make sure this reporting improves understanding and is calculated in a proper way."*

The audit committee may play a critical role in overseeing the use of non-GAAP financial measures, precisely because these measures are not part of the formally audited financial statements. *"Alternative performance measures should be aligned to how the board wants to evaluate strategy and performance. The audit committee ensures that these metrics are clear, well defined, consistent, and reconciled to underlying statutory accounts,"* one audit chair explained.

“Non-GAAP measures are not part of the audit or review engagement of the external auditor. However, the auditor reviews the annual report for reasonableness. He informs the audit committee if he has any obvious remarks regarding non-GAAP measures.”

The external auditor may provide some form of review of a company’s non-GAAP disclosures, though it is likely to be limited. *“Non-GAAP measures are not part of the audit or review engagement of the external auditor. However, the auditor reviews the annual report for reasonableness. He informs the audit committee if he has any obvious remarks regarding non-GAAP measures,”* an audit chair explained. The external auditor may report about the processes involved in preparing the measures, the staff involved and their competencies, and the relevance of the measures. One trigger for more scrutiny by both the audit committee and the external auditor, several audit chairs noted, is when there is a large gap between the IFRS figures and the non-GAAP measures.

The audit committee may also oversee nonfinancial performance metrics, such as market share, same-store sales, and other key performance indicators. One audit chair noted that some of these metrics may be difficult to verify. *“We take a common-sense approach,”* the director noted. As with non-GAAP financial measures, the auditor may be asked to take a look and provide at least some limited assurance. Some audit chairs said they spend as much time reviewing non-GAAP measures—financial and nonfinancial—as they do reviewing GAAP measures.

Overseeing ESG reporting

In the area of nonfinancial reporting, one type that is currently of great interest and concern is ESG reporting, also referred to as sustainability reporting or corporate social responsibility reporting.

A new and challenging imperative

While ESG reporting emerged decades ago, it has gathered momentum in recent years. Investors and other stakeholders are increasingly interested in understanding the environmental and social ramifications of companies’ activities, and governments are obliging by issuing more specific reporting requirements. Many companies today publish annual ESG reports or integrated reports that incorporate ESG issues.

ESG reporting requires companies to address several challenges. They must identify the issues that are most material for stakeholders and determine the proper metrics to demonstrate the company’s progress on those issues. In addition, the company may also tap insights from the risk management team and others across the organization. Once the metrics are selected, they must establish rigorous data collection processes and controls, preferably with the

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assistance of the finance function. Finally, they must decide on what kind of assurance is necessary and feasible.

Full board versus audit committee responsibility

Just as companies are struggling to establish effective ESG reporting, many boards are trying to understand their oversight role in this area. Audit chairs noted that the full board is ultimately in charge, either conducting a large portion of the oversight work itself or acting as a coordinator and final reviewer. The implications for strategy might necessitate the attention of the full board, and oversight of ESG issues could benefit from diverse knowledge and perspectives, so drawing on the full board's broader expertise is helpful.

Board committees also assist with oversight, with the audit committee playing a key role because of its experience with reporting processes. A chair said that the audit committee reviews the processes and assumptions behind the data, at a high level at least. It also checks to see if controls are strong enough to ensure the quality of the information.

Obtaining assurance from the external auditor is also likely to be an audit committee responsibility, as it seeks assistance in evaluating ESG measures. It can be difficult for nonspecialists to check the numbers; audit chairs noted that it is up to the audit committee to decide how much assurance it needs to confirm the accuracy of the reporting and to commission this assurance when needed.

Other committees—such as a sustainability or corporate responsibility committee—may be involved too. An audit chair explained, *“Initially, I thought the audit committee should be in charge, but the differences between financial and ESG reporting are great. A specialized ESG committee could be better. One practice can be for the ESG committee to invite the audit committee chair from time to time to advise.”*

Overseeing the external auditor

An audit committee works with its external auditor to support audit quality by helping the auditor challenge management and by monitoring auditor performance. In addition to general performance evaluations, ongoing oversight of the auditor includes the periodic selection of a lead partner and the review and approval of nonaudit services provided by the auditor.

Evaluation criteria

While a variety of organizations have proposed criteria for evaluating the performance of auditors,⁵ most audit chairs said that they and their committees have their own perspectives on what they value most from their external auditors. They highlighted both relationship-related elements and technical skills.

Elements of a trust-based relationship

Audit chairs want an auditor whom they can trust to communicate openly and effectively. This is assessed qualitatively, based on how the audit chair, other members of the board, and management experience the audit engagement. Audit chairs emphasized that these “*soft factors*” are critical to the success of the relationship between the company and a global audit team. They noted the importance of the human element in an engagement: “*At the end of the day, it’s not the firm—it’s the people.*”

Open communication

Proactive communication helps prevent problems from escalating and enables the audit committee to fulfill its oversight responsibilities more easily. Audit committees want to hear about problems as they arise. One summed it up, “*I tell the auditor, the only way you can make me mad is if you surprise me. I describe it as a race between management and the auditor to see who will tell me the news first. That’s the level of responsiveness that I expect.*” Regular communication with the audit partner helps the audit committee gain confidence in the partner’s capabilities and provides an early-warning system to spot potential issues. Communication should be initiated in response to problems, but audit chairs also want regular off-cycle meetings, such as quarterly check-ins over breakfast or lunch.

Effective communication is not measured solely by its frequency. Audit chairs emphasized the importance of candor and courage. They want an auditor who provides the audit committee with an unvarnished perspective. Some described transparent communication as crucial to a functioning relationship between the audit chair and the external audit partner in conveying the performance of management. One explained, “*I rely on informality, and I judge the degree to which the auditor is open with me about the quality of management and judgments being made. They don’t expect me to overreact or that I’ll go to management and tell on them. What I will do is filter the information into the system. The audit partner has to have a working relationship with management, and I can’t be seen as a tattletale.*”

“I tell the auditor, the only way you can make me mad is if you surprise me. I describe it as a race between management and the auditor to see who will tell me the news first. That’s the level of responsiveness that I expect.”

Another aspect of open communication is the willingness of the audit team to share knowledge gained from working with companies both in and outside the industry. Auditors can demonstrate value to the audit committee by sharing broader perspectives on good or emerging practices and suggesting ways the company could do a better job.

Independence

As important as it is for auditors to build strong relationships throughout the organization, audit chairs said that it is even more critical that their auditors remain independent. For the external audit firm, maintaining a positive, constructive relationship with the audit client while remaining objective and skeptical is not always easy. Yet independence is the key criterion for measuring audit service quality, an audit chair explained: *“For me, quality is about real independence. I want to know about issues, even if already solved; I want to know the main items discussed between the external auditor and management; and I want to know how they solved the problem as a way of understanding independence.”*

Assessing independence can be difficult. In addition to assessing independence when reviewing the resolution of audit issues, audit committees test specific, measurable criteria such as the financial interests an auditor might have in a company.⁶ Ultimately, though, independence is gauged through the quality of communication and the auditor’s proactivity and transparency. Audit chairs discussed the importance of balancing independence with partnership:

“Independence does not mean you cannot have great communication and a good relationship. We are working toward a common objective; partnership does not prevent independence.”

In fact, independence from management is a key area where audit committees actively support the auditor, helping the auditor exercise skepticism and challenge management, when necessary. Audit chairs meet privately with lead partners to discuss issues that may need to be raised with management: *“The direct contact between the audit committee and the auditors, with free and open contact, is a good way to understand issues.”* One audit chair mentioned giving the auditor the opportunity to put a challenge to management in writing, after which the audit chair and the auditor together raised the issue with management on a call. The audit chair might even ask questions on behalf of the auditor, either in a meeting of all three parties (auditor, management, and audit committee) or in a more private conversation with just the CFO.

“Independence does not mean you cannot have great communication and a good relationship. We are working toward a common objective; partnership does not prevent independence.”

The professional practice office

An external audit firm's professional practice office (PPO), sometimes called a national office, plays a major role in resolving issues requiring extraordinary technical expertise or difficult accounting judgment. In assessing the effectiveness of an audit team, audit chairs consider the performance of the firm's PPO. One chair explained that audit committees seek lead partners who are able to effectively manage the PPO review process: *"We look for an audit partner with credibility to deal with the national office, where we are confident that the national office and the lead partner are unlikely to disagree. From the auditor's perspective, it can be difficult to protect objectivity if the client company demands to see the technical concurring partner [from the national office], who is not meant to see the client."*

Audit chairs recalled being frustrated when they received top-down rulings from a PPO without consultative engagement with local teams. They expressed the need for more open communication among PPOs, audit teams, management, and audit committees.

Essential technical skills and expertise

While most audit chairs agreed that the technical competencies of the major firms were of high quality, they noted some key capabilities that they look for in an audit team, including audit proficiency, a deep understanding of the business, and the use of new technologies.

Demonstrating audit proficiency

First and foremost, the auditor must provide comfort to the audit committee that its opinion on the accuracy and fairness of the company's financial statements is well supported. Audit chairs look for an audit team that has proficiency in technical accounting principles as well as in auditing standards. They also recommend that audit teams demonstrate specialized knowledge in areas that are critical to the audit—areas that vary by company and industry. *"In a complex world, you have to have specialists on the team,"* one audit chair said, echoing others' comments about the value of multi-disciplinary audit teams. Experience in areas such as mergers, spin-offs, and asset revaluations is helpful. The ability to implement audit standards consistently across different jurisdictions and cultures is also important.

In its framework for audit quality, the International Auditing and Assurance Standards Board identifies the audit team's knowledge, experiences, values, and ethics, as well as timely reporting and appropriate interaction, as key inputs for determining audit quality.⁷

"In a complex world, you have to have specialists on the team."

One way that audit firms enhance their technical expertise is by committing to the training and continuing education of their audit professionals. In recent guidance, the Financial Reporting Council included training as a key element of an audit firm's quality control.⁸

Using an understanding of the business to set audit priorities

Audit chairs noted the importance of an auditor setting priorities for an audit, then allocating resources and building a team to execute against them. Setting accurate priorities requires the auditor to have a detailed understanding of the company's problems and risks. Audit chairs emphasized their expectation that external auditors demonstrate a deep understanding of the business.

An external auditor can provide insight to an audit committee beyond the tasks outlined in a traditional audit plan. Audit chairs rely on their auditors' expert perspectives on the company's culture, business, and sector. One audit chair explained how the external auditor could help monitor activity across the company: *"There are things that you do not see after a period of time within a company. The auditor's outside perspective is very important, as is their ability to bring external experience."*

Implementing new technologies

Audit chairs emphasized the need for the audit firm to stay ahead of the technological curve, creating efficiencies and solving problems by introducing automation and analytics to the audit process. While some audit chairs focus on technological competency, others have come to expect it from all of the Big Four accounting firms. One audit chair said, *"We look for digital or innovative techniques in performing the audit. You can tell how on the ball an external auditor is based on how they use technology in their process."*

Evaluation processes

Audit chairs described both formal and informal evaluation processes; some described checking auditors only on certain key points, while others detailed more comprehensive approaches. Many audit chairs described using more than one technique in order to track long-term trends in audit quality.

Formal evaluations

In some cases, audit committees employ a formal auditor evaluation process running on a preset timetable and using tools designed in advance. This often involves an annual assessment via questionnaires, surveys, or interviews that capture both quantitative and anecdotal feedback from various stakeholders. Typically,

"There are things that you do not see after a period of time within a company. The auditor's outside perspective is very important."

Some audit chairs said they consciously avoid questionnaires in favor of free-flowing interviews that yield more substantial answers.

members of management, including finance staff, internal audit, and risk management, provide reflections on their experience working with the audit team. In some cases, audit committees work with management to come up with their own questionnaires; in others, they use standard templates that are provided by audit firms, national regulators, or other stakeholders.

Audit chairs at UK-based companies noted that the Financial Reporting Council has provided them with substantial guidance on topics to include in a questionnaire. In May 2015, the organization released guidelines to aid audit committees in assessing the quality of the external audit, focusing on four key elements: mindset and culture; skills, character, and knowledge; quality control; and judgment. The guidelines underscore that the first three elements “are necessary to support [the auditor] in making reliable and objective judgments at all stages of the audit. These judgments underpin their audit opinion and are critical to delivering high audit quality and enable them to win the trust of those to whom they report.”⁹

Several audit chairs appreciated the fact that quantitative data provided by formal evaluations—when conducted in a consistent, well-documented manner, year to year—allow a committee to track auditor performance over time. Putting a number on the level of satisfaction with a certain activity, for example, and arriving at that number in the same way each year, allows for more precise comparisons. One chair noted that auditor rotation can impede the audit committee’s ability to observe trends in longitudinal data: *“Evaluation is made more difficult by audit rotation. Our surveys help to quantify performance, but it’s meaningless unless you have multiple years of data.”* On the other hand, many audit committees do not use quantitative metrics, even if they have a more formal evaluation process in place. Some see little value in these metrics, while others would like to explore their use.

Some audit chairs said they consciously avoid questionnaires in favor of free-flowing interviews that yield more substantial answers. Management can then review the results with the top audit partners, creating a plan for addressing specific issues. If problems are identified in specific geographic areas, audit chairs might travel to those locations to gain more insight.

Annual inspection reports of audit firms by national regulators offer another benchmark by which audit chairs can evaluate the audit firm and its performance. By incorporating the report into a conversation with the audit partner, audit chairs can gain insight into issues and risks discovered in the audits of competitors and peers, as well as

an understanding of the health of the auditor's business. Again, however, audit chairs find little value in some of the quantitative audit quality indicators used by regulators, such as the number of hours spent on an audit or the number of specialists involved.

Informal evaluations

Informal evaluations provide audit committees with another means of assessing their auditors, often giving insight into the qualitative elements essential to successful audit partnerships. Many audit committees use informal measures, alone or in addition to questionnaires and other types of surveys. An audit chair said, *"I'm desperately looking for ways to supplement the formal process."* More intimate and candid conversations conducted outside a formal process can yield insights that might not surface otherwise.

A number of audit chairs said that an ad hoc evaluation process carried out over the course of a year is more effective than a formal process that occurs on a schedule. One chair assessed the auditor based on real-time communication regarding problems in the audit: *"Any issues arising in the formal report should have been raised throughout the year. Whether or not issues have been raised at the right time is a factor that I consider."*

In order to *"get beyond the questionnaire,"* another audit chair recommended that audit chairs attend planning briefings of the global external audit team: *"The firm briefs the global auditors on the audit plan. I go because it's useful to have those regional leaders interact with me, and I am able to get a sense of how the audit is being run around the world."* Describing a high-touch method of monitoring global activities, several audit chairs spoke of traveling to visit remote locations where there is a concentration of risk.

Giving feedback to the external auditor

When issues arise or when a committee observes exceptional service, it is important to deliver feedback in real time. Several audit chairs found that informal conversations were an appropriate way to discuss the partner and firm's performance. One chair said that informal settings helped build rapport with the auditor. The member noted, *"You can be independent and maintain a great working relationship. I like to report assessments back to the auditor in a relaxed environment over a meal."* Other audit chairs use a session at an audit committee meeting—without management present—to discuss the auditor's performance. This forum allows audit chairs to share feedback showing year-to-year trends, provide critique, and create a plan of action with the external auditor. Audit chairs expect

their external auditors to provide candid feedback about finance teams operating in different parts of a business or in different countries.

