

ViewPoint

July 06

Audit Committee Effectiveness

**Taking the initiative:
High-quality audit committees
should present a full picture of
their effectiveness***

*connectedthinking

Audit committees in the spotlight

Now more than ever, the capital markets tend to punish unpredictability in corporate performance. Unpleasant surprises of any kind – whether these are erroneous financial statements, ethical scandals or inadequately anticipated/improperly managed risks – have the potential to wreak havoc among corporate reputations and share price values.

In this environment, audit committees should consider taking the initiative – looking to go beyond compliance, and actively seeking to identify ways in which they can enhance the quality of governance that exists in their organisations.

By fulfilling their functions as effectively as possible, committees can play an important role – helping to minimise the likelihood and impact of conditions in which unpredictability might otherwise thrive.

Our **ViewPoint** is that companies should not only be looking at ways in which they can build greater effectiveness into the way their audit committees work, but also taking into account the benefits of communicating these activities to the markets.

There are potential advantages for companies that seek to go beyond the boilerplate reporting of audit committee structure and process. Communication to the markets of the audit committee's role in monitoring the integrity of financial reporting, exercising robust oversight of risk management and internal control processes, and ensuring the proper performance of external and internal auditors could provide the markets with greater assurance on the effectiveness of the audit committee.

As things stand, the information demands made by investors and other

stakeholders are not always adequately met through companies' disclosures in their annual reports, proxy statements and websites. Under these circumstances stakeholders may turn elsewhere for the information they require, or make their own assumptions.

In the following pages, we explain what we mean by audit committee 'effectiveness', before suggesting six ways in which this effectiveness might be improved – and ways in which the markets can be presented with a full picture of those activities.

Getting to the heart of effectiveness

In many territories, audit committees are required to review their effectiveness, helping to ensure that they meet the expectations of the committee members themselves, the board, the shareholders, the regulators and the capital markets. However, in some companies, the assessments are geared towards a 'checklist' approach, with the emphasis on structure.

Companies could benefit from broadening their outlook. Audit committees must have the right structure and **process** in place. But without strong **leadership** and good **group dynamics** to promote a culture of challenge and engagement, they may be unable to fulfil their role effectively.

Process

As things stand, some effectiveness reviews are conducted with the primary aim of achieving compliance with codes and regulations. Focusing largely on committee charters and composition (in terms of the independence and financial literacy of members), they can offer, at best, a one-dimensional view of this vital oversight function.

In a more comprehensive process audit committees should be asking themselves how they can become more effective, by enhancing their oversight of core issues, as well as by ensuring that they are getting the right information and holding the right discussions.

Leadership

Strong leadership is essential. The chair plays a crucial role in driving the agenda for committee meetings, ensuring that all relevant issues are included – and that they all get discussed. Active chairs should also spend significant time between meetings keeping current on market developments, discussing issues with management and internal and external auditors, and preparing for meetings. Chairs need to be ready and willing to take the lead, encouraging engagement of all directors, setting the agenda and running the meetings in the interests of the board and ultimately the shareholders – not for the benefit of management, lawyers, auditors and other advisers.

Group dynamics

The dynamics of the committee – the way in which its members interact with each other, with the chair and with the board, management and auditors – is a vital, and often overlooked, factor for review and development. Specifically, it is essential to ensure that audit committee members possess the right qualities and experience, as well as a willingness to challenge and fully participate in the committee's activities.

Particularly when the audit committee meets only infrequently, there is limited opportunity for its members to learn about each other's preferred ways of working and communicating in a group setting.

Without specific interventions designed to accelerate the process, an audit committee may take many meetings to reach the point where it is working well, if indeed it ever does so at all.

By putting in place an ongoing development programme focused on audit committee dynamics, companies would be setting themselves apart from the vast majority of their peers. By going a step further, and communicating what factors are included in the programme (and what forward-looking objectives are set), they would be providing best-in-class insights into audit committee effectiveness.

Six suggestions for improving effectiveness – and what to tell the markets

Based on examples of good practice that we have seen in various companies around the world, we have identified six areas where there may be room for improvement in the effectiveness of audit committees around process, leadership and dynamics, as well as the factors that could be communicated to the markets in respect of each of these.

1 Getting a grip on risk...

It is established best practice for audit committees to plan how they will fulfil their oversight responsibilities over the course of the year, updating their working agendas on a regular basis to reflect new developments. Effective work-plans will be inherently riskorientated, reflecting the company's current situation and strategic priorities.

In the context of the current and emerging corporate governance environment, it is important to ensure that the audit committee's oversight of risk is not too broad – and to communicate to stakeholders how this is being achieved. Rather than leaving all risk management oversight to the audit committee, some companies are forming a risk committee, or designating the entire board as being responsible for ensuring that there is an effective risk identification and management process. This helps audit committee members, by focusing their oversight on specific (rather than all) risks.

