Central Audit Committee Network

April 2019

CACN

SUMMARY of THEMES

Audit committee effectiveness, oversight of major transactions, and geopolitical risk

Audit chairs are eager to learn about practices that can help their committees run more efficiently. As board members, they also seek effective approaches to overseeing transaction strategies and exposure to geopolitical risk. Members of the Central Audit Committee Network (CACN) discussed these topics on March 28 in Chicago.

Foundations of audit committee effectiveness

Members discussed practices to enhance the quality of committee meetings and manage packed and expanding agendas. They also recognized the importance of building relationships of trust with management and the external auditor.

Setting up the meeting for success

Audit committee chairs generally set the full meeting calendar at the start of the year and agenda items are closely aligned with the committee's charter. Standing items tend to dominate the agenda: one member estimated that they comprise around 80% of the committee's work. However, chairs also solicit the views of committee members, management, and the external auditor on emerging issues and leave space to incorporate topics that may arise unexpectedly, such as personnel matters and opportunistic transactions.

In their capacity as audit committee chairs, members said they regularly meet with key members of management and external auditors in an effort to establish greater familiarity and to make sure that meetings run smoothly. To better structure and reduce the length of committee meetings that sometimes ran as long as six hours, one firm developed a full *"dress rehearsal"* with management and external audit teams a week in advance of the committee meeting. *"This can help reveal holes in the presentation, or they learn that it'll be 40, not 20 minutes to get through an item."* Other members spoke of having *"calls and face-to-face meetings to get a bit of a dry run of what's going to come up that we should be aware of."* Even in the case of geographic distance, members find ways of keeping in touch outside the boardroom, often monthly, with the CFO, the controller, the CEO, the general counsel, internal audit, and external auditors. *"It's a huge advantage and reduces surprises."*

Audit committee chairs also strive to make the best use of everyone's time and promote candor by structuring discussions so that most executives are present only for the portions of the meeting that are relevant to them. This effectively limits the number of people in a meeting at one time—which at one audit committee had grown to as many as thirty people. As one member said, *"You can't be candid if there are too many people in the room. And why should the IT guy sit there listening to financial reports for two hours?"*

Information gathering

Members spend considerable time before meetings educating themselves on the matters to be discussed in committee. They expect to receive information from management well in advance of the meeting so that committee members will have time to read it. It is common to receive meeting materials a week in advance of the meeting; however, some committees struggle with timely delivery. Since the volume of background and briefing material can be onerous, reaching as much as 500 pages, members agreed on the need for more streamlined and synthesized pre-read material. One member said, *"In any audit committee self-evaluation, there will be a comment that we need to shorten the information."*

Taking advantage of executive sessions

Members also stressed the importance of executive sessions, which can foster candor and bring out additional insights and unspoken concerns. Members favored sessions in which the audit committee has one-on-one conversations with key individuals, including the CFO, general counsel, internal and external audit, and sometimes compliance. These meetings are very frank and allow the committee to ask each individual whether there is *"anything you're uncomfortable with, anything you want to tell us?"* One member noted, *"We use this to share our thoughts as well. We say, 'maybe we should look more into this area, or tell them what they've done well, or what they can improve.'"* Another member remarked, *"I'm always surprised what comes out."*

Building relationships of trust

Members agreed that it is critical to develop good relationships, chemistry, and trust with management and the external auditor. *"You want to be alerted when there are problems,"* said one member. Another commented, *"Sometimes we don't put as much focus on this as we should. It's a problem if the culture is: 'Don't say anything to the board that you haven't said to management.' Setting the right tone at the top is important; management has to understand that we expect open discussions."* Members also stressed the importance of having a good working relationship with the staff members of the audit team, the lead audit partner, and senior leaders from the audit firm, in case problems or questions arise during the audit and to help ensure a smooth partner rotation.

Audit committee scope and workload

Audit committee responsibilities have expanded far beyond the traditional purview of financial reporting oversight to include oversight of a range of critical functions, with cybersecurity and enterprise risk management (ERM) among the most significant. One member said, *"Now, we hear from the controller about revenue recognition, the new leasing standard from internal* *audit and the external auditor, cyber, Foreign Corrupt Practices Act (FCPA) compliance and culture plus one or two other items. There has to be a better way to do this."* Another member suggested that *"new issues like cyber, privacy, or sustainability often fall to the audit committee—or go to the full board—because they don't fit into any other committee's charter, which [is] more restricted and narrower."* In addition, the chair carries most of the workload. Members agreed that audit committee chairs find it hard to delegate, although views were nuanced. One member said, *"Different people are sharing the load. I'll say, 'This isn't my area, could you take a look at this?' The chair still bears the responsibility, but those with expertise do speak up."*

Measuring audit committee success

When asked how they define committee success, several members said that it is a hard question to answer well. A few members offered: *"no restatements," "no surprises,"* and *"preventing bad things from happening."* To enhance effectiveness, several advised doing a self-evaluation of the committee, asking *"how do people feel about what's going on, where leadership is taking the committee?"* As another member put it, *"a sense of continuous improvement is needed."*

Oversight of major transactions

Members discussed the board's role in the oversight of mergers, acquisitions, and divestitures, joined by Dan Dickinson, Managing Partner of HCI Equity Partners, and Chris Smyth, Transaction Advisory Services Leader for EY's Central region. As context for the conversation, Mr. Dickinson and Mr. Smyth noted that, despite geopolitical uncertainty and concerns about softness in the economy, the current transaction environment is strong. Facing modest organic growth, many companies are turning to acquisitions. Due to inexpensive debt, strong balance sheets, and a strong equities market, there is abundant capital to deploy. As a result, deal volume is up, and deal valuations are at all-time highs.