Lead partner rotation

Audit committees also play an important role when a new partner takes over a company's audit, often following the seven-year maximum partner tenure mandated in the EU or the shorter tenures imposed in some member states. Audit chairs described a partner rotation process that is led by the audit chair but also involves input from members of management and final approval by the audit committee and the board. It begins with the audit firm proposing one or more partners for consideration. Then the chief accounting officer, the controller, the CFO, and the audit chair meet with the candidates and select the preferred one. That person then meets with the audit committee, which makes a recommendation to the full board for the final approval.

Aspects of the process may vary from company to company. For example, an audit chair might steer the audit firm's selection of candidates; conversely, the influence of the client might be relatively minimal. One audit chair explained, *"We asked for a short list of candidates. We had some seasoned candidates, but I said if there are others more out of left field, we would consider them. A couple of people interviewed them on the management side and on the board side. The preferred candidates met other members of the audit committee, but it was more about socializing the decision."*

Audit chairs stressed that the audit committee and board should not delegate too much of the lead partner selection process. One said, *"I've seen the audit committee say [to the audit firm], 'You know us, so pick who it should be.' But the client shouldn't abdicate this decision to the firm—that would make them less committed to making a person successful."* It must also be clear that management does not dictate the final decision: *"I think it's very important that the external perception that the auditors are the province of the management is allayed. One way to do that is to be clear and visible that the choice of the audit partner is not the CFO's or any other executive's."*

Audit chairs monitor the transition process when a new lead partner takes over, assessing the transition plan and interviewing the new person as well as the incumbent on their perspectives. They try to ensure that the incumbent is motivated to implement a smooth transition, and they track progress at every meeting during the first year of the new auditor's tenure. An audit chair emphasized the

"I think it's very important that the external perception that the auditors are the province of the management is allayed. One way to do that is to be clear and visible that the choice of the audit partner is not the CFO's or any other executive's."

duration of the process: *“It is a very extensive process. We are in a process where we have to change leaders every couple of years. We have brought in a potential lead auditor a couple of years ahead of time; he’s already participating in our meetings.”*

Policy on nonaudit services

As part of overseeing the auditor, the audit committee must establish and enforce a policy on what nonaudit services the company can procure from the auditor. The ARD prohibits several kinds of nonaudit services, but it allows others if the total fees for these services do not exceed 70% of the average fees paid over the last three consecutive financial years for the audit, and if the audit committee approves them after assessing potential threats to independence.

Regarding approaches to nonaudit services, audit chairs fall roughly into three groups. Some are reluctant to approve such services; they have a very limited set of services that they allow the auditor to perform, and they generally discourage management from using these services.

A second group more readily acknowledges the value of procuring certain nonaudit services, highlighting specific advantages, such as the efficiency of using the auditor and the auditor’s knowledge of the company. For certain services, such as reviewing interim reporting, they believe it makes no sense to hire a third party. Other services, such as performing due diligence on transactions, are acceptable to some but not all audit chairs in this group.

A third group is not overly concerned about the independence issues around nonaudit services. They simply ensure that these services are comfortably below the 70% threshold and do not violate the other prohibitions in the ARD. They may often agree with management that harnessing the advantages of procuring certain services from the auditor is an opportunity to be explored.

Leading the audit tender

An audit tender is a major undertaking for the audit committee of any large international company. Appointing a new external audit firm requires the audit committee to trust that a new and largely unknown team can quickly learn about a complex global company well enough to provide external stakeholders with confidence in its disclosures. Conducting a tender involves many of the tasks and decisions that audit committees undertake when they tackle the evaluation of an incumbent external auditor. Yet tenders are more complex and time consuming for the audit committee, demand more engagement from management, and involve additional evaluation criteria. *We have treated audit tenders at some length in this report because of audit chairs' recent focus on this critical task.*

The ARD requires many companies to tender after an incumbent auditor's initial 10-year engagement, with the option to extend the engagement a single time after tender to a maximum of 20 years or, in the case of joint audits, 24.¹⁰ It also allows member states to choose to adopt or retain shorter rotation periods. As a result, while all EU member states require mandatory firm rotation, there is substantial variation in required rotation frequency. Nothing prohibits a firm from tendering or switching audit firms before it is legally required to do so.

Because the ARD only became effective in 2016, many audit chairs have not yet had extensive experience with tenders or mandatory firm rotation. Nonetheless, many companies have recently completed or are in the process of a tender.

The decision to tender

Audit committees put their audits out for tender for a variety of reasons, including the following:

- **Dissatisfaction with audit firm performance.** Outside any legal requirement, audit committees often consider a tender when serious problems arise with an audit or when interactions with the auditor are unproductive. One audit chair discussed a firm that had mishandled a difficult situation: *"We had a bad experience on an impairment issue, and it should have been spotted sooner."* Another mentioned a firm that was not offering additional value: *"We felt that the incumbent was not very active. They were pure audit. For example, we did a risk mapping and we asked them if they had any thoughts; they said no, without any comments."* A third audit chair described a lack of collaboration: *"We didn't develop the right kind of relationship*

with the auditor. They had a square-headed application of routines and roles and a very limited ability to listen to alternative approaches and interpretations. Not that they have to agree, but you need a collaborative way of working. Partly that was a personnel issue.”

- **Mergers.** Committee chairs noted that a large merger is often a good time to reflect on the performance of the external auditor. In particular, if the parties to a merger have different auditors, they will have to select which will audit the combined entity.
- **Role change.** One audit chair said that it would be natural to consider a tender when the audit chair changes: *“The new audit chair should have the opportunity to take another look.”* Another audit chair said, *“The lead audit partner rolling off was the trigger.”*
- **Long-tenured incumbent.** New legal requirements and pressure from institutional investors to improve financial oversight by changing auditors more frequently are disrupting the model by which companies have the same auditor for decades on end. One auditor said, *“In both of my companies a tender was almost mandatory. We had those auditors for 20–25 years.”* Those legal requirements accompany increased investor scrutiny about auditor selection. *“We will increasingly have to factor in a more robust position from shareholders,”* an audit chair predicted.

Audit chairs also cited two less common reasons for tendering:

- **Testing the market.** A few audit chairs said that periodic assessment of the audit marketplace is good practice, even in the absence of specific problems. *“Society expects audit committees to go through such a process at appropriate intervals,”* one remarked. Another said, *“Every year, we have a review with the internal auditor, finance group, and audit committee on whether to keep the external auditor or not.”*
- **Price.** *“We didn’t have to do it. We were pretty satisfied with the provider we had, but we wanted a cost reduction.”*

Audit chairs noted that, absent a legally required rotation, tendering and switching to a new auditor are not steps to be taken lightly. One chair noted that these considerations weigh heavily on the committee because ultimately *“the audit committee is responsible for proposing to the full board whether a change in the auditor is warranted or not.”* Audit chairs remarked on how long and costly the process can be and on how the drawbacks of a new auditor, such as a lack of knowledge about the company, must be weighed against the benefits of a fresh look from a new firm.

Timing considerations

In cases where the audit committee has the discretion to select when to proceed with a tender, audit chairs said they preferred to do so when the organization is not going through other major changes. For example, changing audit firms can be especially difficult during a CFO transition or a corporate restructuring. Another timing consideration concerns “clearing” audit firms to be able to tender: audit firms are prohibited from performing certain nonaudit services for the tendering company for 12 months prior to the commencement of the audited year, also known as a “cooling-off” period. Furthermore, subsidiaries of large companies, such as banks, may themselves be public interest entities and subject to ARD rotation requirements. This might mean that a subsidiary in one country is required to rotate auditors before its parent. Audit chairs said that in these cases, part of the tender planning process requires mapping out the legal requirements and discretionary tender timelines for the parent and each of its subsidiaries.

The expected availability of auditor talent can also present a timing concern: in some sectors and countries, there are a limited number of auditors who have the necessary experience and skill set for the audit. Audit committees sometimes consider when another company will be forced to rotate its audit firm or lead audit team and then invite the departing firm or team to bid on their tender. Companies sometimes take steps to ensure that some personnel from an incumbent team survive a rotation.

Despite regulatory changes encouraging joint audit,¹¹ the practice has not yet gained traction among European audit chairs. *“No, we wouldn’t consider that,”* said one, echoing the responses of several others. Other audit chairs said they had considered joint audit but elected to remain with a single firm to reduce complexity. One audit chair said, *“Management considered joint audit to promote competition under the EU legislation, but it was abandoned.”*

Tender process timeline

Once an audit committee has elected to launch a tender, the first step is to agree to an overall timeline. At the end of the process, the audit committee must present two choices and a “duly justified preference for one”¹² to the full board. In our survey of audit chairs, the average reported time between the start of the process and the selection of the auditor was 5.7 months. However, the time from when an audit committee initiates a tender until the point at which the new auditor undertakes the role after being cleared of nonaudit services can often be measured in years. An audit chair reported of

*“Are you sitting down?
We’ve been working on this
for three years.”*

lengthy, unfinished tender: *“Are you sitting down? We’ve been working on this for three years.”*

The components of the tender process differ from company to company, but invariably the steps are many and require substantial effort from management and the board. The selection process effectively ends for the audit committee when, as required under the ARD,¹³ it presents two choices and a “duly justified preference for one” to the full board. One audit chair described the process at their company: *“The first step is financial: management looks at it. After that, there’s an audit selection panel [made up of management and the audit committee]. We preselect the auditors and select two candidates—the top ones—that are going to present to the audit committee. Presentations last two hours. The two best selected firms present to the audit committee with the chair and the CEO. Then it leads to the selection of the audit committee for proposal to the full board and the presentation to the AGM [annual general meeting].”*

Another audit chair recounted a similarly lengthy experience that involved many stakeholders on the board and in management: *“After invitations, the audit firms got access to a data room. As audit committee chair, I had a part in deciding what information they would have access to. The audit committee did not participate in meetings on legal structure. Then, there were written proposals and pitches. Again, the audit committee did not participate, but when we came down to two firms, we went through the process again. Management had evaluated the firms according to criteria developed by the audit committee. We made sure it was clear that the auditor would report to the board. In the final stage, the pitches, I participated with one of my colleagues on the audit committee. I took references for the lead audit partner and the lead audit partner in each major geography.”*

Roles of the audit committee, audit chair, and full board

The audit committee is the central, directive body in a tender process. One audit chair said that it is important for the audit committee to exercise its authority over management; audit committees are more directly involved in tenders than the typical non-executive director in other company affairs. *“I was very insistent that the audit committee is in control of the process. You can’t be overseen and oversee at the same time.”* Another explained, *“It’s the audit committee that has to be 100% convinced of its process.”* To manage that responsibility—and the burden added to an already

hefty committee workload—one respondent’s audit committee formed a subcommittee to focus on a tender. *“We briefed the full audit committee about progress. We also involved the full audit committee in meetings with the candidates.”*

Audit chairs typically have individual responsibility for aspects of a tender process. *“The audit committee chair has an ownership capacity, which is a heavy word,”* an audit chair said. This can be particularly challenging because prior to the ARD, audit tenders were less common and, as a result, boards typically lack deep experience with the tender process. *“Not that many people on the board had gone through the process. I’m the only one on the selection panel who’s done it,”* one audit chair said.

An audit chair’s leadership capacity may mean that person must manage the company’s management team through the process. One audit chair said, *“I led and oversaw the whole process. There is a lot done by the management team, but ultimately I was accountable for the process. Alongside the CFO, I made recommendations to the audit committee on which firms to go through a detailed process with. I was involved in a number of meetings with management and a series of meetings with various lead partners.”* Another audit chair had a similar experience: *“I was in a leading position. I was very much involved with the finance organization, including the CFO, but also the heads of finance in different countries.”*

Appointing a new auditor is somewhat like appointing a new CEO: it is a decision that the board must own. The full board is less involved throughout the process; the audit committee typically keeps the board apprised of progress on the tender, involving it in key moments of evaluation and selection. *“After the audit committee put together recommendations, we involved the chair of the board. He had a conversation with the two lead partners. Then we brought it to the full board with our recommendation. The full board went along with it, as expected,”* one audit chair reported of a roughly representative example of other audit chairs’ experiences.

Role of management

While the audit committee leads a tender, audit chairs stressed that management plays a vital role in the project’s ultimate success. Audit chairs generally reported that at the outset of the process members of the finance organization perform preliminary work, subject to audit committee review. *“As audit committee chair, I was involved in approving the RFP [request for proposal]. It was prepared by management, but I was actively involved.”*

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Management handles the administrative details. *“We let the company do a lot of work. It was completely run by the company,”* an audit chair said.

Examples of management’s responsibilities include the following:

- **Drafting an RFP.** Management typically drafts RFPs, often for audit committee approval, before transmitting them to bidding firms.
- **Creating and supplying bidding firms with information.** One of the most important ways to test prospective auditors is to provide them with retrospective information about the company and ask for their analysis. One audit chair said, *“The information packages have to be put together on behalf of the potential auditors, with data rooms. We made over 50,000 pages available to tenderers.”*
- **Bringing bidders and internal stakeholders together.** *“Management organizes local meetings, identifies who participates, who has contacts, and the technical teams who will meet,”* an audit chair said. Management is responsible for *“arranging meetings of finance teams across the organization with prospective auditors,”* said another.
- **Planning and structuring evaluations.** *“Management puts together the proposal for what the final presentation should look like and how evaluation should occur.”*

Management’s role often goes beyond administrative tasks. Members of the leadership team, including the CFO, the chief accounting officer, and their respective direct reports can be deeply involved in recommending criteria and conducting their own evaluations. *“The most important input comes from the chief accountant. He works with the external auditor on a daily basis. And the auditor’s technical capability is an important element in the evaluation,”* an audit chair said. Others in the organization, in particular corporate secretaries and other members of the legal department, work closely with the audit committee on the process as well.

Investor consultation

Most audit chairs said that they had not consulted with institutional investors during tender processes. One audit chair did not see the need: *“We involve management and the supervisory board, and that’s enough.”* However, one audit chair did seek investor input—but without result. *“I wrote a letter to the top 20 investors and solicited thoughts or questions about our audit tender. I did not*

“I wrote a letter to the top 20 investors and solicited thoughts or questions about our audit tender. I did not receive even an acknowledgement.”

receive even an acknowledgement. I sent out the letter because we had a meeting with representatives who said investors wanted this—but I got the answer I got.”

The challenge of limited choice

Because large global companies require an external auditor with a centrally managed international network, they typically limit their tenders to the Big Four firms, except where a company is considering a joint audit. This means that during a mandatory firm rotation, companies of a certain size and scale have at most three firms to consider. Audit chairs said that in some cases, the pool is smaller because one of the three remaining firms is providing advisory services that would be difficult for the tendering company to replicate elsewhere.