...and telling the markets

Regardless of the structure the board has adopted to oversee risk, the markets might be told about:

- Whether the audit committee is overseeing the effectiveness of the risk identification and management process, and if not, where at board level this oversight is carried out.
- Which specific risks are within the scope of the audit committee and how the oversight of business risks is apportioned (eg, between the board, the audit committee, the risk committee and the nomination and remuneration committee, where appropriate).
- How the board deals with assigning oversight of new risks that arise.
- How assurance is obtained over the effectiveness of the risk management process, as well as over the integrity and appropriateness of the risk information being presented to the board, the audit committee and other oversight committees. Audit committees can obtain assurance over the information presented to them from a number of sources, in addition to internal audit. These would include management's own assessments (if robust), legal and compliance departments and even external parties (including actuaries, valuers and auditors).
- How the audit or risk committee periodically (annually in some countries) assesses these various sources of assurance, as well as how it judges whether they are, in aggregate, sufficient.

2 Understanding the business...

Among the many good practices already performed by the most effective audit committees, getting out and about to 'kick the tyres' of the business is one of the best. By visiting a selection of the company's locations, meeting local management and employees, functional groups (including the internal auditor) and possibly also the local external audit team, the committee can obtain invaluable insights into the business. These will aid decision-making back at headquarters, as well as helping to highlight critical areas for discussion in regular audit committee meetings.

...and telling the markets

Information that could be communicated to the markets includes:

- The existence of the site visits programme and how locations visited are determined.
- The programme's main focus (eg, understanding a new business unit, focusing on risk management, agreeing scope of audit work, getting to know local management).
- The functions of the people who have been met (and who have presented to the committee) during this programme.
- Key developments resulting from the visit (and whether or not they have strengthened the audit committee, or caused it to change its practices in some way).

3 Injecting objectivity into the reporting process...

CEOs and CFOs make inherently subjective assessments and judgements every time a company produces external reports. Audit committees have a valuable role to play in overseeing this process, helping to inject objectivity and independence into CEO/CFO decision-making. By ensuring that management forms a disclosure committee (as has been the practice for SEC registrants as a result of the Sarbanes-Oxley legislation), with members drawn from the senior executive (including risk, internal audit, legal and compliance), assurance can be provided that everything that should be considered for disclosure has, indeed, been considered objectively.

For non SEC-registrants and smaller companies, the same result could be achieved by establishing clear relationships between the audit committee, management and the auditors, ensuring that the audit committee has a clear understanding of areas of subjectivity and is notified promptly about major issues.

...and telling the markets

By announcing the formation of such a disclosure committee, together with details of its composition and schedule throughout the year, companies would be ensuring that their financial reporting has greater credibility among stakeholders in the capital markets.

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4 Overseeing the C-suite...

Recent corporate collapses have consistently pointed to failings in the C-suite. Audit committees have a crucial role to play, restoring trust among shareholders by putting in place monitoring processes designed to pre-empt these types of failings. Of central importance to its oversight function are the ways in which the audit committee gauges the 'health' of the corporate culture and ethics and assesses the behaviours of the senior management team leading that culture.

...and telling the markets

The following items could be communicated to the markets:

- How the committee gauges the candour, adequacy and timeliness of reporting (on issues including strategy and/or milestone deviation, undisclosed related party transactions, code of ethics violations, etc) from business units and functional heads to the board. In practice, this will often be achieved via confidential anonymous culture surveys.
- How the committee monitors the process through which the 'health' of the organisation's culture is assessed so as to ensure that this is being done thoroughly and thoughtfully. The committee should also ensure that there are action plans in place to address any important issues that emerge.
- The existence of an in-house whistleblowing process and the frequency with which issues are reported to the audit committee, as well as the policy for such reporting.

5 Honing effectiveness...

Keeping abreast of fast-changing commercial developments represents a major challenge. Audit committees can only be effective if they have the knowledge needed to evaluate the information on which they are basing their decisions.

In practice, most members of audit committees will sit on a number of boards and will therefore be receiving information and education from a wide range of sources. This means that they will probably already be well supplied with information on:

- Governance rule changes and how they will impact on the audit committee's work – including its responsibilities and membership.
- Evolving regulatory requirements, if the audit committee's mandate includes overseeing compliance with laws and regulations.
- Accounting and reporting developments, and the effects on the company's financial statements.

The important point is therefore to ensure that they are provided with all the support they need to plug any gaps and correct any deficiencies they feel they might have. Focused education and development programmes to address company-specific learning needs are especially important. For example, audit committees in mining companies will need to know about any changes in health and safety/environmental

legislation that apply in any of the jurisdictions where the company has (or plans to locate) its business.

To ensure that the committee members develop robust knowledge of the company's lines of business, it can be helpful to have a different business unit manager attend each meeting to describe the business strategy, operations and key risks, with finance people outlining any related impacts on accounting estimates and judgements. This can often be achieved during one of the regular site visits (see above).

