Audit Committee Self-Assessments: Why and How?

by Peter L. Rossiter
Schiff Hardin LLP

Introduction

Financial institutions and other companies with securities listed on The New York Stock Exchange do not need to consider whether the Audit Committee of the Board of Directors should conduct an annual self-assessment. They must have an Audit Committee charter that requires self-assessment, under Section 303A(7)(c)(ii) of the NYSE Listing Standards. Other companies however, have a choice, because the Nasdaq has no similar requirement and nothing requires such a self-assessment by unlisted or privately held organizations. These companies therefore need to decide whether to conduct an Audit Committee self-assessment voluntarily.

Any Audit Committee that conducts a self-assessment, whether it is required or optional, faces another issue: what is the best set of self-assessment procedures?

This white paper addresses both of these issues. First, for financial institutions not subject to the NYSE requirement, does an Audit Committee self-assessment make sense? Second, for NYSE-listed institutions, and for others that conclude a self-assessment is worth performing, what methodology or protocol should the Committee use?

In general, this paper concludes that the benefits of a self-assessment outweigh the risks, and offers some advice about how to conduct a self-assessment in a manner that maximizes the benefits and minimizes the risks. Because no single protocol is right for every organization, it also offers some alternative ways to proceed.

Why Conduct A Self-Assessment?

The first benefit of conducting a regular Audit Committee self-assessment is also the most obvious one: the Committee is likely to improve its effectiveness. Self-assessment can help the Committee identify and implement better procedures in a wide range of areas, from meeting preparation to the nature of presentations and discussions. Self-assessment can also help Committee members develop over time a better and shared understanding of the Committee’s mission and role in the overall governance and control structure of the institution. Finally, if conducted in the right way, a self-assessment promotes civility and collegiality, by channeling into a constructive process the sort of candid comments that might otherwise build up, erupt and cause unnecessary strain.

In addition, because the New York Stock Exchange has adopted the requirement described above, and because any number of corporate governance reform groups and writers recommend it, self-assessment is rapidly becoming a “best practice” in corporate governance. The fact that an Audit Committee regularly conducts a self-assessment is therefore likely to be
helpful if it becomes necessary to defend the Committee’s performance of its fiduciary duty in a lawsuit or a regulatory proceeding.

Finally, self-assessment may become a practical necessity. The Public Company Accounting Oversight Board, the agency created by the Sarbanes-Oxley Act of 2002 to oversee the independent auditors of publicly-held companies, in March 2004 issued Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This new Standard requires the auditors to evaluate the effectiveness of the Audit Committee’s oversight of the company’s external financial reporting and internal control over financial reporting. Since the auditors will be required to evaluate the Committee’s effectiveness, the Committee would be well advised to do so itself. In that manner it can surface and address issues in advance of the auditors, and create something of an evaluation “roadmap” that may be helpful to the auditors.

The new Standard applies by its terms only to audits of publicly held companies. But for some years auditors have been required to attest to the management assessment with respect to internal controls required by regulations adopted pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991. There are some indications that the bank regulators may look to Auditing Standard No. 2 as a way to add additional content to these requirements for all institutions subject to them, whether or not they are publicly held.

**The Downside of Self-Assessment**

Engaging in an Audit Committee self-assessment is not without its risks, however. To the extent that the self-assessment focuses on individual performance, it can generate ill will and actually undermine the group’s ability to work together. Many directors react negatively to proposals for Board or Committee self-assessment out of concern this could be the result.

In addition, conducting a good self-assessment takes time, something that can be in short supply for boards and committees these days, and additional time will be needed to follow up to make sure that recommended changes are actually implemented. From a risk management perspective, it would probably be better not to conduct a self-assessment at all than to conduct one, identify needed changes and then fail to implement them.

The biggest risk, however, is that a self-assessment may create a body of evidence that the Audit Committee has done a less than optimal job, which evidence can be used against the institution, the Board and members of the Committee in the event the institution encounters problems and lawsuits ensue. Nothing will help a plaintiff demonstrate a Committee’s shortcomings as eloquently as the members’ own words. There are also situations in which the results of a self-evaluation will be of interest to bank regulators, the Securities and Exchange Commission or other enforcement agencies. Criticisms – especially if unremedied – will not be helpful.