Audit chairs disagreed on whether the number of potential bidders was a problem. One said that this lack of choice was frustrating: *“We didn’t have enough candidates; we added two other smaller firms, but one was not competitive and the other pulled out.”* Another faced similar circumstances yet raised no issues, saying the tender requirements were designed from the start to target the Big Four: *“We set our requirements in a way that smaller audit firms could not fulfill it in terms of international size and quality. We really had tenders from a group of the Big Four, and this limited choice—but three offers from the Big Four is enough.”*

Many audit chairs acknowledged the problem of choice but also had decided not to look beyond the Big Four as a matter of course. *“Compared to the next tier down, they’re so far ahead.”* Another audit chair accepted the reality of the concentrated industry structure but noted that it presented occasional challenges: *“It had to be one of the Big Four. We were positively surprised that all four jumped at the opportunity. They really invested time and money. One challenge we did have, in small geographies: there might be conflict of interest involving other companies that might be your competition.”*

Audit chairs noted that companies could address the challenge of constrained choice through careful planning. An audit chair explained, *“You need to sort out the services that are conflicted, and you need to plan what you need. You need to plan the process early. The decision-making on where we want advisory activities to land is the most interesting.”*

Other factors stemming from audit regulation and the state of the audit market provide further constraints. The requirement that audit firms refrain from providing nonaudit services to audit clients means

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that auditors have to weigh the financial trade-offs of bidding, and the substantial cost of doing so. It has been reported that some audit firms are responding by raising fees and becoming more selective about which clients they accept.¹⁴ Audit committees are feeling the effects of these pressures on the audit profession. One audit chair said, *“I had an experience where a firm had higher fees with nonaudit services and would not bid for the audit.”* Several other audit chairs reporting having the same experience.

Selection criteria

Each company typically develops selection criteria to guide its consideration of the bidding firms. Criteria vary widely from company to company and can depend on geography, industry, current challenges at the company, and any number of other factors. *“The organization, the partner, the team—it’s a series of criteria that have to be assessed and ranked.”* Audit committee chairs noted that their assessment includes looking both at the firms themselves and at the proposed engagement teams.

Firm-level criteria

Audit chairs reported that every one of the Big Four firms is formally and technically qualified to audit their companies. The tender process allows audit committees to identify subtle distinctions between firms. As part of the RFP process, companies often submit questionnaires to the audit firms to uncover information about expertise and capabilities. Audit committee chairs provided examples, described below, of some of the kinds of questions they include in their questionnaires.

Geography and industry

Several audit chairs said that for large global companies, it is critical that the audit firm be capable of auditing remote regions effectively. *“We look at the way the firm is integrated on a worldwide level in order to serve clients with operations on different continents.”* Another added, *“One area where I’d be more thorough is the depth of local staff in key countries.”* One audit chair said that while each global audit firm is a network of national partnerships, the more they are able to centralize control and oversight of the audit, the better: *“Accidents are happening everywhere, especially in distant places where controls and management are weaker. It’s a plea for an integrated auditor.”* At times, an auditor’s presence and track record in a particular country can influence the selection process.

Audit chairs also stressed that while all of the Big Four firms have comprehensive technical expertise, it is important to select one that brings industry experience to key geographic regions. Matching

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partner expertise with regional need is an essential part of the tender process.

Audit technology

As in many industries, audit firms are energetically adopting new technologies. One audit chair said, *“Development in that area is so unbelievably fantastic today compared to five years back. It has such an impact on their work and approach.”*

Although some audit chairs did not feel they had a clear understanding of how the firms stack up against each other with regard to technology, others asserted that technology can be one of the most important differentiators. One said, *“This is the biggest question in the assessment. There are differences between firms. All of the Big Four are pushing technology. I really try to understand what they have and how is it employed through demonstrations.”* Another audit chair elaborated, *“Technology is one of the most important points to consider, for speed, quality, and accuracy. This is one of the most important criteria. In the preparation phase, there were workshops being held between the tech guys at the audit firms and the company.”*

Still other audit chairs, however, felt they understood the firms’ technologies but did not think their capabilities differed substantially. One said, *“In one or two cases, we had a strong argument from the firm we eventually selected that said they had better technology than the others. I’m not convinced there are major or critical differences between the Big Four. There are slight advantages sometimes, but in principle I’m convinced that in the long run they have similar technological know-how. There are some differences but not sustainable ones.”*

Audit firms use data analytics to identify potential risks they would target in an audit. *“Technology must help identify risk areas. Technology is used to assess control systems, like IT controls. It provides an overall IT perspective,”* an audit chair said. Another audit chair agreed: *“Ultimately, when we talk technology, it’s foresight and protection.”*

Audit chairs said they understand audit firms’ technologies by engaging with the technology experts at the firms and at their own companies as part of the tender process. *“The technology presentation is important. Get it from the horse’s mouth,”* one audit chair said. Another recommended, *“Bring the firms’ tech people together with yours and see what those tech people say.”* Another audit chair pointed out, *“One interesting thing is to visit their lab and*

have finance people and tech people extract value. That helps you think about the longer-term perspective.”

One of the most effective ways for audit committees to assess a firm’s technological strength is to provide firms with real data. One audit chair shared an example: *“We gave the firms access to the data from financial accounts and asked them to show us what to do with it. They all want to analyze data; it’s a question of how they match. It’s not just numbers; it’s about conclusions they’d draw. We really found out quickly how they do it differently. Fundamentally there are differences to their approaches.”* Audit chairs also want confidence that a firm’s audit technology will evolve as a company’s business and its own technology evolves. One explained, *“The audit firm not only must have good technology—it must invest to keep pace with the company.”*

Audit chairs also want confidence that a firm’s audit technology will evolve as a company’s business and its own technology evolves.

Regulator views

Another factor that audit committees consider is the way in which an audit firm is viewed in the eyes of audit regulators in different countries. Many regulators issue periodic reports with details of firm-level quality controls and findings from inspections of individual audit engagements. A regulator’s adverse opinions or its sanctions on a particular firm in a country where a tendering company has substantial operations can undermine an audit firm’s bid. *“All my companies are international. Frankly, I tried to understand how each audit firm was working in those countries and what kind of issues they had with those countries’ regulators,”* an audit chair said.

Lead partner and engagement team criteria

Much of audit chairs’ deliberations focus on sizing up the tendering firms’ proposed lead partners and engagement teams. *“The Big Four as a whole are very similar, which led to the result that it depended on how the people presented themselves,”* an audit chair said. Evaluating the proposed audit team helps stakeholders develop confidence that the relationship with the auditor will be a good one and that the company will receive a high-quality audit. Audit chairs said they evaluate the proposed audit team on a combination of experience, judgment, chemistry, and other qualitative criteria. *“Trust must be the overarching thing,”* one audit chair said. Another elaborated, *“The human factor is important. You need confidence in the partners, good knowledge of them, and good relationships and understanding with them.”*

Many audit chairs meet with the lead partners of bidding firms early in a tender process. One audit chair who had been through two tenders said, *“In one case, management met individually with each*

candidate, and in the other, there was a joint session; they spent a few hours answering questions. I also spent a few hours with each of them. The audit committee was aware, and it agreed on the process.”

The skills and strengths audit chairs look for are difficult to define. Assessing them can come down to feel and professional chemistry. One audit chair said, *“The most critical point was the team quality and what they present.”* Another audit chair countered that decisions revolved more around competence than chemistry: *“Part of it for me is to have the right skills on the partner side. There is also an element of insight into the business: are they capable of doing an assessment from a professional point of view?”*

Although the lead partner is a prominent figure in any bid, audit chairs tended to agree that, as one put it, *“a really important question is who is number two on the account.”* They said it is important to ensure that all important internal stakeholders are comfortable with their counterparts on the proposed audit team. Moreover, understanding a firm’s bench strength is helpful because eventually the lead partner will have to rotate off the account.

Audit chairs also look for indications that the proposed audit team can take advantage of its own firm’s resources. One asked, *“Can they bring the firm with them? Can they talk to their partnership and bring the group to bear on the challenges?”* Other audit chairs noted the importance of a team that has clout within its own firm, especially with the professional practice office.

Audit chairs identified some of the specific characteristics and criteria that they, their fellow committee members, and their management teams look for in a lead partner and the people on an engagement team:

- *“Service, people, the background of the partner, depth of international experience, financial services experience.”*
- *“We asked the auditor to have a conversation with us—a specific conversation on a particular project or country. They provided us with a sense of their approach and how they react to pushback. It also showed whether they’re too eager to please.”*
- *“We look at the track record of team members,”* including auditors’ past performance in other engagements.
- Some companies ask bidding firms for their views on previous audit opinions: *“We do it on important accounting judgments. I*

Understanding a firm’s bench strength is helpful because eventually the lead partner will have to rotate off the account.

find it valuable to understand how bidding firms think about those issues. I want to understand that before I hire you.”

The audit firms’ engagement teams make formal presentations, often to some combination of the audit committee, management, and the full board, and audit chairs consistently said that seeing these presentations near the end of the tender process was critical to their evaluations. Many audit chairs said that they revealed important qualitative aspects of the teams’ ability to provide a quality audit. *“The auditor we picked was the choice because the people they presented were very committed, very good—a clear number-one position. They were really invested in their people.”* One audit chair described a presentation that made a positive impression in the moment but was ultimately less valuable. A leader of an audit firm *“made a superb presentation,”* the audit chair said, *“but he was not on the audit team. He was a very good speaker, but we took a different choice.”* Others noted, however, that such a presentation nevertheless has value, as it can help show how the audit team will engage with the leaders of its firm and bring the full resources of its firm to bear.

Some factors may limit whether otherwise qualified partners merit consideration—or are available at all. If a partner appears to be unable to perform the audit with full independence, that can be a disqualifier. One audit chair recalled a case in which *“management’s chief accountant and the bidding firm’s lead partner had been working together for many years. They were too close, so we didn’t choose that bidder. We need somebody who’s very independent.”* Another audit chair had a similar experience and *“completely disregarded a firm for these reasons.”*

Price

Many audit chairs described tender processes that minimized fees as a factor. Audit chairs reported in our survey that, on a scale of 1 to 10—where 1 represented “price was not a factor in the evaluation” and 10 represented “price was the only factor considered”—price received an average weight of 3.1. *“At the beginning, I said price is important, but it was not criterion number one. Number one is the quality of their work,”* an audit chair said. One audit chair, listing criteria in descending order of importance, said that audit quality was first, while price was fifth. Another said, *“Fees were visible, but we determined that they wouldn’t be the determining factor as long as they were in the right zone. We chose the higher fee of the two. That has been true of all the tenders I have led. We felt the capability of the team offering a lower price than the other was not as good.”* Sometimes, however, price can act as a tiebreaker, as one

“We chose the higher fee of the two. That has been true of all the tenders I have led.”

audit chair noted: *“If two firms are difficult to distinguish, it might count at the end.”* Another said, *“You can’t say that fees are not important.”*

Some audit chairs nonetheless said that their companies conducted detailed analyses of the firms’ proposed fee structures. *“We divide fees by country, the hourly rate, the balance between junior and senior people. In the case of one tender, all of the firms were at the same level except in [one country], where one firm was much higher.”* Another said, *“We asked for a fee proposal and we got three almost identical and a fourth a bit higher. We concluded that one knew the complexities of our company better. In the end, we were more concerned about not putting too much weight on fees. Pushing them down too much would lead to lower quality. The ones that were lower didn’t really understand, so we were prepared for fee creep.”*

“A tender should never be a cost-cutting exercise.”

Many audit chairs expressed suspicion about low bids. *“One of the elements you watch out for is cheap fees. They want to buy the mandate. At the same time, if they increase the scope to 100% and the partner hours by 50% but offer low fees, you have to look at that and the seriousness of the proposal. If, at the end of the day, we think auditor A is the best and has a higher fee than B, then we can look at effectiveness and efficiency. I would probably negotiate with the best auditor despite its higher fees.”* Another audit chair said, *“I don’t think there’s much of a disparity among the Big Four, and if there is, I want to know why. If the difference is more than 10%, I’d want to know if somebody has something that the other doesn’t. A tender should never be a cost-cutting exercise. What have I missed if there’s a 20% disparity?”*

“We were blind to anything about price in the first phase. Only after you reach a short list do you ask for price.”

Some companies intentionally exclude price from consideration, using fee-blind tenders and “two-envelope” bid submissions. Although most audit chairs said they did not entirely exclude price during the tender, several avoided considering it until the end or managed to shield some decision influencers from price. One audit chair said, *“We were blind to anything about price in the first phase. Only after you reach a short list do you ask for price.”* If the selection team disregards price during the evaluation process and ends up picking a firm with a high price, the team then has leverage to negotiate price.

One audit chair’s company, whose tender process did consider fees, took creative measures to prevent low bids from having an undue influence: *“Management put in a good idea: an antidumping mechanism. If the audit firm puts out an offer that is 11% less than what the company is currently paying, the audit firm won’t receive*

any benefit in the point system. An audit firm was a candidate but offered half the price and didn't get credit for doing that."

Cost predictability and stability can matter as much as absolute cost. Audit chairs are skeptical of low-fee bids because they may indicate that the firm does not understand or is not attending to the likely scope and eventual cost of the audit. In the face of potential scope changes, committees strive for shared expectations with their auditors. *"The important thing is to have the granularity in the fee proposals. You need an understanding on how the auditors would react. Complexity can also be reduced,"* one audit chair said. Negotiation can also create fee predictability, if not always stability. One audit chair shared an approach a company took to ensure that fees remained stable: *"We got a clause in the agreement that said as long as we stay within 10% of revenues from the previous year, then the fee doesn't change."*

Process conclusion and auditor transition

Once all relevant criteria have been considered and auditors have presented, audit committees make a recommendation to the board about which audit firm to select. This reflects input from management but is ultimately the responsibility of the audit committee.

After a board selects a new auditor, it faces the challenge of managing the incumbent while onboarding the replacement. Audit chairs described practices that can smooth the transition:

- **Advance planning.** A smooth transition from auditor to auditor requires ample time. While the planning period varies, one audit chair reported, *"We will make the decision a year before the new auditor starts, so we will have a year to set up the transition."*
- **Management support.** Management can play an important role in assisting the new auditor. Under some circumstances, management, typically in the finance function, may be the chief steward of the process. One observer of the process in Turkey explained that in that country, because the working papers of each audit firm are structured differently, it may fall to management to explain everything to the new firm.
- **Coordination between the two firms.** Audit committees and management can take steps to ensure that the incoming and departing firms work well together to ensure a smooth transition. One audit chair mentioned a case in which the incoming audit team shadowed the incumbent for almost two years, working on the transition full time.

Unforeseen outcomes and experiences

Despite the challenges and burdens of the tender process, several audit chairs reported that their overall experience was good. An audit chair noted that tendering had brought *“pleasant surprises,”* including valuable internal discussions on how to streamline and restructure the financial reporting process and innovations offered by tendering audit firms. Audit chairs also mentioned questions for bidding firms, the answers to which have proven valuable; examples include what the bidding firm’s perspective is on the audit profession and its evolution and how the firm has resolved difficult client disputes in the past.

Audit chairs reported other unforeseen experiences from their tenders. One audit chair said, *“The auditors we expected to perform didn’t. The short list was different than expected. Also, the final decision surprised us.”* Another chair noted higher-than-expected demands on the committee and especially the chair: *“I had to involve myself more than I expected.”*

Internal audit

One of the most important partners for the audit committee is the internal audit function and its leader, the chief audit executive (CAE). The activities undertaken by internal audit—financial and operational audits, audits of compliance activities, involvement in enterprise risk management (ERM), and support for the external auditor—all take place in domains where the audit committee has important responsibilities, and internal audit often reports functionally to the audit committee.

