

## Addressing audit committee overload

On October 7, 2011, members of the Audit Committee Leadership Network (ACLN) met in New York to discuss their perspectives on audit committee overload, among other topics.<sup>1</sup> This document summarizes the key points that members raised in the discussion, along with background information and perspectives that members shared before the meeting.<sup>2</sup> For further information about the network, see “About this document” on page 8. For a list of participants, see Appendix 1 on page 9. For a list of discussion questions for audit committees, see Appendix 2 on page 10.

### Executive summary

Like the accounting scandals at the turn of the century, the recent years of financial and economic turmoil have created new challenges for audit committees and their chairs:

- **The audit committee’s agenda is expanding** (*page 2*)

Though audit committees today spend less time on internal controls compliance with Sarbanes-Oxley Section 404, they are focusing on other matters that have increased in importance and, in many cases, landed squarely on the audit committee’s agenda. Two major areas are enterprise risk – including information technology (IT) risk and risks associated with international operations – and compliance issues beyond Sarbanes-Oxley that reflect the recent wave of regulation and regulatory enforcement worldwide.

- **Responses to overload include changes in issue allocation and improved efficiency** (*page 5*)

Boards and audit committees are taking a two-pronged approach to avoid audit committee overload. First, they are seeking an appropriate allocation of responsibilities among board committees – such as the finance committee – and the full board, in some cases creating separate risk or compliance committees. Second, audit committees are enhancing their efficiency through better planning and prioritization, improved pre-reading materials and meeting management, and more continuous self-evaluation.

- **Audit chairs take the lead in managing overload** (*page 7*)

Audit chairs disproportionately bear the burden of the audit committee’s new challenges. They play a critical leadership role in achieving the proper allocation of responsibilities and in implementing measures that improve efficiency. When audit committees spend more time on new agenda items, it is often the audit chair who is contributing the additional hours before and after the formal meetings.

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<sup>1</sup> In another session, members discussed investors’ perspectives on financial reporting. See Audit Committee Leadership Network, “[Investors’ perspectives on financial reporting](#),” *ViewPoints*, November 3, 2011.

<sup>2</sup> *ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and guests and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Member quotes appear in italics.



## The audit committee's agenda is expanding

Nearly a decade ago, the Sarbanes-Oxley Act expanded the duties and obligations of audit committees significantly. Compliance with the new law required major changes in how audit committees functioned. Today, members reported, *"We spend less time on SOX – it's been routinized, and we understand the internal audit process."*

Nevertheless, audit committees face continuing challenges in managing the scope of their charters. As developments in the global economy have brought new issues to the fore, the audit committee has often assumed the burden. A member explained, *"The audit committee is now viewed as a powerful, important committee that can scale issues of any kind. It has become the workhorse of the board. It meets more often, so it has fresher data ... and it has more familiarity with management, so it's able to make quicker judgments on things."*

## More topics are crowding the agenda

External developments, such as the fallout from the financial crisis in 2008, increasingly aggressive regulation and taxation enforcement, and the evolution of information technology, have added new items to the audit committee's traditional responsibilities. These issues have been parceled out in various ways among the full board and its committees, but the audit committee has ended up with partial or full responsibility for many of them.

### Enterprise risk management

Recent calamities such as the Japanese tsunami, the Gulf oil spill, and the financial and economic crisis have driven a renewed emphasis on identifying and mitigating risks, and boards have had to step up their oversight of these matters.<sup>3</sup> Financial and reporting risks are a core concern for audit committees, but other types of risks are now appearing on some audit committee agendas:

- **Strategic risks.** The risks associated with strategic decisions such as whether or not to enter an international market, acquire another major company, develop a new product line, or dispose of a business unit are significant. Boards have always insisted on overseeing these kinds of decisions, but in the current environment, the risk aspects have become a key concern.
- **Operational risks.** The risks associated with the company's day-to-day functioning are very diverse, including such issues as supply-chain reliability, the environmental impacts of operations, and the physical security of buildings and staff. Operational risks can be small, falling below the radar of the board, but they can also be highly significant, as the Gulf oil spill made clear.