...and telling the markets

To highlight the ways in which their audit committees are honing their effectiveness, companies could communicate the schedule of planned sessions to the markets. Companies might consider reporting audit committee targets for development, as well as how those targets will be met (in-house training sessions, together with external education, such as conferences, tailored courses and 'directors' colleges').

Getting the right dynamics

We believe that development programmes that promote strong group dynamics can play an important part in building effective audit committees. Companies should consider seriously the benefits of adopting such programmes – as well as communicating their agendas and areas of focus to the markets.

Developing dynamics...

A development programme should include:

- A briefing on group dynamics and its relevance to audit committees.
- Self-assessment of the committee's effectiveness in working together.
- Self-assessment of the working and communication styles of the individual members.
- Case studies/scenarios to explore ways of working together even more effectively.
- Agreement on the 'ground rules' for working together, including debate and decision making.
- Agreement on a process for ongoing, regular review of the committee's dynamics.

...and reporting them

In the current climate, where heightened fears over compliance requirements and directors' liability are making it harder to recruit new directors, it is especially important for companies to communicate the steps they are taking to develop audit committee dynamics, since the best candidates may more readily take up positions on the most effective committees.

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6 Disclosing what matters...

Regular reviews of audit committee effectiveness are already a core requirement in many territories. However, few companies provide the markets with any details of their approach to these assessments, or of the improvements that are being targeted as a result.

Each committee member might be asked to assess the committee's procedure and performance, with each director providing feedback on committee structure; the appropriateness of committee assignments and committee chair assignments; the effectiveness of committee decision making and the relationship and quality of communication between the committee and the board, management and external stakeholders. The result of the evaluation would be discussed with the chair, and recommendations for improving committee operations would be made.

If the assessment includes individual committee members, the factors might cover independence and integrity; knowledge and expertise; participation and input; preparation; availability; and teamwork. Having completed the assessment process, whether via self-assessment, peer assessment or assessment facilitated by third parties, the chair would discuss his or her evaluation with each committee member, identifying areas for improvement.

...and telling the markets

By communicating the requirements that are placed on the audit committee, as well as the ways in which ongoing, systematic performance assessments of the entire committee – and those of individual members, if such assessments are done – track performance against these requirements, companies would shed real light on audit committee effectiveness, in terms of current performance and future opportunities for improving operations and procedures.

Time for action

Each of the above recommendations can play an important role in improving audit committee effectiveness and, as a result,

helping to minimise the likelihood and impact of unpredictability. However, while some companies might already be moving towards good practice in a number of these areas, few have taken the initiative in a convincing fashion, and even fewer have started to communicate the full scope of these activities to the markets.

Risks...

As a consequence, some companies are exposing themselves to risk, as well as potentially losing out on some valuable opportunities.

If these companies do not commit to building greater effectiveness into the way their audit committees work, their governance will be (at best) adequate, providing them with limited protection from the various factors that could threaten to undermine corporate stability.

And if they do not communicate the steps that audit committees are taking to improve their effectiveness, they run the risk that key stakeholders may turn elsewhere to obtain the reassurance they seek. If this happens, companies will have, to a large extent, lost control of the way they are perceived, risking damage to share values and corporate reputations (as well as the reputations of audit committee members themselves).

The information gap is currently filled by a plethora of rating agencies, employing measurement metrics that tend to support a boilerplate approach to governance – offering little insight into the key drivers of effectiveness. This, however, is the source of information that the markets will look to if there is a paucity of quality information from companies.

In failing adequately to communicate the steps they are taking to enhance the effectiveness of their audit committees, companies are also inviting additional regulation of the reporting model, with a commensurate increase in the compliance burden. New regulation would be likely to push companies further down the boilerplate route, adding to frustrations for companies and their observers.

...opportunities...

On the other hand, by moving now to build true audit committee effectiveness

– and by telling the markets how they are doing so – companies could seize a rare opportunity for market differentiation, moving beyond checklist effectiveness assessments to achieve valuable competitive advantage. By enhancing their reputation for good governance, these companies would be well positioned to recruit the best possible candidates to their audit committees, as and when spaces needed to be filled.

...and next steps

Pressure for change is building. The capital markets are hungry for extra assurance from companies on the reliability of financial information. The appropriate response is for companies to push towards improved audit committee process, leadership and dynamics – as well as improved communication around these essential factors.

If you would like to discuss any of the issues raised in this paper please contact

PricewaterhouseCoopers
Av. Francisco Matarazzo, 1400
05001-903 - Água Branca
Torre Torino - São Paulo - SP - Brazil

Carlos Sousa
Tel.: 55 (11) 3674-3637
e-mail: carlos.sousa@br.pwc.com

Jorge Manoel
Tel.: 55 (11) 3674-2243
e-mail: jorge.manoel@br.pwc.com

Fernando Alves
Tel.: 55 (11) 3674-3806
e-mail: fernando.alves@br.pwc.com

or your local PricewaterhouseCoopers office.

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