The rise in importance of many of these domains, such as ERM and compliance, has expanded the demands on internal audit. Meanwhile, new digital technologies are both challenging and strengthening internal audit’s capabilities. Audit committees spend substantial time and effort assessing and supporting the activities of the internal audit function, which an audit chair referred to as the *“eyes and ears”* of the audit committee. The CAE may even report directly to the audit chair.

Audit committee interaction with internal audit

Audit chairs said that their audit committees interact extensively with the internal audit team and the CAE. *“The head of internal audit reports in every audit committee meeting about the internal audit plan, the results of audits performed, and the internal control system. In preparation for every audit committee meeting, there is a separate meeting between the head of internal audit and the*

chairman of the audit committee,” an audit chair explained. The audit committee’s focus on internal audit continues to grow as the function’s mandate expands. Some audit chairs said they are adding two or three hours to their annual calendars for conferring with internal audit.

“As the chair of the audit committee, one of my most important relationships is with the head of internal audit. You should build enough trust so that he can say to you, ‘The CEO might be committing fraud.’”

Audit chairs also reported having email exchanges and phone calls with the CAE in advance of the in-person discussions that take place during audit committee meetings. Some chairs described contacts with other internal audit staff as well, including those focused on internal controls and IT. Others mentioned travelling internationally to meet with internal audit leaders in key geographic regions at least once a year or if a report suggests a problem. By doing so, they demonstrate through their presence the importance that the board and the audit committee place on the internal audit function.

One audit chair described improving the flow of information from the internal audit team to the audit committee by building trust: *“I’ve built up an atmosphere so that they can tell me about problems, so that I’m included and involved.”* Another audit chair said, *“As the chair of the audit committee, one of my most important relationships is with the head of internal audit. You should build enough trust so that he can say to you, ‘The CEO might be committing fraud.’”*

Audit chairs described several topics that they address in their interactions with internal audit:

- **The internal audit plan.** Audit chairs mentioned engaging in extensive discussions about the internal audit plan. One said that the audit committee can check that the plan is focused on the right risks. Another noted that evaluating a plan can be challenging: *“The biggest problem I have is determining if the audit plan is sufficient and universal.”*
- **Specific internal audit issues.** Audit committees review internal audit reports, often delving into the details. Audit chairs said that these reviews can lead to spirited discussions with the audit team as well as management. One audit chair highlighted the importance of high-quality reports that flag the most important issues: *“The report has to be meaningful, clear, and digestible to the audit committee. We work with internal audit to make sure we are not getting voluminous data in which important facts are buried.”*
- **ERM issues.** In the three lines of defense model for ERM, internal audit is the last line, working to ensure the other two—the business units/line management and the risk and compliance functions—are working as intended.¹⁵ But internal audit may also

be involved in certain second-line activities, advising management on how to identify and respond to risks. Audit committees consult with internal audit as part of their oversight of risk, checking not only on internal audit's assurance activities but also on its more direct involvement in ERM activities. *For more detail about the three lines of defense, please see page 43.*

- **Internal audit's performance and capabilities.** One audit chair described a comprehensive review process: *"We review the quality of the staff. We review and approve the budget. We review the scope of the work. Periodically, there's an external review. On an ongoing basis, we get feedback from the external auditor on the quality of the internal audit department and their work."* Another emphasized the importance of assessing the resources available to the internal audit team; the audit committee asks the team if these resources are adequate given the scope of their work, checking whether they are under excessive pressure from management to cut costs.
- **The CAE.** The audit committee may be responsible for the appointment and dismissal of the CAE, or at least approving these decisions. The committee may also establish a framework for periodic turnover in the CAE role to ensure independence. When the CAE leaves the role, an audit chair noted, it is important to conduct a thorough exit interview to understand why he or she is leaving and if there are concerns the audit committee should know about.
- **Relations with management.** An audit chair described the challenge that internal audit faces in helping the company achieve its goals while remaining objective: *"Finding a balance between independence and being part of the corporate organization is hard."* CAEs at some companies risk being removed if they clash with the CEO or another member of the senior management team, and it is precisely in these situations that the audit committee must support the CAE. The CAE should be able to report inappropriate behavior to the audit committee with full confidence that the committee will stand up for the CAE. Audit chairs also expressed concerns about management not always implementing the recommendations of internal audit, or not doing so in a timely manner. An audit chair described a situation where the audit committee had to intervene: *"The operating divisions were sidelining internal audit, making access to the right management people difficult. They were slow in implementing recommendations, and they were not reporting up."*

The CAE should be able to report inappropriate behavior to the audit committee with full confidence that the committee will stand up for the CAE.

- **Relations with the external auditor.** Audit chairs said that they try to encourage internal audit and the external auditor to support each other in their work. The key is to ensure constructive relations between the two, which audit committees can ascertain in executive sessions with each of them, comparing their responses.

Impact of digital technologies

New digital technologies are changing the work of internal audit, creating additional issues of interest for audit committees as they oversee this work. Digital advances in areas such as mobile and cloud computing, automation, and artificial intelligence are transforming the way companies do business, creating a new landscape of internal controls and risk management. Large-scale digital platforms are changing business processes from end to end, and the boundaries with customers and business partners are becoming blurred. These developments are shifting control points across organizations and demanding more proactive approaches from internal auditors.

At the same time, digital technologies such as robotic process automation and advanced analytics are helping internal audit improve its performance. They allow internal auditors to test an entire population rather than just a sample of transactions, and they can lead to significant cost savings by automating rote tasks. They also free up the internal audit staff to focus on the tasks that require human judgment, deepening insight and enabling internal auditors to provide better advice.

Achieving these benefits, however, requires new skills and more flexible approaches to audit planning. Moreover, as internal audit functions develop new ways to provide value across the organization, audit committee chairs must continue to ensure that their internal audit teams maintain their professional skepticism and independence.

Audit chairs encourage the internal audit function at their companies to understand and utilize new technologies and techniques. They seek CAEs who understand the tools and resources required and how these should be integrated into the function and the broader organization. But audit chairs also want to maintain the integrity of assurance, which could be jeopardized as new technologies cause the three lines of defense in ERM (described above) to encroach on each other's responsibilities. Collaboration among these lines of defense is important, but the independence and objectivity of internal audit must be maintained.

V. Audit committee responsibilities derived from governance codes, company law, and practice

Risk management

Overseeing risk is a core function of every board of directors, but most boards delegate a substantial portion of this task to their audit committees. Boards consider the risks that companies face in areas such as strategy, cybersecurity, compliance, third-party relationships, and company reputation. They review ERM systems and controls, assessing risk mitigation against companies' "risk appetite."

For many audit committees, oversight of risk and risk management goes beyond financial reporting, often entailing a more significant role than that played by other board committees.

The most significant risks are generally addressed by the full board because they are critical to the success or failure of a company. *"I think everyone in the full board has responsibility. The chairman especially has to focus on this,"* one director said. However, various board committees are likely to play both formal and informal roles, including the audit committee. The ARD requires audit committees to monitor risk management "regarding the financial reporting of the audited entity." Therefore, financial reporting risks—for example, the risk of errors leading to restatements—are squarely the responsibility of the audit committee. For many audit committees, oversight of risk and risk management goes beyond financial reporting, often entailing a more significant role than that played by other board committees. Many European corporate governance codes explicitly assign risk oversight to the audit committee (unless there is a separate risk committee).

The audit committee as leader of risk oversight

When the audit committee is delegated to lead risk oversight, it oversees the company's—and the board's—overall process as well as some subset of specific risks. The audit committee reviews risks and mitigation plans at a high level, then allocates risks among committees. Risks that might have an important financial impact often stay with the audit committee, but others might go to other committees, such as a human resources committee or a sustainability committee. These committees follow their assigned risks on a day-to-day basis and report back to the audit committee. The full board is kept informed, with the most important issues coming to the board at least once a year.

Determining the proper scope of responsibilities assigned to the audit committee, other committees, and the full board is an ongoing challenge for boards.

Some audit chairs warned that as an audit committee assumes more responsibility for risk oversight, it may take on risks that it is less equipped to handle than those related to financial reporting and internal controls. Without a clear and explicit understanding on the board regarding the scope of an audit committee's responsibilities, this scope can easily grow broader and broader. Determining the proper scope of responsibilities assigned to the audit committee, other committees, and the full board is an ongoing challenge for boards.

Coordination with a risk committee

In some companies—primarily financial institutions—boards have established risk committees to deal with the growing burden of risk oversight. A 2018 Spencer Stuart survey of the largest 150 companies in the Financial Times Stock Exchange rankings, for example, found that 19.3% of boards had a separate risk committee, with more than 85% of these in financial services.¹⁶ Experts point to several advantages of a dedicated risk committee, which can focus all its time and effort on the complexities of risk oversight and can be composed of members with expertise in risk management.¹⁷

Audit chairs acknowledged these benefits, but they also noted that an audit committee's core duties complicate the assignment of risk oversight to a different committee, as there are tight interlinkages between risk oversight and an audit committee's core functions. *"There is a risk of overlap between the risk committee and the audit committee. Mitigation is about strategy and controls, which is what the audit committee does. Yet the risk committee looks at risk mitigation. You need to ensure that topics are properly shared,"* an audit chair explained.

Given this overlap, risk committees and audit committees need to coordinate their activities. One audit chair explained that a risk committee is responsible for understanding the inherent risk in an area, seeing what level of residual risk the company will tolerate, and understanding the mitigation required. The audit committee's responsibility is to evaluate whether the design of the controls is effective and to ask whether those controls have been implemented and are working. If not, the audit committee lets the risk committee know so that it can decide if the residual is acceptable or must be fixed. Another audit chair summed it up: *"The risk committee focuses on outcomes, and the audit committee focuses on controls. We manage the overlap by having some members sit on both committees."*

"The risk committee focuses on outcomes, and the audit committee focuses on controls. We manage the overlap by having some members sit on both committees."

Risk oversight activities

Audit chairs highlighted several activities that are important in a board's oversight of risk. Though the full board could undertake these activities, the audit committee could also do so, on its own or in collaboration with the full board and other committees.

Applying the three lines of defense framework

For many companies and boards, a useful framework for managing and overseeing risk management is the three lines of defense model, initially promulgated in financial services but rapidly spreading to other sectors. Under this framework, the first line of defense is comprised of the business units, which own and manage risks during the course of their day-to-day operations. The second line is the risk management function itself, which develops and promulgates consistent policies and practices across the company. Finally, the third line is internal audit, which provides independent assurance that the two other lines are performing as required. Outside of the company, regulators and the external auditor may provide additional lines of defense.¹⁸

Audit committees interact with all three lines as they oversee risk management efforts, such as risk identification and risk mitigation, and they interact regularly with internal audit, which typically has a reporting line to the audit committee. Audit chairs also mentioned the value of a separate risk function providing the board with an integrated, holistic view of risk management efforts; they like hearing from a dedicated chief risk officer, who can spot trends across the organization and provide a consolidated view. They also said it is essential for the board to hear from the executives who actually own the company's most critical risks. Some audit chairs noted that a robust second line is not ubiquitous yet: *“Outside of financial services, I’ve had limited experiences with true second lines of defense—i.e., an independent function that challenges management. They haven’t been required to do so.”*

Identifying and assessing risks

Audit chairs reported extensive interaction with senior members of management—in all three lines of defense—to identify risks. One said, *“We have a chief risk officer with a dedicated team, including actuaries and top-level people. We have them meet with the board four or five times a year, and we have decided on a dashboard with assessments of the top risks.”* Others reported meeting with the head of internal audit five or six times a year. Because of its close relationship with internal audit, the audit committee gets unique and

substantial insight into a company's risks. *For more detail, please see the internal audit section, on page 37.*

Audit chairs elaborated on the use of dashboards or risk maps as a way of comparing risks in a systematic way. Some noted that they develop a risk map at least once a year that can then be used to track risks over the course of the year. The time commitment may be considerable. One audit chair said their audit committee spends a full session to review the risk map in detail, after which there is a presentation to the full board lasting 15 to 20 minutes. Some audit committees also review historical risk maps to assess the accuracy and impact of the company's ERM process. This process can either validate the company's efforts or provide guidance on how to reprioritize its focus.

Directors also talked about inquiring beyond senior management by venturing out across the company and its operations, conducting field trips to business units to learn about the company's risks and to build relationships with those in charge of managing them.

Anticipating emerging risks

Emerging risks are always a concern, audit chairs noted, and a board needs to be sure that management is not ignoring or underestimating such risks, even if they are more speculative. *"Emerging risks are like other risks—they need to be identified, and people need to be made accountable. You can't just talk about them. The role of the audit committee or the board is to challenge management on whether new things are emerging,"* one audit chair said.

Emerging risks are not necessarily unknown or surprising. They include risks that have been lower in priority because of their probability or potential impact but are now beginning to move up in the relative ranking. Board members, who are a step removed from the business and have great wisdom because of their experience, are uniquely suited to help management identify and plan for emerging risks. They see things slightly differently from management and can therefore add value.

Looking for lessons from the financial services sector, one audit chair commented on the value of stress tests to help the board more fully appreciate systemic risks: *"The risk practices in financial services institutions may be moving into other industries. For example, do you reverse stress-test? What combination of factors would it take to break this business? I've found it hugely informative to help to identify risks that could really bring the business down."*

"It requires imagination. We are looking at a few scenarios, getting external help to think outside the box. You have to be creative but not outrageous."

Directors mentioned scenario planning as an emerging and helpful tool, perhaps facilitated by outside experts: *“For tail risks, which are low probability but high impact, we are looking into scenario planning. You can’t eliminate these risks, but you have to understand the potential impact. What’s plan B?”* Trying to identify these risks means going beyond routine exercises: *“It requires imagination. We are looking at a few scenarios, getting external help to think outside the box. You have to be creative but not outrageous.”* Scenario planning can help the audit committee and board understand the potential for multiple risks to be correlated, and the resulting amplified impact.

Monitoring mitigation

Once the risks that the board should track are identified, boards and audit committees can focus more closely on how these risks are managed. An audit chair described a common approach: *“We ask if there are risk owners, responsible parties. Are there mitigation plans in place in case the risk occurs? Is everything that must get done on track, or does the business need to remediate the plan? We figure out what needs to be solved, and we have a dashboard of things we have to solve, things that need action.”*

Deeper investigation of some risks may be necessary, though not always by the whole audit committee. In the case of one audit chair, *“We decided that one of the audit committee members, the former deputy CEO of a company, and I would do a deep dive.”* Such deep dives may involve more extended discussions with managers responsible for specific risks; discussions with internal audit are helpful too. In some cases, outside experts are brought in to provide fresh perspectives and additional knowledge, including benchmarks based on other companies’ experiences. *“Since risks are very polymorphic, I think that entails different solutions, given the various kinds of risks,”* one audit chair noted. Another said their audit committee had been delegated oversight of corporate insurance; the committee looks at the types of insurance policies taken out, though not the amounts.

The audit committee’s evolving role

Regardless of what audit committees currently do in the area of risk management and oversight, their responsibilities are likely to change over time, as new risks rise to prominence in an increasingly global and digital world, in the same way that cybersecurity and third-party risks have grown in importance. These might be added to the audit committee’s portfolio, initiating a process of experimentation and learning in which the audit committee

develops the appropriate lines of communication and practices for overseeing them. They might also be assigned to other committees or the full board, with the audit committee playing a supporting role. Over time, assignments could change as lessons are learned and risks evolve.