Several aspects of the board's oversight role emerged from the conversation, including:

Robust due diligence

Recognizing the competitive market, Mr. Dickinson said, *"The environment is driving up pricing, but companies are doing a lot of diligence. Multiples are up, but these are not necessarily bad deals that are going to blow up."* Compared to a decade ago, boards are undertaking more robust due diligence to identify potential deal risks, including technology issues. Today, diligence often involves deep investigation into potential targets' IT systems to ensure robust cybersecurity procedures and up-to-date operating systems and hardware. In addition, if a deal is primarily about acquiring technology, companies need to "*go in to look at the technology to make sure it can scale, and the software does what it says it does,"* said Mr. Smyth. He continued, *"Businesses recognize they need help to do that diligence and they are getting outside help."*

Alignment of corporate strategy and M&A strategy

Members and guests stressed that clarity around how transactions fit into overall corporate strategy allows management and the board to agree on what deals make sense and to prevent management from spending time evaluating potential deals that do not fit. One member said, *"Asking the question, what's the key strategy for a potential acquisition: diversification of geography, diversification of solutions, addressing the major challenges for the business – that's where the board starts."*

Testing management's assumptions

Members noted that boards often have to act as a brake on management and *"bring them back to reality"* if their assumptions about a deal are overly optimistic. This is easier to do if the board is involved early in the conversation. Mr. Dickinson said, *"When deals bubble up, there can be too much passion and excitement. Fundamental questions are easier to ask early on. When a deal is fully baked, it's harder to turn the tide."* There are also situations where the board has to push management to move faster, including when technological changes or industry shifts require investments in new areas with uncertain returns. One member recalled when, despite technological advancements upending an industry, *"management was not going to move. The board moved them to focus on the future of the industry and how to make that transition."* Another example is divestiture. As one member shared, *"Getting out of things you are not supposed to be in and freeing up capital. That's hard to get management to do, to let go of a baby, something they've been with for a while. Sometimes the board has to push."*

Post-deal integration

Members noted the importance of monitoring the performance of acquired businesses, which can be difficult as they are integrated into the existing business. One member said, *"After an acquisition, we hold the business owners accountable. It goes into their strategic plan and they are responsible for delivering the ROIC [return on invested capital]."* Members also noted the challenge of integrating different corporate cultures, especially if the target is a startup. One member said, *"culturally those companies have a tough time integrating into the existing business. We most often fail on this—they don't fit. We've gotten more methodical when we bring in technology and entrepreneurial companies, asking, how do we retain talent?"*

Geopolitical risk

Members discussed geopolitical trends with Kevin Kajiwara, Co-President, Political Risk Advisory, Teneo, and Scott Sarazen, Global Deputy Leader, Geostrategic Business Group at EY. CACN members noted that global developments could impact their firms directly or indirectly, but companies can be somewhat reactive on this front, especially if they have limited exposure.

Much of the discussion centered on China, which has overtaken the United States as the world's largest economy in purchasing power parity (PPP) terms. As China tries to make the transition from an export-led economy to one more heavily reliant on domestic consumption, the era of double-digit growth is almost certainly over. Nevertheless, outbound foreign direct investment (FDI)—whether through natural resource investments or the Belt and Road Initiative—offers new growth opportunities for Chinese companies.[1] Mr. Kajiwara noted that supplanting one economy with another is a rare historical occurrence that has often led to conflict in the past. The outcome may not be zero-sum, however, particularly since China benefits from the Bretton Woods system of institutions that undergirds globalization.

One member expressed concern that NATO, the European Union (EU), and other alliances that form the backbone of the post-WWII system are being challenged. Mr. Kajiwara argued that NATO has demonstrated considerable flexibility and remains stable and durable at age 70, but faces a number of challenges, including Russia's aggressive posture and military capability. He pointed out that while the US-European policy of deterrence *"kept the peace through parity,"* this has now been destabilized by a third party, China, which may use its military as a tool to build its strategic and economic hegemony. Even so, the *"real battleground"* is cyber, which will largely play out in the private sector as companies become collateral damage in state conflicts. On the technology front, one member suggested that China might surpass the United States in artificial intelligence and 5G. Mr. Kajiwara believes, however, that the situation is *"not quite as dire,"* given China's restrictive data policies, cybersecurity laws, and a relatively weak innovative tradition. Some disagreed and gave more weight to the strong support and guidance that Chinese companies receive from the state in important industries like high tech that often require massive, lump-sum investments.

Mr. Sarazen argued that companies need a geopolitical strategy, whether motivated by *"something that has happened to you, e.g., the steel tariff changed your supply chain"* or because *"you're about to do something, e.g., enter Africa."* Mr. Kajiwara suggested that boards often have good *"situational expertise,"* but need to think long term, including *"building decision trees about what could happen."* He advised members to ask: *"what's lagging in how I run my business? How are you asking for a regular cadence of reporting on this? How are you bringing that education and experience onto the board?"*

Endnotes

[1] Chinese companies now own nearly 11% of global FDI assets, "second only to the US, and approximately double the FDI stock of British, Japanese, or German companies." Courtney Rickert McCaffrey, "How Chinese FDI Will Transform the Global Economy," *The Diplomat*, December 16, 2017

Meeting participants

- Anne Arvia, GATX
- Howard Carver, Assurant
- Dick Gabrys, TriMas
- Marla Gottschalk, Big Lots
- Mike Hanley, BorgWarner
- Frank Jaehnert, Nordson
- Rick Navarre, Covia
- Neil Novich, Hillenbrand
- Al Smith, Simon Property Group
- Phoebe Wood, Invesco

EY was represented by the following:

- Julie Boland, Vice Chair and Central Region Managing Partner
- Rich Bonahoom, Partner, Business Development Leader, Central Region
- John King, Americas Assurance Vice Chair-Elect, EY