Both strategic and operational risks can become reputational risks as well, and some risks can be catastrophic, threatening the company's very existence. Because the New York Stock Exchange (NYSE) listing rules require audit committees to discuss risk assessment and risk management policies,<sup>4</sup> the responsibility for directly

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<sup>3</sup> See Audit Committee Leadership Network, ["Leading Risk Management Practices,"](#) *ViewPoints*, November 30, 2009.

<sup>4</sup> New York Stock Exchange, ["303A.07 Audit Committee Additional Requirements,"](#) in *Listed Company Manual* (New York: NYSE Euronext, 2011).

addressing various risks in many cases falls to the audit committee, except in certain industries where a separate, board-level risk committee exists.

Members discussed the scale and scope of their audit committees' increased focus on risk. One member said, *"We've moved from four to six face-to-face meetings per year in the past six years, primarily due to risk issues. We have moved from looking at internal controls to looking at the judgments made. We have two meetings focused on risk, including cyber security, corruption, IT, and reputational."*

The member's point about reviewing judgments as well as the controls themselves echoed remarks made in pre-meeting conversations, in which members noted the greater depth of analysis expected of audit committees: *"Audit committees are increasingly being asked to judge or pass comment on the effectiveness of management and their controls and processes, rather than just assess whether they exist, so it's judging outcomes rather than inputs."*

Other members also mentioned the types of risk they consider. One member said, *"We spend half of the committee meeting on two areas of risk: acquisitions and IT."* Other members highlighted the breadth and severity of potential risks, particularly in two areas:

- **International market risk.** One member referred to recent international events: *"The audit committee gets called with anything [enterprise risk management] related. At 3:00 a.m, that's real. For example, the Japanese tsunami or the Arab spring. How do we get 200 expats out with their families?"* Speaking of an overseas acquisition, another member said, *"With the head of internal audit and external audit, I spent several days getting to know the culture and processes, in order to report back [to the committee]. We have to grow significantly, but we want to make sure we understand the risk. Outside of the US, it's a different agenda with different challenges."*
- **IT risks.** IT risks have multiple elements of concern, as a member explained: *"We're spending more time on IT controls and more time around cyber procedures and security and privacy. Sony's PlayStation lost control of customer data recently – the CEO is making a public apology. It's not only the bad press and the bad reputational hit; it's also about to bring a lot of privacy lawsuits."*

### Regulatory compliance

The wave of regulatory initiatives sweeping the globe has made compliance an urgent topic (and a risk in its own right), leading to innovations in how compliance is handled by management and monitored by boards.<sup>5</sup>

Recent initiatives of note include the rulemaking required in the Dodd-Frank Act and the healthcare reform legislation, both of which will affect companies in a broad range of industries by influencing, for example, policies on whistleblowing and healthcare benefits. ACLN members have also pointed to initiatives from federal agencies such as the Food and Drug Administration and the Environmental Protection Agency, as well as regulations from state and foreign governments. Regulations on bribery and corruption are a mounting concern that ACLN and EACLN members discussed at length at the recent summit in

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<sup>5</sup> See Audit Committee Leadership Network, ["Regulatory Compliance,"](#) ViewPoints, March 4, 2011.

Washington.<sup>6</sup> ACLN members have also remarked on regulators' increasingly vigorous enforcement of regulations generally.<sup>7</sup>

NYSE listing requirements assign responsibility for oversight of compliance programs to the audit committee.<sup>8</sup> Several members have observed that compliance is taking up more and more time, noting moves in some industries (such as healthcare) to establish compliance committees of the board.<sup>9</sup> At the October meeting, members reiterated those general points: *"We are always looking for more time or trying to delegate to others – we spend so much time on compliance."*