Compliance

Although it is not always a legally mandated responsibility of the audit committee, compliance oversight has many ties to the mandatory audit committee role of certifying financial reporting.

Board delegation of compliance oversight

Audit committees have heavy workloads, and audit chairs are mindful that adding compliance to their agendas can leave less room for other oversight duties. While many boards delegate ethics and compliance oversight to the audit committee, some companies charge specific committees other than the audit committee with overseeing parts of compliance. Risk committees, for example, could examine certain compliance risks, while finance committees might oversee aspects of compliance with financial regulations.

Since the audit committee's core work includes financial reporting and overseeing the system of internal controls, it is involved in compliance issues even when another committee or the full board takes the lead. Some audit chairs request formal reports on compliance from management once or twice a year, while others ask for one every committee meeting. These reports provide audit committees with the chance to hear whistleblower reports and updates on training and internal controls. The company's general counsel conducts a deep dive on pressing issues.

Compliance priorities

Once a board decides how to organize its oversight of compliance, it typically identifies a number of areas for compliance focus. Such areas, described below, include overseeing compliance policy and implementation, high-profile compliance risks, and the whistleblower program; fostering a compliance culture; and ensuring a comprehensive approach to compliance oversight.

Compliance policy and implementation

Audit chairs often weigh in on compliance policies and codes of conduct and offer practical suggestions for enhancing them. Codes of conduct, which are often high-level sets of principles for ethical decision-making and "good behavior," can influence behavior in a consistent way across the enterprise. An audit chair said, "You

should have a code of conduct—that’s fundamental. You need a guiding framework on ethics and honesty and corporate values. The code of conduct should be reformulated from time to time.”

“We think prosecution is the best education you can have. It spreads like wildfire in the company. When employees are fired, people want to know why.”

Some audit chairs favor zero-tolerance policies against unethical conduct. Making the policy clear to employees is an important element. *“We think prosecution is the best education you can have. It spreads like wildfire in the company. When employees are fired, people want to know why. We don’t explain exactly what they did, but that they did do something, and the company acted,”* an audit chair explained. Most audit chairs said that a code of conduct must be accompanied by training and that this is where companies often fall short. If the head of compliance recommends a change to the compliance function and the audit committee agrees, the audit committee follows up to ensure that the recommendation was implemented.

High-profile compliance risks

New regulations can transform a company. Although some changes in the law might only affect operations in one country or even a smaller jurisdiction, some regulations have much broader implications. Audit chairs described some of their experiences overseeing compliance with particular legal requirements:

- **Antibribery laws.** The UK Bribery Act, US Foreign Corrupt Practices Act, and other similar laws have global reach and come with the threat of serious financial penalties for violations. Audit chairs noted their role in encouraging their management teams to take these threats seriously. One said, *“I had to insist that our people be educated on the UK antibribery act. It was almost a struggle.”*
- **Fraud prevention.** Beyond compliance with antibribery laws, audit chairs noted that the audit committee is often responsible for working with management to avoid or uncover fraudulent practices. An audit chair said that to test the company’s fraud-prevention system, *“I will occasionally put a false transaction into the system to see what happens. I call it ‘mystery shopping.’”*
- **The General Data Protection Regulation (GDPR).** As companies seek to take advantage of the data they are collecting from customers, employees, and others, they are paying close attention to the legal constraints on the use of personal data. The consequences of misusing data became even more acute for audit committees when the GDPR became effective in 2018,¹⁹ as it included the potential for massive fines in the event of a violation.

The whistleblower program

One audit chair called the insights from whistleblower reports “*real and tangible.*”

Whistleblower hotlines are a direct channel of information from any level in the organization to the board, typically the audit committee. Unlike facts and figures, whistleblower reports provide a direct view of behaviors within the organization, and that exposure is particularly important for non-executive directors. One audit chair called the insights from whistleblower reports “*real and tangible.*”

Whistleblower reports commonly are a component of compliance reporting to the audit committee. An audit chair said, “*In my company, we get a report at every audit committee meeting on compliance issues. We also get a whistleblower report.*” In addition to providing a glimpse at the behaviors within the company, whistleblower reports indicate whether there is a speak-up company culture. One audit chair said, “*We have a whistleblower program, and we measure progress by an increasing number of calls.*”

A compliance-oriented culture

The relationship between corporate culture and compliance has become a major area of interest among boards and audit committees. Many companies seek to cultivate agility, resilience, and ingenuity within their corporate cultures. Yet these can lead to excessive risk-taking or a willingness to override process, and hence to serious compliance breaches. Corporate culture is both a reflection of the behaviors and norms that pervade an organization and a shaper of individual future decisions. An audit chair said, “*Culture touches every aspect of the organization: strategy, business processes, employees. It’s in everything we do.*”

Audit chairs said that a formal assessment can help management and the board better understand culture across an organization. There are a variety of methods and resources that the audit committee, working with the full board and management, use to oversee culture:

- **Site visits.** As previously noted, some audit chairs visit far-flung company operations to see how the company operates away from headquarters and to assess risk. Many of these site visits focus on culture.
- **Employee surveys.** One audit chair said, “*We do surveys. I don’t know of a company that doesn’t.*” Audit committees often receive samples of responses that can offer a window into the company’s culture. An audit chair explained, “*Surveys help to see if there is buy-in to the leaders.*”

- **Management performance reviews.** Several audit chairs mentioned using management reviews for cultural assessment. One said, *“One of the data points on culture is, How are the leaders? This goes to the human resources side of the business. How is management appraised? Do you see common threads?”*
- **External auditors’ perspectives.** Audit chairs reported that the external auditor can be helpful in gauging a company’s culture. One audit chair said the external auditor was particularly useful at global organizations to help *“see the culture in every country.”*

Comprehensive compliance oversight

Because audit committees need to remain abreast of regulatory developments, receiving a comprehensive flow of information is essential. They frequently obtain updates from the general counsel’s presentations to the board. They also learn about changes in the law from other C-suite executives, senior managers, and the external auditor. The chief information security officer or chief technology officer may inform the audit committee or full board of regulatory changes affecting cybersecurity or data privacy, such as the GDPR. Lead securities and environmental lawyers often support the general counsel in presentations to the board in their respective areas of expertise.

The external auditor, which tailors its services to the company’s industry and compliance obligations, supplements this flow of updates to the audit committee. Some audit chairs receive information from the external auditor about the state of the company’s compliance and areas of potential weakness, but in general, they indicated that they do not view the external auditor as the ultimate authority on their compliance programs.

Cybersecurity

The evolving nature of cybersecurity risk presents a unique oversight challenge. Unlike financial control risk, there is no established model, arising through either shared practice or regulation, for a board’s oversight of cybersecurity risk. In practice, audit committees have undertaken the majority of their boards’ cyber-risk oversight. They use a variety of frameworks and techniques to assess their companies’ cybersecurity capabilities. This often requires audit committees to work closely with IT experts. A growing number of board members have cybersecurity expertise and can materially help audit committees in their work.

Expanding agendas and adding expertise

“We have split the tasks so that our technology committee handles the ‘what and how,’ and the audit committee then assesses whether the decisions—processes, routines, documentation, and follow-ups—are implemented and followed.”

While audit chairs agree that the full board is ultimately responsible for cybersecurity, most said that at least part of its oversight is delegated to the audit committee. One audit chair said, *“We have it on every agenda for the audit committee. We cycle through various topics. We look at the overall structure, then identify the areas we’ll home in on for the rest of the year.”* As part of their oversight, audit chairs routinely receive briefings from chief information security officers (CISOs) when major incidents occur. Additionally, dedicated cybersecurity presentations and discussions regularly take place in audit committees.

Some audit chairs were concerned that adding cybersecurity oversight to already crowded audit committee agendas may not be the most effective course of action. One said, *“In the current-year plan, we have two sessions on cyber. At the audit committee, things get squeezed by other items. We are feeling that we are not spending enough time, but it can be hard to find another 20 to 25 minutes.”*

Some boards delegate aspects of cybersecurity oversight to other committees. One audit chair reported, *“We have split the tasks so that our technology committee handles the ‘what and how,’ and the audit committee then assesses whether the decisions—processes, routines, documentation, and follow-ups—are implemented and followed.”* Some boards even establish cybersecurity committees to handle the bulk of the issues. Still, audit chairs expect that their committees will remain engaged in cybersecurity oversight.

Having a cybersecurity expert on the audit committee or full board can be valuable. A non-executive director with deep cybersecurity expertise can bridge the communication gap between management, technical experts, and the board. One audit chair said that non-executive directors with a background in IT or security *“can coach CISOs to not talk in technical speak; they help translate. We get better at what questions to ask. Helping someone bridge that focus with cybersecurity operations is essential.”*

However, audit chairs emphasized that such an expert cannot be a single-issue director. One said, *“If you have a good cyber person who is a bright, expanded businessperson, great. But having narrow and deep cyber experience is not a recipe for success at the board level.”* Furthermore, the presence of one director with cybersecurity expertise cannot release the rest of the audit committee or board from its oversight obligations.

Enhancing oversight

Audit chairs said that effective oversight relies in part on consistent and appropriate metrics for tracking and benchmarking a company’s cybersecurity practices. This helps audit chairs develop confidence in management actions. *“You need standards. We’re tracking our performance and we feel good about where the company is,”* one audit chair said.

Many audit chairs work with broadly accepted cybersecurity frameworks and standards, which CISOs use to track progress in securing a company’s information. Audit committees often ask their CISOs to prepare risk matrices or dashboards that provide a snapshot of this progress. Audit chairs view these frameworks primarily as management tools but said that audit committees can use them to assess the relative maturity of the organization’s cybersecurity measures and to track progress over time.

The International Organization for Standardization (ISO) promulgated several standards, some of which are industry specific, which many European companies use.²⁰ The US National Institute of Standards and Technology Cybersecurity Framework is used by companies based in the United States and Europe.²¹ Other standards, which European companies may use, are available as well.²²

These standards and frameworks usually provide high-level operational views of cybersecurity. Audit chairs described further approaches for overseeing their companies’ cybersecurity functions:

- **Tabletop exercises.** Cyber-breach scenarios help non-executive directors understand who would handle the response and how. They also help expose weaknesses in response planning. *“We have the audit committee involved in tabletop exercises. It’s very important—nobody knew who was in charge. Directors need to know what the plan is during a cyber breach and when they will be informed,”* one audit chair said.
- **Postcrisis reviews.** Audit chairs emphasized the importance of learning from a major breach, either at their own company or at a competitor. One said, *“When breaches happen periodically, you want to ask what we learned from the last event.”* Conducting a postbreach evaluation of management’s response and giving feedback are important tasks for the board. While exercises provide rich learning opportunities, one audit chair said, *“There is no better instruction than having a breach happen in real life.”*
- **Third-party assessment.** The high stakes associated with cybersecurity raise the question of whether the board should

Some audit chairs recognized that their own lack of technical fluency can complicate communication with CISOs, but nonetheless expressed frustration with the technical jargon that security professionals often use.

supplement communication from the CISO with input from an independent adviser, which can help assess the threats and evaluate the CISO and the cybersecurity program.²³ Some audit chairs said that their boards rely on outside consultants for assistance with penetration testing and other services. While management often retains the outside consultants, it is becoming more common for these third parties to brief audit committees on their impressions and conclusions.

- **Individual training.** Participating in training programs can enhance an audit committee member’s expertise. One audit chair had a positive experience with an extensive cybersecurity training course for board members: *“It brings in people dealing with cyber—police, bankers, cyber agencies—so you get a good perspective on what’s going on. It makes the conversation and the questions being asked more relevant.”*

Communicating effectively with CISOs

Audit committee chairs reported that they benefit from having an open and direct relationship with their companies’ CISOs and other managers responsible for information security. They said that a strong rapport—built on regular communication using a shared vocabulary—makes it easier to ensure that the function has adequate resources and to provide sufficient oversight of the controls in place to mitigate cyber threats.

Some audit chairs recognized that their own lack of technical fluency can complicate communication with CISOs, but nonetheless expressed frustration with the technical jargon that security professionals often use. Audit chairs try to foster effective communication with CISOs by encouraging them to use less technical terms. Presentations to boards and audit committee are most effective when they provide enough technical detail for board members to grasp the key concepts, without getting too detailed. Board members with IT or cybersecurity expertise can facilitate communication, but audit chairs said it ultimately falls on all members of the committee to understand the subject matter. One audit chair said, *“As audit committee members, our knowledge needs to increase in order to understand what the CISO does. If we could make recommendations to them about how to present, it would be helpful.”*

Audit chairs outlined the issues that are most important for boards to discuss with CISOs:

- **Threats and incidents.** Learning about actual events or threats helps audit committees provide oversight. Audit chairs said that it

is not realistic for them to hear about every incident, but some mentioned seeing aggregated information, such as data on the frequency of attacks. The quantity and quality of incident reports to the board or audit committee can be an indicator of a CISO's effectiveness.

- **Organizational maturity.** It is important for an audit committee to understand where the company's cybersecurity function is in its evolution. One audit chair said, *"It's the audit committee's responsibility to understand where the company stands in terms of a maturity scale. I ask what the CISO's plan for the cyber program is. How are we getting better? You have to understand in terms of timeline."*
- **Budget.** Audit chairs said that cybersecurity spending needs to align with the level of risk that the organization is willing to incur. An audit chair said, *"If you wanted to prevent all cyber threats, you'd have to spend three times as much as we do. Instead, you need to define the company's risk appetite and determine what is nonnegotiable."*
- **Performance compared with leading companies.** It is important for audit chairs to know how the company's cybersecurity program performs compared with others, including industry competitors. Some CISOs provide information about trends, such as what other companies are doing or what regulators are demanding. One audit chair found it valuable for the CISO to benchmark the number of cyber incidents against those suffered by other companies, a common practice in some sectors. Another audit chair said, *"It's a journey, and despite inadequacies, by benchmarking we've discovered that we're actually ahead of the curve."*

Tax strategy

Companies review and modify their tax strategies and policies on a regular basis. Given their importance, tax issues are often reviewed by the board. When they are, the audit committee plays a key role. One audit chair said, *"Every year, at least once a year, we get an overview of tax risks of the company. We have discussions of tax strategy and changes in the tax environment and the risks."*

Tax optimization versus other strategic objectives

Companies strive to strike a proper balance between tax optimization and other important objectives. Audit chairs explained

Audit chairs explained that the company's tax strategy has shifted from being a "value-creating lever," as one put it, to being more of a compliance issue.

that the company's tax strategy has shifted from being a "value-creating lever," as one put it, to being more of a compliance issue.

A fundamental aspect of tax strategy today involves protecting the company's reputation. Even if the amount of tax a company pays in a given jurisdiction is legal and goes unchallenged by tax authorities, it may draw public scrutiny. Oversight of tax issues is a natural role for the audit committee given the implications on both financial reporting and risk management. One audit chair said, "Reputational risk plays a more and more important role for global companies. Is a loophole worth using, or is it increasing reputational risk too much?" Another audit chair reflected, "It has to be defined case by case, whether to be aggressive or cautious, and important cases are discussed with the audit committee—what strategy we should follow."

To satisfy the Organisation for Economic Co-operation and Development's Inclusive Framework on Base Erosion Profit Shifting,²⁴ audit committees may review country-by-country reporting. To accomplish that, they can probe management to reconcile any apparent differences in reporting. In addition to maintaining sound reporting practices, this oversight helps maintain a good reputation for quality reporting.

