

Board Paper

Audit Committees: heaven or hell?

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Audit Committees of publicly quoted companies have faced increased expectations in recent years, as a result of both regulatory change and growing shareholder scrutiny.

As all aspects of Governance were reviewed and strengthened, and a new breed of independent Non-Executive Director (NED) emerged, the implications of Audit Committee chairmanship and membership were better appreciated and the daunting nature of the challenge realised.

This was particularly true for the 100+ UK companies with a US listing or American Depository Receipt programme and who thus fell under the sway of the Sarbanes-Oxley Act. This established onerous new requirements for Audit Committees and the directors who served on them.

The greater regulatory focus on both sides of the Atlantic resulted in Audit Committees where members understood – to a significant extent at least – the responsibilities they faced. But they had not necessarily learned enough about the skills required and how to work together as a team well enough to achieve the required standards. However, with increasing encouragement from Chairs, Boards, the Audit Community, regulators and shareholders, an effective Audit Committee is now seen as the foundation of an effective Board and a place that many enlightened NEDs are now keen to serve.

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Undoubtedly, in the current economic environment, companies will need their Audit Committees to be of the highest calibre. The financial crisis, and subsequent recession, has placed the balance sheets of numerous companies under strain, and Audit Committees will need to be the Board's eyes and ears as far as spotting any emerging problems is concerned.

To be successful, the Committee needs to recruit the right members, have clear terms of reference, a focused agenda and rigorous processes. It must enable individual members to express clear independence of view and yet work effectively as a team. As well as carrying out their core role of financial scrutiny, in

many cases Audit Committees are also expected to lead the Board's thinking on risk management, an area of heightened scrutiny in the wake of the financial crisis. It goes without saying that Committee members must be fully aware of the broad business issues as well as the details of audit.

■ **The Provisions of the Combined Code (The Code)**

The general principle is that Audit Committees are responsible for the oversight of the company's financial reporting processes, including related risks and controls, as well as the company's internal and external auditors. In detail, the remit is to:

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- Monitor the integrity of financial statements and announcements on financial performance, reviewing significant financial reporting judgments;
- Review internal financial controls and risk management systems, unless the board has a separate Risk Committee or deals with risk itself;
- Monitor and review the effectiveness of internal audit;
- Make recommendations to the board on the appointment, removal, remuneration and terms of engagement of the external auditor;
- Review and monitor the external auditor's independence, objectivity and the effectiveness of the audit process;
- Develop and implement policy on the extent to which the external auditor supplies non-audit services, such as management consultancy, keeping an eye on ethical principles;
- Report and make recommendations to the Board on any matters on which action or improvement is required.

A successful Committee will also play a critical part in general Board matters, such as dialogue with shareholders, although the Code stresses this is a collective Board responsibility. The Committee must also ensure that all NEDs are fully informed on financial reporting and risk.

■ Membership

The Code calls for at least three independent NEDs – two for smaller companies – who must be elected to the committee by the Board. Whilst the Code defines the minimum requirement, views vary widely over what size and composition works best. A significant component of this debate must be that what is right for one company or Board, is not necessarily right for another.

On some Boards every Independent NED sits on every Board Committee. On others each Committee is composed of only the

minimum number of NEDs. While it is inappropriate for us to suggest the ideal composition, one of the arguments for large Committee memberships focuses on the need for a common level of understanding between the NEDs. For example, the Audit Committee should be aware of the behaviour that remuneration packages are intended to promote and, furthermore, ensure that performance data are not being inflated by executive management. Combined Committee membership can also help to make for smaller and therefore more efficient Boards.

The Board should, however, ensure effective communication between all of its members at all times and not rely on Committee work to achieve it. In considering the size and membership of its various Committees the Board should determine how they will best meet the needs of the company, the shareholders and regulators. This may well be best achieved by forming smaller, more skill-aligned Committees. The added advantage of this is that, if every Independent NED is not on every Committee, they have more time to spend on the ones on which they do sit. It also means that when, for example, the Audit Committee reports back to the Board there are fresh minds to challenge or approve the recommendations made.