In addition, members mentioned specific compliance issues that they expect to be increasingly challenging, such as dealing with whistleblowers. One member said, *"We're spending more time on the whistleblower issue. Over the long term, this is going to be a problem. Layoffs drive this, and the SEC's whistleblower bounty."* Another member concurred: *"Get ready – the whistleblower issue is going to be something we spend hours and hours on."*

Many companies are very concerned about the impact of the SEC's new whistleblower rule, and 10 have jointly written a letter to the SEC arguing that it will undermine compliance programs and lead companies to self-report even those allegations that lack merit.<sup>10</sup> In August 2011, a bill was introduced in the House Committees on Financial Services and Agriculture that would require whistleblowers to report their allegations to their employers before reporting to the SEC.<sup>11</sup>

### **Are audit committees spending more time on their responsibilities?**

Members discussed the number of meetings their audit committees have per year and the number of hours devoted to each meeting. A few members mentioned that they have recently increased the frequency of their meetings; however, unlike the added responsibilities imposed by Sarbanes-Oxley, the recent additions to the audit committee agenda do not appear to have caused an overall increase in the number of in-person meetings that audit committees hold. However, members agreed audit chairs are spending significantly more time in the role than they have in the past, particularly between meetings, in order to address the expanding agenda. [See page 7 for information on how audit chairs are taking the lead on handling audit committee overload.](#)

The majority of members said the number of in-person audit committee meetings, excluding telephone meetings to discuss securities filings each quarter, was between four and six, each lasting about three hours, though members reported that they held other telephonic meetings as well. More time may be spent on items like risk or compliance, but less time is spent on internal controls and financial statements. In addition, audit committees are using certain measures to deal with the new demands they are facing. These measures are described in the following section.

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<sup>6</sup> See Audit Committee Leadership Summit, "[Bribery and Corruption](#)," *ViewPoints*, July 14, 2011.

<sup>7</sup> Audit Committee Leadership Network, "[Regulatory Compliance](#)," 2-3.

<sup>8</sup> New York Stock Exchange, "[303A.07 Audit Committee Additional Requirements](#)."

<sup>9</sup> Audit Committee Leadership Network, "[Regulatory Compliance](#)," 6-7.

<sup>10</sup> Kara Scannell, "[SEC Set to Back Cash Rewards for Whistleblowers](#)," *Financial Times*, May 25, 2011.

<sup>11</sup> Reese Darragh, "[House Bill Would Require Whistleblowers to Report Internally First](#)," *Filing Cabinet* (blog), *Compliance Week*, August 23, 2011.

## Responses to overload include changes in issue allocation and improved efficiency

Members' discussion of how to address the problem of audit committee overload revealed a two-pronged approach that included reviewing what issues the audit committee should be shouldering, and analyzing how the committee can tackle its responsibilities effectively.

### Giving the audit committee an appropriate portfolio of issues

One approach to managing the growing burden on the audit committee is to ensure that the allocation of responsibilities to the committee is appropriate. How do boards decide which topics the audit committee should handle? How do they make sure that all issues receive consideration appropriate to their importance while minimizing redundant effort and keeping the audit committee workload reasonable? Members described a number of different approaches:

- **Board leadership plays a role.** Board chairs or lead directors may help decide which committees take on various vital issues. A member said, *"Board chairs have to make the decision."* The delegation of critical issues may also entail *"a discussion at the board level."* One member highlighted the role of the board secretariat: *"The board secretariat attends other committee meetings and is constantly looking for overlaps and cracks."*
- **Committee chairs confer with each other.** If two committees could plausibly take responsibility for an issue, the two chairs may discuss the best arrangement; *"it's a matter of the [committee] chairs getting together and deciding,"* one member said. Another member noted that overlapping committee memberships facilitate the process: *"We can spot [problems], such as when things are talked about twice, or worse, when things are not being talked about at all."*
- **The committee defines the agenda.** The committee itself also makes decisions about the issues it should cover and how it should approach them. One member commented, *"The beauty of audit committees with a variety of backgrounds and experiences is that you get a comprehensive list of issues."* Another member mentioned the committee's use of outside experts to help identify important issues.
- **Management suggests an agenda.** Some members noted that management could have substantial influence on the agenda. Management is especially likely to put issues that are top of mind on the agenda, such as integration problems associated with a recent acquisition.