In order to better understand a company's overall tax picture, audit committees often look for ways to assess how aggressive the company is with respect to tax. The committee may benchmark the company's effective tax rate or look at other indicators—for example, reviewing the reserves for deferred taxes. Given the enhanced tactics that regulators are using to inspect these practices, audit chairs noted that they are doing more to check that management carefully documents and calculates reserves. One audit chair noted, however, that reserves are created when a tax dispute is already underway, so they may not serve as an effective early indicator of tax posture.

The tax function and its staff

In addition to reviewing the substance of important tax issues, many audit committees oversee the tax function itself, including the processes through which strategies are developed and issues resolved. This oversight includes the following:

- **Examining critical processes.** Audit committees examine the internal controls that are used to calculate tax liabilities. In some cases, audit chairs help the tax function improve its communication and coordination with other relevant stakeholders, such as the risk management and financial staff.

Some audit chairs view communication between the tax function and the audit committee as an opportunity for improvement. One explained, *“The big difficulty for boards and the audit committee is finding out what the tax policies are. It’s tough to know what key tax policy decisions a company is making.”* Another audit chair said that the board has to be rigorous in its approach: *“The discussion needs to be structured. Tax needs to be a standing agenda item. You need the CFO and the advisers in the room.”*

- **Assessing the staff.** Audit committees also assess the allocation of resources to the tax function and evaluate the qualifications and performance of the staff, especially the tax director. Audit chairs noted that because the audit committee cannot explore all the details of tax strategy, it needs to be able to trust the team to optimize tax while maintaining a sound control and compliance environment. One audit chair said the audit committee decided to replace a tax director who appeared to be focusing too much on tax minimization.
- **Reviewing outside advice.** One audit chair said that the external auditor can help assess reputational risks related to tax: *“We have discussions with our auditors, and I would expect them to point this out and give input based on their experience from other companies. They play an important role, and I would expect more from them than just assessing if tax strategies are legal.”* Another audit chair said the external auditor can also help evaluate the tax staff: *“They will give us feedback and tell us what they think of the tax director.”*

Major transactions

While most boards do not delegate overall transaction strategy, the audit committee may play an oversight role before, during, or after a transaction such as a merger, acquisition, or divestment, especially if the board lacks a finance or investment committee.

Potential audit committee oversight includes the following:

- **Early-stage oversight.** While many audit chairs said the audit committee has a limited role at the conception of a transaction, one audit chair said, *“The audit committee is extremely involved in the whole process from beginning to end. As independent directors, we have to be extremely careful about how the deal will affect minority shareholders.”*
- **Due-diligence oversight.** Audit chairs’ opinions diverged on what activities the audit committee should be involved in during the due-diligence phase of a transaction. Often, the committee helps to identify potential integration challenges that the company

might face down the road, especially those related to the internal-control environment and financial-reporting practices of a target company. The board may empower the audit committee to evaluate management’s business plan or to spot potential control issues in an acquisition. However, for many transactions, as one audit chair noted, *“there is no involvement of the audit committee at this point at all.”*

- **Post transaction oversight.** The audit committee typically takes a more prominent role after an acquisition, overseeing integration and monitoring the delivery of promised value. One challenge in monitoring value is tracking synergies after the acquisition. To help with this, audit committees can work with management before a transaction to define key performance indicators to be tracked. *“The audit committee should define key performance indicators together with management so that they can be checked regularly. You make sure compensation is linked to this,”* an audit chair said. As time passes, however, and the operations of the company and its acquisition are eventually merged, it becomes difficult to accurately attribute cost savings or revenue increases to the transaction versus other factors.

The external auditor may get involved, looking over the cash flow and debt in considerable detail, and the audit committee compares this assessment with that of management.

Funding and liquidity

Boards oversee their companies’ funding and liquidity to understand the companies’ continued ability to operate and meet their liabilities. In the United Kingdom, directors have been required since 2014 to include in the annual report a viability statement in which they address these questions. Several audit chairs said that oversight of funding and liquidity falls to the audit committee. The Dutch corporate governance code explicitly states that the audit committee should monitor the management board regarding “the funding of the company.”²⁵ Some audit chairs noted that funding is ultimately a full board issue, given its strategic significance, but the board often relies upon the financial expertise of the audit committee to oversee it properly.

Key concerns

Audit committees review the following issues related to a company’s funding:

- **Financial condition.** In the current economic environment, large industrial companies rarely face significant insolvency risk, but audit committees nonetheless look at historical and projected cash flows to assess such questions as a company’s ability to manage debt. One audit chair mentioned that a key concern is making sure that the company’s debt rating does not fall. Another

audit chair noted, *“We basically look at the whole picture in terms of debt structure, tenure of the debt, covenants, and cash flow.”*

- **Financing instruments.** Audit chairs said that funding options are discussed regularly in the audit committee, including an overview of a company’s funding structure and the financing instruments issued by the company: *“We look at the policy on the choice of banks. If a bond is issued, we don’t approve it, but it’s announced and discussed at the audit committee.”*

Audit chairs mentioned stress tests and scenario planning as useful tools, though some see an opportunity for companies to provide the audit committee with better data and more effective briefings. Some audit committees conduct a formal review with the treasurer or CFO. The external auditor may get involved, looking over the cash flow and debt in considerable detail, and the audit committee compares this assessment with that of management.

Crisis issues

During a financial crisis, audit committees sharpen their focus on funding and liquidity. There are more frequent committee meetings, both in person and by telephone, and there is more communication with the treasury function. Audit chairs noted that their attention to the internal control environment may increase, as the risk of accounting fraud and manipulation often rises during a downturn. The audit committee may need to push back on pressures to cut the budget for internal and external audit in these circumstances.

Though the cash position and funding prospects of large, established companies often remain strong even in a crisis, boards and audit committees at these companies may be worried about the health of third parties. It may be necessary to monitor the ability of key customers to keep paying, and weaknesses among suppliers of key inputs and services, including various outsourced services, can pose significant operational risks. For example, in extraordinary circumstances, the audit committee may be involved in discussions about whether to extend credit to a critical supplier.

Investor engagement

Board directors regularly engage directly with investors, particularly on topics such as executive remuneration, CEO succession, and overall strategy. Investors are keenly interested in these issues, and they meet with board chairs and remuneration committee chairs to discuss the board’s activities in these areas. While regular company reporting, such as a company’s annual report, remains the board’s primary method of communication with investors, direct

engagement supplements this reporting and allows for specific follow-up.

For several years, some investors have publicly declared that they are interested in learning more about the audit committee’s activities. Issues that the audit committee oversees—such as audit quality, risk management, and compliance—are rising in importance for some investors, prompting at least a few of them to seek regular meetings with audit committee chairs. For example, in response to the UK Competition and Markets Authority’s invitation to comment on the statutory audit market in October 2018, investors and advocates called for deeper engagement with audit committees.²⁶

Many audit committees have expanded the reports they contribute to their companies’ annual reports, sometimes in response to guidance from regulators. In some jurisdictions, regulators specify elements to include in the report, such as significant issues that emerged in relation to financial statements and explanations of how the external auditor was assessed or appointed. Investors have noted that these enhanced disclosures help them identify areas for direct, targeted engagement. Audit chairs said that more direct dialogue between audit committees and investors has been rare.

So far, however, few audit chairs said they have been contacted by investors, and those who have reached out to investors reported that they have received few responses. On rare occasions, audit chairs have been brought into meetings with investors to address specific issues. One audit chair mentioned participating in a discussion in which a long-term investor had a specific question about a key performance indicator. Another was asked by an investor to comment on related-party transactions.

Many audit chairs have concerns about engaging directly with investors. They believe that for most issues, the CFO or another member of management is better suited than the audit committee to address investors’ questions. Some audit chairs would accept interactions, but only if they were carefully structured. One audit chair explained, *“Good companies organize chairs of committees, and they sit in front of investors and go over the agenda. Investors get a sense of the agenda and the leadership of the board. It’s important for the board to demonstrate its capabilities, but you do not want individual directors on a soapbox.”*

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VI. Managing the audit committee

Managing the audit committee and its busy agenda can be a substantial challenge. Audit chairs draw on committee members' expertise, engage with management, and structure meetings to ensure that committees fulfil their mandate and provide effective oversight. We surveyed audit chairs of large European companies to better understand how their committees operate. Audit chairs responding to our survey reported that their audit committees have four to five members; on average they meet six times per year, for three to four hours at a time. Audit chairs reported that the following executives generally participate in their audit committee meetings: chief financial officer (82%); chief audit executive (76%); chief compliance officer (56%); chief legal officer (44%); chief risk officer (41%). Sixty-eight percent of audit chairs said that their committees hold an executive session at every meeting; their audit committees meet with external auditor, without management present, two to three times per year. Once or twice a year, audit committees engage with their external auditors to discuss audit scope and strategy. Audit chairs said they spend almost seven hours per year discussing key audit matters with their external auditors, and that they meet individually with the external auditor's lead partners four to five times per year. Audit chairs reckoned that, outside of committee meetings, they personally spend over 85 hours per year on audit committee activities. *For full survey results, please see page 79.*

Audit committee composition

Audit committees need a wide range of expertise to deal with the expanded responsibilities they must handle. Audit chairs said diversity of experience—including finance, operations, the company's industry, and IT—helps in tackling issues as they arise. People with general management experience can provide valuable insight on the issues that drive a company's financial performance.

An audit chair suggested having a former line executive on the committee: *"A recent or former CEO provides an operating and strategic perspective. You want people who think and approach problems differently."* Another said, *"In addition to financial experts, I want an industry expert, someone who's been in the business who can connect finances with the business issues in a robust way."* Having multiple financial experts distributes the core workload of

the committee and provides assurance against the loss of the only expert on the committee.

Onboarding new members

Effective member onboarding is critical to preparing a new audit committee member, who may also be a new board member, for the demands of the position. Audit committee chairs cited several effective onboarding practices:

- **Arranging meetings with key executives.** It is important for new audit committee members to build strong relationships with key members of management, most notably in finance roles such as the chief accounting officer, controller, treasurer, and head of tax. New audit committee members regularly participate in meetings to build relationships with these leaders and enhance understanding of the organization. *“These executives know the company perfectly, inside and out, much better than board members,”* an audit chair said.
- **Assigning a board colleague to help new members ramp up.** A more experienced audit committee member can be a key guide for a new member of the committee.
- **Connecting new members with the external auditor.** Audit committees also rely upon their external audit firms to help familiarize a new committee member with the company and its audit committee work. One audit chair described a particularly thorough application of this approach: *“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.”*
- **Enlisting other external resources.** For example, one audit chair 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 audit chairs’ comments was the importance of making sure that a new audit committee member fully understands the business, perhaps in more depth than other board members do.

Preparing for meetings

Audit committee meetings, and the preparation that precedes them, have to make efficient use of time for recurring duties as well as key emerging concerns.

“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.”

Setting an agenda

Many audit committees use their committee's charter, which identifies the committee's duties, as the starting point for setting meeting agendas on an annual basis. An audit chair explained, *"The charter gives you a road map. It's your commitment to shareholders showing what you'll carry out during the year, such as reviewing risk and ensuring regulatory requirements are met."* Audit chairs reported that they take responsibility for the agenda; some said management creates a draft agenda, which the audit chair revises.

Audit chairs outlined several practices that help ensure that the agenda covers charter requirements while leaving room for emerging issues:

- **Using planning calendars.** Many audit committees go through an annual exercise of transposing items from the committee's charter onto individual meeting agendas for the coming year. Other committees use a rolling 12-month agenda planner, which maintains the committee's schedule a year in advance on an ongoing basis. This annual planning exercise helps to structure each meeting and ensure that all essential items are given adequate time and coverage.
- **Coordinating efforts with other committees.** Coverage gaps can be a concern for audit committees, particularly for boards with risk committees. Several audit chairs on boards with both committees said it helps to have a subset of directors serve on both committees to avoid duplication of efforts. Having internal audit report to both the audit and risk committees, with compliance issues going to the risk committee and other issues going to the audit committee, can improve the division of labor and prompt reexamination of the committee charters as part of the process.
- **Staying attuned to market trends.** Audit committee members take steps to stay alert to issues arising with companies in their industries, and in the corporate world more broadly, and noted that experience on other boards also helps them to stay informed. One said, *"I started asking the internal auditor to give us a report on corporate failures outside of the company to show us where we might need to spend more time."* As new information arises, audit committees may reprioritize their agendas to ensure they are spending enough time on the most important items. The external auditor is also a source of information about market trends and other issues.

Obtaining advance materials from management

Audit committees rely on advance materials from management to plan and inform their meetings. In order to be useful, these must provide sufficient detail—which may vary depending on committee members’ backgrounds and preferences—while being concise enough for the committee to digest in a limited amount of time. Audit chairs emphasized the importance of receiving materials, whatever their length, with enough advance time to raise questions before the meeting, allowing management to revise materials accordingly.

One audit chair reported requesting a one-page executive summary in which three fundamental questions provide the framework for any topic discussed: (1) Why is the committee seeing this issue? (2) What are the key conclusions from the data? (3) What are the action items?

To reduce prereading while maintaining an adequate level of detail, several audit chairs described using appendices strategically: *“We are reducing reading by having management put more into an appendix. We now focus on the main issues, but we also offer the opportunity to address any issues in the appendices during the meeting.”* Another audit chair reported using appendices posted separately: *“They are not part of the official meeting materials. Appendices had become dumping grounds.”* And some audit chairs found that the best approach was to do away with appendices altogether. *“Our rule now is that there are no appendices included in the materials. As a result, we have been able to reduce audit committee meeting times significantly,”* said one.

Engaging with management around meetings

Most audit chairs reported that they spend substantial time outside of formal meetings having one-on-one conversations with key members of management, including CFOs, internal auditors, and division heads in important markets. Premeeting reviews with management help audit committees make sure that presentations are crisp, relevant, and on target. In some cases, the audit chair will have an advance call with each presenter to help focus the discussion and prepare for controversial issues. These interactions also help the committee stay aware of any issues in the business.

Having management provide interim reports between meetings reduces the barrage of information at the meeting itself and gives committee members more time to absorb issues and formulate questions for management. After meetings, management can summarize issues and recommended actions.

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Running effective meetings

When audit committees meet, they typically have a lot to cover in a short period of time. Audit committee chairs shared some of their perspectives on how to make the most of these meetings.

“One way to find the space—rather than by crowding up the agenda—is to create a separate committee.”

Timing, frequency, and attendees

Audit committee chairs often schedule audit committee meetings months in advance, and in many cases the meeting schedule is planned for the entire year based in part on the full-board meeting schedule. Meetings are often scheduled to run consecutively with other committee meetings to avoid scheduling conflicts for board members who sit on multiple committees.

In addition to roughly six in-person meetings per year, many audit chairs hold four telephonic meetings, coinciding with the quarterly and year-end financial statements. One audit chair reported having monthly meetings. Audit committee meetings typically last approximately three and a half hours, according to our survey. Audit committees with a heavier meeting schedule sometimes focus on one issue, such as the internal audit function or reporting from subsidiaries, at each meeting. Key members of management like the CFO, CEO, and the head of internal audit, as well as the external auditor, often attend meetings.