■ Independence and expertise

The most recent changes in the UK's Combined Code on Corporate Governance by the late Sir Derek Higgs and Sir Robert Smith stressed the need for Committee members to be suitably qualified. Independence is a non-negotiable quality of every NED of a quoted company, but all the more critical when it comes to Audit Committee members. In addition, at least one Audit Committee member, often the Chairman, was originally required to have recent or relevant financial experience (recent being defined as within the last two years). The "or" in this definition was

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especially important in that every qualified accountant could meet the requirement, even if they did not have any *recent* experience.

As the difficulties of meeting the enhanced responsibilities became ever clearer, the potential weakness of such a definition became clear. This was further emphasised by the fact that, unusually, the European requirement was more stringent than the UK one. In Europe, the definition was for recent *and* relevant experience and it was anticipated that new definition would be implemented in the UK during 2007.

However, when the implications of the new definition were carefully considered, it was seen to be potentially causing as many problems as it was attempting to solve. For example, a finance director with extensive experience of listed company Boards, but who had become CEO of a listed company three or four years prior, could not meet the “and” requirement.

The issue remains unresolved, although this definition has been strengthened by common practice to include only those who have been a finance director, a qualified auditor, an investment banker, or the Chair of an Audit Committee within the last two years.

■ **Risk management**

A healthy debate exists on the extent to which the Audit Committee should oversee risk management. The Audit Committee plays a pivotal role in enabling executives to take reasonable risks and should report at least annually on risk to the main board. The Code allows risk to be managed in any one of three ways. First, the Board may decide that risk is a matter for itself; second it may decide it falls under the responsibilities of the Audit Committee; third it may decide to establish and appoint members to a separate Risk Committee.

Again, different models suit different companies. However, there is a real danger that the Audit Committee can get overburdened with all the elements of risk. As a consequence, an increasing number of companies have split the Committee’s functions and established a separate Risk Committee reporting directly to the board.

■ **Integrity, candour and conviction**

What kind of NED makes a good Audit Committee member? Financial literacy must be assumed, but the really valuable Audit members should also be able to relate the financial detail to the big picture and to have a very clear idea of the law of unintended consequences, both financial and otherwise. Members must have sufficient financial acumen to handle audit, but should also make a quality contribution to the broader Board agenda. Toughness is another requirement. It may be necessary to challenge the validity of financial reports and confidence and tact are required if one is successfully to take a critical line.

■ **Time commitment**

Time commitments vary according to the company’s financial complexity and the individual NED’s capacity to assimilate and appraise audit data. At a minimum, quarterly Audit Committee meetings should be held for the preparation of interim and final reports, a meeting with the auditors and a review of the Committee’s own agenda for the year. This is supplemented with additional meetings as required. There is also the requirement for some companies to make more regular disclosure of financial performance. Meetings need to be scheduled ahead of these announcements. In the past Audit Committee meetings were often held on the same day as Board meetings. However, the sheer scale of Audit Committee work and the intellectual rigour and degree of preparation that is now required of members means that

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many Audit Committee chairs are holding their meetings on separate days.

■ **Transparent disclosure**

When Audit Committees are working really well, they can create a culture of “no surprises” for the Board, while supporting and providing a helpful challenge for the executive team. Timely disclosure of issues is the hallmark of a well run Audit Committee. It can be the route by which market sensitive changes are brought to the Board. Another sign of best practice is the quality of the Audit Committee’s report in the company’s annual report; a critical tool in winning institutional investors’ confidence.

■ **Conclusion**

When poor governance plays a role in destroying shareholder value, the spotlight tends to fall on the Audit Committee.

Depending on circumstances the members may feel, for a time at least, that their lives have become unduly onerous. However, the responsibilities of Audit Committee membership must never be underestimated.

A strong Audit Committee is an essential component of a well-run Board and a major contributor to the creation of value. Whilst few Audit Committee members would describe their work as simple, participating in a well run Audit Committee is increasingly seen as a rewarding career move for appropriately skilled NEDs who have the time and inclination to become deeply engaged with the company they serve.

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