Decisions on the allocation of responsibilities may lead to changes in the charters of the relevant committees. One member mentioned frequent changes to the audit committee charter: *"We do modify the charter – it seems like every year."* Another member spoke of an issue that was shifted from the audit committee to the finance committee, hinting at the usefulness of spelling things out more clearly in committee charters: *"It wasn't clear before where [the pension fund assumptions] belonged. It probably should have been in the charter of the finance committee."*

In general, the allocation process is relatively informal, and members reported some success in reallocating issues to other committees or the full board. One member said, *"On one of my boards, the nominating committee is taking compliance, and that was a conscious effort to get it out of the audit committee."* Another member said, *"On our board, tax strategy was moved to the finance committee. That makes better sense. And we created a separate*

compliance committee; it is so broad that it didn't make sense to have it in the audit committee." Other members reported that they had established risk committees in order to provide the opportunity for more detailed risk oversight.

A member described a different approach at another board: "We created a compliance subcommittee of the audit committee. It meets at a different schedule and we hear from them at the audit committee meeting. It's a standing committee and a subcommittee."

### Improving audit committee efficiency

Once responsibilities have been allocated, audit committees are still likely to face a full agenda. This challenge puts a premium on the committee's efficiency, a topic that has seen considerable research in recent years and an area in which the audit committee chair can have significant influence.

The North American edition of *InSights* took a comprehensive look at the issue of efficiency in fall 2011, identifying four factors that drive audit committee effectiveness: having the right mix of skills; having a skilled, energetic, and creative chair; ensuring high-quality content and effective information flow; and instituting ongoing performance feedback, backed by high-quality committee evaluations.<sup>12</sup>

In the October 2011 meeting, members identified a few tactical and immediately implementable measures designed to deal specifically with the problem of overload, some echoing the specific measures emerging from the *InSights* research and the recommendations of organizations such as the National Association of Corporate Directors:<sup>13</sup>

- **Good planning.** Careful planning is crucial, and it should include internal as well as external audit. One member said, "We are making conscious decisions regarding how we go about things in the audit committee, working with the head of internal audit." Another member elaborated on an approach to the planning session: "We use an eight-hour meeting to set up the rest of the year. It's just the audit committee, not the full board. It includes internal audit and external audit, and we lay out a plan for the year. It includes the internal audit plan, when and what we'll do for deep dives, and lessons learned from the previous year." This approach allows for more concise meetings the rest of the year.
- **Better materials.** Members noted that the quality of the pre-reading materials makes a big difference. One member explained, "The audit chair has to direct the quality of the pre-reading. The committee has to agree this is appropriate. We ban presentations and ensure there is high-quality written stuff to read – no more 'death by PowerPoint.' We ask management for a one- to two-page summary of each document." Other members also mentioned the importance of executive summaries, either in written or oral form: "The executive summaries force the authors to say things succinctly."

<sup>12</sup> Tapestry Networks and Ernst & Young, "The Audit Committee Journey Continues to a Higher-Functioning Committee," *InSights*, January 2011, 6-10.

<sup>13</sup> See National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on the Audit Committee* (Washington, DC: National Association of Corporate Directors, 2010). Available for purchase at [NACD website](#).

- **Effective self-evaluation.** Members noted that taking the time to assess audit committee effectiveness is key, even if the process is informal: *“We have a really good, interactive self-evaluation process. We sit down and talk about it. There are no forms.”* Research for InSights found that while few audit chairs believed the standard annual evaluations helped them improve performance, they thought that feedback gained via executive sessions before audit committee meetings and one-on-one meetings between key parties could provide opportunities for improvement.<sup>14</sup>

### Audit chairs take the lead in managing overload

A key point emerging from the discussion in New York was that the increasing load on the audit committee is falling mostly on the chair: *“The chair spends 60–70% more time [than other committee members].”* If more time is being spent, it is being spent chiefly by the audit chair.