Deep dives

Issues that are complex and difficult, like a major change to a relevant accounting standard, require more attention and discussion than others. Because these deep dives can be especially hard to squeeze into an audit committee’s meeting agenda, carving out additional meeting time is sometimes necessary.

An audit chair reported having two 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 audit chair suggested a more structural solution, which other audit chairs share, 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.”*

Executive sessions

Executive sessions, which by design include some members of management while excluding others, allow audit committees to explore issues with a particular focus and candor that they would

not achieve in more inclusive meetings. Audit committees tailor the list of participants in executive sessions to achieve the kind of conversations they hope to have in those sessions and in any meetings that will follow.

Preceding committee meetings with executive sessions

Some audit committees hold an executive session before the start of each meeting. In some cases, the CEO or CFO participates in these sessions; in others, the session includes just the audit committee members. Audit chairs said that these sessions help to highlight key issues and establish priorities for the rest of the meeting, ultimately saving management time. One audit chair said, *“We hold a non-executive director meeting prior to the main meeting to identify key issues and align on the key areas. This focuses the meeting considerably.”*

The opening executive session can be useful for revealing some internal dynamics—for example, if the CEO and CFO do not agree on an issue. A premeeting executive session can also help prevent a situation in which a committee member could derail the meeting agenda. Audit chairs added that in cases where the CEO attends the session, it allows the committee to hear his or her perspectives on the key issues at the outset, and often frees the CEO from having to attend the entire committee meeting.

Holding separate sessions with key members of management

Nearly all audit committees hold individual dialogues with members of management, including the CEO, CFO, and the head of internal audit, in addition to the external audit partner. These sessions typically occur at or near the end of an audit committee meeting. One audit chair emphasized the benefit of these individual interactions with the committee: *“I’ve found that the CFO often needs an open mic, and this unstructured time allows the committee to hear them out and to find out what they’re really worried about.”*

Several audit chairs cautioned that executive sessions should not supplant regular meetings of the committee. One said, *“You need to make sure that people are not holding back in the committee meeting in order to talk about an issue in the executive session. That can be a waste of time. Executive sessions should really be for those sensitive topics where you need that closed conversation.”*

Strategies for spreading committee work among members

Audit committee chairs recognize that there are both opportunities and challenges to spreading a committee's workload evenly among its members, especially as committees are composed of directors with a broader range of skills. They take advantage of the full expertise of the committee by enhancing cooperation rather than by full-scale delegation.

Audit chairs described several approaches to sharing work among the committee members:

- **Assigning specific responsibilities based on expertise.** An audit chair might task a resident IT expert on the committee with reviewing materials and asking questions about cybersecurity, for example, or ask a retired audit firm partner to take the lead in interactions with the external auditor.
- **Having other members join preparatory meetings and manage post meeting follow-ups.** Much of the work of an audit committee chair occurs outside of committee meetings, reviewing materials with management and doing dry runs of presentations. It can be beneficial to have other members of the committee participate in those efforts so more issues can be resolved in advance.
- **Encouraging proactive interaction with management.** Audit chairs said that meeting regularly with the CFO, the external auditor, the CAE, and others outside of committee meetings helps the audit chair and other committee members stay abreast of issues, maintain openness with management, and reduce the length of committee meetings. One audit chair noted how these conversations made committee meetings more efficient: *“Because of this openness, the financial experts on the committee have their questions answered before the meeting.”*
- **Increasing committee engagement to prepare for chair rotation.** One audit chair observed that mandatory audit chair rotation can also lead to increased engagement: *“We had five-year rotation for each of the committee chairs, and it made for a more engaged board and more membership engagement on each committee, because you knew eventually you’d have to be doing the job.”* Shadowing the chair through the entire audit cycle can allow a prospective chair to prepare for the role.

Many boards schedule committee meetings consecutively so board members can attend meetings of committees other than those on which they serve. One audit chair sat on a board in which all board members typically attend audit committee meetings.

Communicating to the board

Audit chairs emphasized the importance of ensuring that everyone on the board is familiar with the issues that come up in each committee meeting. One audit chair focuses only on key items: *“Some audit chairs feel the need to report out everything. I find it better to report on the top five issues, skipping the routine items. The board is interested in the big issues; they do not need to know the routine details.”* Another audit chair’s committee distributes a condensed version of the committee secretary’s notes to other board members the evening before the full board meets, thus minimizing or even eliminating the verbal report.

For some boards, overlapping committee membership and the sequencing of committee meetings obviates the need for detailed reporting. Many boards schedule committee meetings consecutively so board members can attend meetings of committees other than those on which they serve. One audit chair sat on a board in which all board members typically attend audit committee meetings. Other audit chairs attend other committee meetings only when that committee has an oversight topic that overlaps with the audit committee. In some cases, directors cross-serve on committees to ensure proper coverage of key issues.

Assessing the audit committee and its chair

Most boards conduct periodic, systematic assessments of their performance, including evaluations of individual committees of the board. Typically, evaluations include the performance of committees as well as of the full board. Many audit chairs said that their audit committee assessments were part of the board’s overall evaluation process, which typically occurs annually, but in some cases the audit committee conducts its own, separate self-evaluation.

Audit committee evaluations begin with gathering data and other input. Audit chairs reported using the following methods:

- **Questionnaires.** One audit chair reported, *“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.”*
- **One-on-one conversations.** An audit chair said, *“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.”*

- **Periodic informal discussions.** Audit chairs 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 audit chair said.
- **Input from management.** One audit chair said, *“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.”*
- **Feedback from the external auditor.** External auditors are helpful sources of insight about an audit committee’s effectiveness, especially as it compares with other companies’ audit committees.

Several audit chairs said they receive third-party assistance with their evaluations, not necessarily every year but on a regular schedule. This assistance is required by some corporate governance codes. For example, the UK Corporate Governance Code states that “evaluation of the board 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.²⁷ Third parties can bring rigor to the process and, like the external auditor, can offer perspectives gleaned from working with other boards.

Formal assessments of the audit committee chair’s performance are less common than assessments of the committee. One audit chair said, *“It’s hard to monitor your own performance unless you have metrics or benchmarks to measure against.”* Another audit chair said that experience on other boards can be helpful for benchmarking performance: *“I try to stay ahead of the curve and get feedback from the audit committee, since they also sit on other audit committees.”*

Most typically, audit-chair assessment is an element of the overall committee assessment. Audit chairs agreed that encouraging honesty and openness is key. Once assessments have been made, audit committee members systematically follow up, much as they might with any other issue. One audit chair 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.”*

VII. Appendix

Tapestry Networks

Tapestry Networks is an independently owned professional services firm founded in 2002. Our mission is to advance society's ability to govern and lead. We enable business, government, and NGO leaders to address difficult issues that require the public and private sectors to work together more effectively than they typically do. Successes arise from the ability and willingness of these leaders to extend their skills beyond the borders of their sectors, geographies, and constituencies.

Many of our networks are groups of about 25 to 40 members who share the same role—non-executive board committee chairs, for example—in companies of similar complexity and stature and who are committed to addressing topics of shared concern and to learning from each other.

Others are composed of participants, representing different stakeholder groups, who share an interest in the same issue—for example, board-shareholder engagement, regulation of financial institutions, or the development of personalized medicine. In many cases, regulators and government officials are active participants.

The European Audit Committee Leadership Network

The European Audit Committee Leadership Network (EACLN) is a group of audit committee chairs drawn from Europe's leading companies who are committed to improving the performance of audit committees and enhancing trust in financial markets. The EACLN works closely with the Audit Committee Leadership Network (ACLN) in North America.

Since its inception, the EACLN has been organized by Tapestry Networks pursuant to a services agreement with EY, the global professional services firm. However, Tapestry Networks is a separately owned, managed, and controlled legal entity distinct from EY. No member firm of the global EY organization controls, is controlled by, or is under common control with Tapestry Networks.

The EACLN discussions drawn upon for this report were held under a modified form of the Chatham House Rule, which allows for quotation but not for attribution of any comment or perspective to an individual director or company. Directors in meetings speak personally, rather than as representatives of their companies or their

boards. Most of the meetings took place under the sponsorship of EY, which has also sponsored this report but has not exercised editorial control over it.

Current members of the EACLN include the following:

- Jacques Aigrain, WPP
- Jeremy Anderson, UBS
- Mike Ashley, Barclays
- Werner Brandt, Siemens
- Julie Brown, Roche
- Aldo Cardoso, Bureau Veritas
- Carolyn Dittmeier, Generali
- Eric Elzvik, Ericsson
- Edgar Ernst, TUI
- Renato Fassbind, Nestlé and Swiss Re
- Catherine Guillouard, Airbus
- Byron Grote, Tesco, Akzo Nobel and Anglo American
- Margarete Haase, OSRAM Licht
- Marion Helmes, Heineken
- Siân Herbert-Jones, Air Liquide
- Liz Hewitt, Novo Nordisk
- René Hooft Graafland, Ahold Delhaize
- Arne Karlsson, Mærsk
- Dagmar Kollmann, Deutsche Telekom
- Helman le Pas de Sécheval, Bouygues
- David Meline, ABB
- Hanne de Mora, Volvo Group
- Marie-José Nadeau, ENGIE
- Brendan Nelson, BP
- Nathalie Rachou, Veolia
- Jon Erik Reinhardtsen, Telenor Group
- John Rishton, Unilever
- Guylaine Saucier, Wendel
- Erhard Schipporeit, RWE
- Carla Smits-Nusteling, Nokia
- Alan Stewart, Diageo
- Charlotte Strömberg, Skanska
- Stephan Sturm, Lufthansa
- François Thomazeau, Bolloré
- Isabel Torremocha, Repsol
- Martine Verluyten, STMicroelectronics
- Norbert Winkeljohann, Deutsche Bank and Bayer

The advisory board

The advisory board consists of EACLN members who agreed to assist with this research project by providing advice and insight on key issues and reviewing initial drafts. The board includes the following audit chairs:

- Mike Ashley, Barclays
- Werner Brandt, Siemens
- Julie Brown, Roche
- Renato Fassbind, Nestle & Swiss Re
- Byron Grote, Tesco, Akzo Nobel and Anglo American
- Liz Hewitt, Novo Nordisk
- Arne Karlsson, Maersk
- Dagmar Kollmann, Deutsche Telekom
- Hanne de Mora, Volvo Group
- Guylaine Saucier, Wendel
- Erhard Schipporeit, RWE
- Isabel Torremocha, Repsol

Participating audit chairs

The following audit chairs participated in interviews and meetings—conducted from roughly 2010 to the present—from which the research project drew its content:

- Jeremy Anderson, UBS
- Mike Ashley, Barclays
- Patricia Barbizet, Peugeot and Total
- Werner Brandt, Lufthansa, RWE, and Siemens
- Julie Brown, Roche
- Aldo Cardoso, Bureau Veritas, ENGIE, GDF SUEZ
- Carlos Colomer, Abertis and Telefónica
- Carolyn Dittmeier, Generali
- Ángel Durández, Mediaset España and Repsol
- Eric Elzvik, Ericsson
- Per-Olof Eriksson, Biotage
- Edgar Ernst, TUI
- Renato Fassbind, Nestlé and Swiss Re
- Byron Grote, Akzo Nobel, Anglo American, Tesco, and Unilever

- Margarete Haase, OSRAM Licht
- Siân Herbert-Jones, Air Liquide
- Liz Hewitt, Novo Nordisk
- Phil Hodgkinson, BT
- Jean-Marc Huet, Heineken
- Lou Hughes, ABB
- Shonaid Jemmett-Page, GKN and MS Amlin
- DeAnne Julius, Roche
- Arne Karlsson, Maersk
- Ewald Kist, Royal Philips Electronics
- Dagmar Kollmann, Deutsche Telekom
- Maurizio Lauri, UniCredit
- Daniel Lebègue, Technip and SCOR
- Richard Meddings, Deutsche Bank
- David Meline, ABB
- Hanne de Mora, Sandvik and Volvo
- NasserMunjee, Tata Motors
- Marie-José Nadeau, ENGIE
- Brendan Nelson, BP and RBS
- Helman le Pas de Sécheval, Bouygues
- Ian Prosser, BP and Sara Lee
- John Rishton, Unilever
- Pierre Rodocanachi, Vivendi
- Hans-Joerg Rudloff, Rosneft
- Guylaine Saucier, Areva, Danone, and Wendel
- Erhard Schipporeit, Deutsche Boerse, SAP, and RWE
- Jean-Michel Sévérino, Danone
- Carla Smits-Nusteling, Nokia
- Jakob Stausholm, Statoil
- Alan Stewart, Diageo
- Kees Storm, Anheuser-Busch InBev and Unilever
- Charlotte Strömberg, Skanska
- Tom de Swaan, GlaxoSmithKline and Royal Ahold
- Jack Tai, ING and Royal Philips Electronics
- Jacques Theurillat, CNH
- François Thomazeau, Bolloré
- Isabel Torremocha, Repsol
- Martine Verluyten, STMicroelectronics and Thomas Cook
- Bernd Voss, Continental and ABB
- Lars Westerberg, Volvo
- Mario Zibetti, Fiat Group

Tapestry Networks Publications

Tapestry Networks published the following *ViewPoints*, which reflect the contributions of the participating audit chairs referenced above before and during EACLN meetings and Audit Committee Leadership Summit (ACLS) meetings. ACLS meetings host members of the EACLN and the North American Audit Committee Leadership Network (ACLN).

EACLN

[Oversight of corporate culture](#) (March 2019)

[Board oversight of risk](#) (March 2019)

[Perspectives on audit reform](#) (December 2018)

[ESG reporting](#) (August 2018)

[Oversight of third-party risk](#) (August 2018)

[CISOs and the board](#) (January 2018)

[Dialogue with the IASB](#) (January 2018)

[Dialogue with the Committee of European Auditing Oversight Bodies](#) (May 2017)

[As new regulatory standards take effect, audit committees formalize assessments of their external auditors](#) (May 2017)

[The impact of digital technologies on internal audit](#) (January 2017)

[Dialogue on audit policy](#) (May 2016)

[The evolving tax landscape and oversight of tax strategy](#) (January 2016)

[Oversight of major transactions](#) (January 2016)

[Cyber risks and cybersecurity](#) (May 2015)

[Audit committee agendas and charters](#) (December 2014)

[Update on cybersecurity](#) (May 2014)

[A dialogue with Stephen Haddrill](#) (May 2014)

[Audit firm retendering and rotation](#) (January 2014)

[Audit committee composition](#) (January 2014)

[Dialogue with institutional investors about audit policy](#) (January 2014)

[Ethics and compliance](#) (August 2013)

[Evaluating audit quality and the external auditor](#) (July 2012)

Investors' perspectives on financial Reporting (December 2011)

Navigating the European debt crisis (December 2011)

Internal controls over financial reporting (April 2011)

Enhancing audit committee effectiveness in a changing environment (April 2010)

ACLS

[The audit tender process](#) (October 2019)

[Cybersecurity governance](#) (July 2019)

[Lessons from cyber-breach responses](#) (May 2018)

[Audit committee effectiveness](#) (May 2018)

[Audit chairs share practical guidance for running effective meetings](#) (August 2017)

Board and audit committee oversight of cyberrisk (July 2015)

The evolution of audit regulators (July 2015)

Board oversight of corporate culture (July 2015)

Mandatory audit firm rotation: the Dutch experience (July 2014)

Enhancing communication among investors, auditors and audit committees (July 2014)

Enhancing audit committee reporting (May 2013)

Challenges of the global internal audit function (May 2013)

Board-shareholder engagement (July 2013)

Bribery and corruption risk (July 2011)

Legal and practical framework for audit committees in Europe

Audit committees operate within a framework of laws and practices that include both EU requirements and member-state statutes, regulations, and norms. These address overall board structures and the audit committee itself. Some requirements influence the work of the audit committee indirectly, shaping the context of activities, while others include specific provisions regarding what the audit committee should do and how. While there are differences across countries that may lead audit committees to behave differently in some circumstances, there is also a great deal of commonality across jurisdictions, driven partly by EU legislation and partly by converging norms.