In InSights interviews, “research participants agreed the audit chair plays a vital role in enhancing the effectiveness of the audit committee.”<sup>15</sup> In order for the audit committee to manage its load, the audit chair must step up his or her efforts, crafting an effective agenda, managing the meetings, engaging the other members of the committee, and coaching management before presentations.<sup>16</sup>

At the meeting, ACLN members made similar points. One member noted, *“The only way to limit in-person audit committee meeting time is for the audit chair to do triage, and decide when and how to spend the audit committee time.”* Another member added, *“The audit committee chair goes through all materials to ensure what needs to be covered is covered.”* These efforts take time: on average, members reported they are spending over 30 days a year on board and audit committee work per public company.

Members noted that it is not always feasible for the audit chair to delegate work to other audit committee members, since *“the other audit committee members are chairs of other committees”* and may be very busy as well. At the same, the audit chair has to avoid seeming imperious as he or she takes on responsibilities: *“The audit chair has to be careful to ensure that other members are included in the process, or they may not feel they are part of the team. For example, if the audit chair goes to Africa, this needs to be done in a way that the others agree on.”*

### Conclusion

Audit committees are facing new challenges as issues such as risk management and compliance crowd their agendas, demanding more time and attention. To avoid audit committee overload, boards and audit committees are seeking an appropriate allocation of responsibilities among board committees; in some cases, the board is establishing new committees focused on areas such as risk or compliance. Audit committees are also paying attention to efficiency through improved planning and preparation for meetings. Leading these efforts are the audit chairs, who are contributing the lion’s share of the additional hours that audit committees are spending on their new agendas. If the question of whether audit committees are really overloaded is debatable, the continuing overload of the audit chair is less so.

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<sup>14</sup> Tapestry Networks and Ernst & Young, [“The Audit Committee Journey Continues to a Higher-Functioning Committee.”](#) 10.

<sup>15</sup> [Ibid.](#), 8.

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



## About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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## Appendix 1: participants

The following Audit Committee Leadership Network members, who collectively sit on the boards of over 30 large-, mid-, and small-cap public companies, participated in all or part of the session:

- Denny Beresford, Fannie Mae and Legg Mason
- Les Brun, Merck
- Phil Hodkinson, BT\*
- Judy Richards Hope, General Mills and Union Pacific
- Marie Knowles, McKesson
- Mike Losh, Aon and TRW Automotive
- George Muñoz, Altria and Marriott International
- Oscar Munoz, United Continental Holdings
- Chuck Noski, Microsoft
- Bill Osborn, Caterpillar
- Pam Patsley, Texas Instruments
- Pierre Rodocanachi, Vivendi\*
- Peter Ueberroth, The Coca-Cola Company
- Steve West, Cisco Systems
- Chris Williams, Wal-Mart

\* Mr Hodkinson and Mr Rodocanachi are members of the European Audit Committee Leadership Network.

Ernst & Young professionals participating in the meeting included:

- Tom Hough, Americas Vice Chair of Assurance Services
- Steve Howe, Americas Managing Partner



## Appendix 2: questions for audit committees

- ? What new issues has the audit committee had to tackle in the last several years? Which are the most challenging?
- ? What impact has this broadening of the agenda had on the audit committee? Has meeting frequency or length increased?
- ? Given the breadth of audit committee oversight today, how do you avoid creating a ‘board within a board,’ with the audit committee acting as such?
- ? How does your board decide how issues should be allocated? Who contributes to the decision? Who makes the ultimate decision?
- ? How does your board make sure that important issues do not fall between the cracks?
- ? How could the allocation process be improved? What approaches work best?
- ? What measures have you found most helpful for increasing the efficiency of the audit committee?
- ? What role does the audit chair play in managing the load on the audit committee? Is the audit chair devoting more time to his or her duties? Is there anything the chair can do about that?
- ? How can management and the external auditor help the audit committee be more efficient?