Board and management structures

Board and management structures vary across companies and countries, in some cases with implications for audit committees.

One-tiered versus two-tiered boards

One important structural aspect is whether a company has a unitary or a two-tiered board. Germany and Austria, for example, require a two-tiered structure, in which there is a management board and a supervisory board. The United Kingdom and Spain have a one-tiered structure, in which there is one board that includes both independent directors and company executives. Several countries, including France, Italy, and the Netherlands, allow companies to choose their preferred structure. There is a common perception that these structures can influence the flow of information between the board and management. In practice, board structure seems to have little impact on how audit committees perform their work.

Labor representation on boards

A key aspect of German corporate governance is that employee representatives serve on the supervisory board and its committees, including the audit committee. Fifty percent of the supervisory board members at large German companies are elected by the employees, an element of corporate governance known as “codetermination.” This practice is followed in several other countries as well, though the required percentage of employee representatives varies by country and company size.²⁸ Audit chairs note that labor representation

influences the priorities of the board (as it is intended to), and this influence can extend to the audit committee.

Committee structure

Another element that varies across companies is committee structure. While most boards have three core committees—remuneration, nomination, and audit—many also have specialized committees that take on responsibilities that would otherwise be delegated to the audit committee or another core committee. For example, companies in the financial services sector, and some in other sectors, have risk committees that offload risk oversight from the audit committee. Similarly, finance committees may take responsibility for oversight of funding, while compliance committees take the lead on compliance oversight.

The relationship between the committees and the full board may also vary. In some countries, for example, responsibility for various areas of oversight is not formally delegated to committees because it is deemed important that it stays with the full board. In these cases, while the audit committee may perform a variety of tasks and prepare decisions, the full board actually makes the decisions.

An Italian exception

In Italy, companies have the option of a one-tiered or two-tiered board structure, but most listed companies choose to have a governance body that is situated outside the board of directors, known as the board of statutory auditors, which handles many activities undertaken by audit committees in other countries. This body—the *collegio sindacale* in Italian—is made up exclusively of independent members appointed by the shareholders. By law, the chair of the *collegio* is selected by the minority shareholders as a balance to the board chair selected by majority shareholders. The *collegio* manages the process for selecting the external auditor, makes the selection, and presents its choice to shareholders for approval. It also oversees compliance, including compliance by the board of directors with national laws, corporate governance codes, and company by-laws.²⁹

The board of directors has a committee on internal control and risk that performs those functions of a typical audit committee that are not performed by the *collegio*, especially oversight of controls. As an oversight body for the board, however, the *collegio* reviews the board's activities in these areas. An audit

chair confirmed that the unique position and responsibilities of the *collegio* entail a role that is substantially different from that of more typical audit committees. The *collegio*'s duty to oversee the board of directors itself means that oversight is more extensive; in the area of controls, for example, it goes beyond financial controls. The breadth of oversight also means that coordination with the controls and risk committee of the board is important.

Statutory requirements for audit committees

Requirements and guidance aimed specifically at the audit committee can be found at both the EU level and the member-state level. Recently, requirements and guidance have expanded in the wake of concerns about the efficacy of the independent audit and the market for audit services.

The EU Audit Regulation and Directive

The most comprehensive and detailed EU-level requirements for the audit committee can be found in the ARD, which was adopted in April 2014 and took effect in June 2016. The ARD targets many aspects of the audit process, including how listed companies secure audit services. Though it provides members states with some flexibility in implementation, the ARD led to major changes for all the players involved in audits—companies, auditors, regulators, boards, and audit committees—accelerating the convergence of their practices. Both the regulation and the directive contain provisions related to the work of the audit committee.³⁰

Most notably, of course, the regulation requires rotation of the auditor and imposes restrictions on the nonaudit services that the auditor provides. These requirements influence the work of audit committees across Europe, though they may intersect with local requirements in distinct ways. In France, for example, a joint-audit requirement means that, under the regulation, companies can keep their auditors for 24 years, thereby automatically reducing the frequency with which audit committees must engage in a tender process.

The regulation also directly assigns tasks involving rotation and nonaudit services to the audit committee. The audited company is responsible for organizing the auditor-selection procedure, but the audit committee validates the conclusions and presents at least two choices to the board, expressing a preference for one of them and justifying the recommendation. Regarding permitted nonaudit services, the audit committee is

responsible for approving these services after assessing the potential threats to independence and the safeguards against them. The regulation also requires the audit committee to discuss threats to independence and their mitigation with the auditor when the fees paid to the auditor represent more than 15% of the total fees earned by that auditor.

The directive discusses the audit committee more broadly, providing details about what kind of companies must have an audit committee, the qualifications of the audit committee members, and the overall responsibilities of the audit committee (beyond involvement in selecting the auditor and oversight of nonaudit services, as addressed in the regulation). The audit committee must be composed of non-executive members of the board, the majority of them independent, and at least one must have competence in accounting or audit. Among the responsibilities mentioned are monitoring the financial reporting process and the effectiveness of related internal control and risk management systems, including internal audit. The audit committee must also report to the board about the outcome of the audit.

National-level corporate governance codes

At the member-state level, provisions on the audit committee are included primarily in corporate governance codes, but they may also appear in company law. Member states typically have their own corporate governance codes that spell out, in more detail than company laws, the role and responsibilities of corporate boards. These codes are usually applied according to the “comply or explain” principle, whereby companies and boards either comply with the provisions or identify in public disclosures which provisions they have not implemented and explain why they did not do so. The objective of this approach is to grant some flexibility to companies while holding them accountable to investors and other stakeholders through disclosure. It constitutes a so-called “soft law” approach as opposed to more rigid and compulsory laws and regulations.

This regime is the main vehicle for shaping corporate governance in Europe. Company laws often refer specifically to the country’s corporate governance code, as do stock exchange listing requirements. At the same time, member states may enshrine what they consider to be the most basic and important rules into their company law, in which case these rules may not be included in the corporate governance code. Company law may include some provisions about the

audit committee, given its important role on the board. For example, Spain specifies the audit committee's responsibility for selecting the auditor in the Spanish Company Law rather than its corporate governance code.³¹

In most cases, however, provisions on the audit committee are part of corporate governance codes. These codes reflect not only EU legislation that has been enacted on a comply-or-explain basis but also national-level norms and preferences. Many of these provisions are similar across member states. Audit committee responsibilities that are common across the codes include oversight of accounting, internal controls, financial reporting, internal audit, and risk management. Many codes also mention involvement in the selection of the auditor and monitoring of the auditor's performance.³²

However, the codes are not identical. Some do not include certain EU mandates, presumably because they have been transposed into company law (in the case of directives) or apply directly (in the case of regulations). Other codes go beyond the EU mandates to specify additional responsibilities for the audit committee. The Dutch code, for example, mentions oversight of funding, technology, cybersecurity, and tax policy, which few others mention. The German and French codes mention nonfinancial reporting, which is not an enumerated audit committee responsibility in many other codes. In the United Kingdom, the regulator in charge of the code, the Financial Reporting Council, has been very forthcoming with supplementary guidance on how it would like to see audit committees perform their duties.³³

Quantitative survey: Methodology and results

A quantitative online survey was conducted between 30 June and 13 September 2019.

The 34 survey participants were audit committee chairs of European listed companies with revenues of €8 billion or more. Results were as follows:

Including yourself, how many members serve on your audit committee?	4.7
How many times per year does your audit committee meet for regularly scheduled meetings?*	5.8
How many hours does a typical meeting of your audit committee last?*	3.7
How many times per year does your audit committee meet with the external auditor without management present (in executive session)?	2.6
Is there an executive session at every audit committee meeting?***	Yes: 68% No: 32%
How many times per year does the audit chair meet individually with the lead partner/partners of the external auditor?	4.5
How many times per year does the audit committee engage with the external auditor to discuss audit scope and strategy?	1.7
How many hours per year do you spend discussing key audit matters with the external auditor?	6.9
How many hours per year do you personally spend on audit committee activities, including preparation and one-on-one meetings with management, outside of the audit committee meetings themselves?	86
Which of the following executives are standard participants in audit committee meetings? (percentage of respondents)	
<ul style="list-style-type: none"> • Chief financial officer/finance executive 	82%
<ul style="list-style-type: none"> • Chief audit executive/internal audit executive 	76%
<ul style="list-style-type: none"> • Chief compliance officer/compliance function executive 	56%
<ul style="list-style-type: none"> • General counsel/chief legal officer 	44%
<ul style="list-style-type: none"> • Chief risk officer/risk function executive 	41%
Have you led an audit tender since 1 January 2016?***	Yes: 45% No: 55%
Approximately how many hours did the entire audit committee spend meeting for the tender process?	16
Approximately how many additional hours did you personally invest in the tender process, outside of audit committee meetings?	21.6
Approximately how many months did the tender process take, from the start of the process until the audit committee selected/recommended the new auditor?	5.7
On a scale of 1–10, where 1 represents “price was not a factor in the evaluation” and 10 represents “price was the only factor considered,” how much weight was given to price in the tender evaluation?	3.1

*Responses assumed to reflect in-person meetings.

***Some respondents did not answer this question.

Endnotes

¹ Directive (EU) No 2014/56/EU of the European Parliament and of the Council of 16 April 2014 Amending Directive 2006/43/EC on Statutory Audits of Annual Accounts and Consolidated Accounts, 2014 O.J. (L. 158) 196; Regulation (EU) No 537/2014 of the European Parliament of the Council of 16 April 2014 on Specific Requirements Regarding Statutory Audit of Public-Interest Entities and Repealing Commission Decision 2005/909/EC, 2014 O.J. (L. 158) 77.

² See *Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745 (2002).

³ Quotations in italics are drawn directly from discussions with audit chairs.

⁴ Vincent T. Papa and Sandra J. Peters, *Investor Uses, Expectations, and Concerns on Non-GAAP Financial Measures* (CFA Institute, 2016), 7.

⁵ International Auditing and Assurance Standards Board, *A Framework for Audit Quality: Key Elements That Create an Environment for Audit Quality* (International Accounting Standards Board, 2014); Financial Reporting Council, *Audit Quality: Practice Aid for Audit Committees* (London: Financial Reporting Council, 2015); Center for Audit Quality, *External Auditor Assessment Tool: A Reference for Audit Committees Worldwide* (Center for Audit Quality, 2 June 2015).

⁶ International Auditing and Assurance Standards Board, *A Framework for Audit Quality: Key Elements That Create an Environment for Audit Quality*, 40.

⁷ International Auditing and Assurance Standards Board, *A Framework for Audit Quality: Key Elements That Create an Environment for Audit Quality*, 4.

⁸ Financial Reporting Council, *Audit Quality: Practice Aid for Audit Committees*, 7.

⁹ Financial Reporting Council, *Audit Quality: Practice Aid for Audit Committees*, 7.

¹⁰ Regulation (EU) No 537/2014.

¹¹ Regulation (EU) No 537/2014.

¹² Regulation (EU) No 537/2014.

¹³ Regulation (EU) No 537/2014.

¹⁴ Tabby Kinder, “UK Accountancy Firms Prepare to Cull Risky Clients,” *Financial Times*, 7 August 2019.

¹⁵ The Institute of Internal Auditors, *The Three Lines of Defense in Effective Risk Management and Control* (Altamonte Springs, Florida: The Institute of Internal Auditors, September 2013).

¹⁶ Spencer Stuart, *2018 UK Spencer Stuart Board Index* (Chicago: Spencer Stuart, 2018), 35.

¹⁷ See, for example, Protiviti, *Should the Board Have a Separate Risk Committee?* Board Perspectives: Risk Oversight (Menlo Park, CA: Protiviti, 2015).

¹⁸ The Institute of Internal Auditors, *The Three Lines of Defense in Effective Risk Management and Control*.

¹⁹ See “GDPR Key Changes,” EU GDPR Portal, accessed 24 July 2019.

²⁰ “ISO/IEC 27001 Information Security Management,” International Organization for Standardization, accessed 16 October 2019.

²¹ “The Five Functions,” National Institute of Standards and Technology, accessed 17 October 2019.

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- ²² Melanie Watson, “[Top 4 Cybersecurity Frameworks](#),” *IT Governance*, 17 January 2019.
- ²³ EY Center for Board Matters, *Taking Charge: How Boards Can Activate, Adapt and Anticipate to Get ahead of Cybersecurity Risk* (New York: Ernst & Young LLP, 2015), 5.
- ²⁴ See the website for the [Inclusive Framework on Base Erosion and Profit Shifting](#), accessed 17 October 2019. The framework guides a collaborative effort among over 130 countries “to put an end to tax avoidance strategies that exploit gaps and mismatches in tax rules to avoid paying tax.”
- ²⁵ Corporate Governance Code Monitoring Committee, *Dutch Corporate Governance Code* (The Hague, Netherlands: 8 December 2016), 16.
- ²⁶ See Investment Association, *Competition and Markets Authority: Statutory Audit Market—Invitation to Comment; Response from the Investment Association* (Investment Association, 30 October 2018), 16; Pensions and Lifetime Savings Association, *PLSA Response: CMA Statutory Audit Market—Invitation to Comment* (PLSA, 5 November 2018), 3; Hermes Investment Management, *Hermes Investment Management Response to CMA Market Study Invitation to Comment* (Hermes Investment Management, 30 October 2018), 3; Sarasin & Partners, *Sarasin & Partners LLP Submission to CMA Market Study on Audit* (Sarasin & Partners, November 2018), 2.
- ²⁷ Financial Reporting Council, *The UK Corporate Governance Code* (London: Financial Reporting Council, 2016), 14.
- ²⁸ Paul L. Davies and Klaus J. Hopt, “[Corporate Boards in Europe—Accountability and Convergence](#),” *American Journal of Comparative Law* 61, no. 2 (Spring 2013), 342.
- ²⁹ Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili, *Corporate Governance in Italy—the Collegio Sindacale* (Rome: Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili, 2009), 7.
- ³⁰ [Regulation \(EU\) No 537/2014](#); [Directive \(EU\) No 2014/56/EU](#).
- ³¹ Comisión Nacional del Mercado de Valores, *Good Governance Code of Listed Companies* (Madrid: Comisión Nacional del Mercado de Valores, 2015), 9.
- ³² Many corporate governance codes can be accessed on the website of the [European Corporate Governance Institute](#).
- ³³ See, for example, Financial Reporting Council, *Guidance on Audit Committees* (Financial Reporting Council, 2016); Financial Reporting Council, *Audit Quality: Practice Aid for Audit Committees* (Financial Reporting Council: 2015).