These risks can be mitigated. Some are addressed by structuring the process properly. The questions asked in the evaluation process, for example, can be phrased so they are designed to elicit helpful suggestions and not mere criticism, and – at least at the beginning – the
Committee can avoid asking for views on individuals and focus on evaluating the Committee’s work and working method. Failure to follow up is a risk that is entirely within the Committee’s control. A good tracking process will greatly lessen the risk that needed changes will be identified but not made.

The risk of creating evidence that could be harmful in a lawsuit is harder to avoid. The courts in some states have recognized a privilege for self-critical analysis that may apply and make at least the evaluative portions of a self-assessment conditionally inadmissible in civil litigation. But this privilege is not recognized in many states, seems to have lost ground in the courts over the last decade, and is in any event not well tested in the context of Audit Committee self-assessment.

The attorney-client privilege is more widely recognized and well established. Many institutions structure their self-evaluation processes to maximize the prospects that it will apply. This means using a lawyer as an integral part of the process, to help the Committee gather information, evaluate the information, decide upon recommendations and organize implementation and follow-up. It should be made clear to all participants that the attorney’s role is to provide legal advice on Audit Committee functions and legal compliance. Of course, the privilege can protect only those communications that the Committee members actually keep confidential. Even when a lawyer plays an important substantive role in the process, the role is properly characterized and the information is otherwise kept confidential--however, some risk remains. A court may view the attorney as a mere conduit, and refuse to protect some or all of the information gathered in a self-assessment from discovery in civil litigation.

In theory, this privilege should apply in the bank regulatory context and in various enforcement contexts as well. In practice, it is very difficult to resist a request for disclosure in these settings, except by arguing that disclosure may result in a complete waiver of the privilege in civil litigation and so harm the institution. This tends to be an effective argument only with bank regulators and not always there. The best way to mitigate this risk is to structure the self-assessment properly, so that disclosure of the results of a self-assessment will not be materially harmful.

For NYSE-listed companies, as noted earlier, there is no need to balance these considerations. They must perform an Audit Committee self-assessment, and their only issue is how to do it well. For other companies, the benefits of a properly conducted self-assessment – one that squeezes as much risk out of the process as is practical -- probably outweigh the residual risk. The litigation-related risk cannot be eliminated, but a good self-assessment process, among other things, increases the likelihood that an effective Audit Committee will help prevent litigation over internal controls in the first place.

**A Self-Assessment Protocol**

There are a number of ways to organize and conduct a self-assessment. The easiest way to get a sense of the possibilities is to outline one process in detail and then briefly describe some alternatives. Whatever protocol is chosen, it is a good practice to reduce it to writing and have the Committee or the Board approve it in advance of the self-assessment. The protocol should
reflect not only what the Committee agreed to do – the process – but also why it decided to do it that way.

The process begins with the preparation of a questionnaire. In order to maximize the prospects that the process will be shielded by the attorney-client privilege, and in order to take advantage of the expertise in this area some lawyers have developed, the questionnaire should be prepared by a knowledgeable lawyer working in close consultation with either the Audit Committee Chairman or the member of management (CEO, CFO, Controller or Auditor) who deals most with the Committee.

The purpose of the questionnaire is to turn up issues that the Committee should discuss with a view toward process improvement. Areas to cover would include:

- Number and schedule of meetings.
- Agenda-setting process.
- Format, timing and usefulness of the materials sent to the Committee members in advance of the meetings.
- Conduct of the meetings, including whether enough time is devoted to the right subjects.
- Quality of the presentations by management and the external auditors, both written and oral.
- Quality of the discussion at Audit Committee meetings.
- Unencumbered access to key individuals such as the independent auditors, the internal auditor and the Chief Financial Officer.
- Committee’s processes for identifying problems, agreeing upon solutions and tracking implementation.
- Orientation, training or educational programs for the Committee, including topics of interest.
- Nature and adequacy of the Committee’s resources.
- Committee’s effectiveness in carrying out a host of responsibilities, from evaluating the external auditors to overseeing the audit process.
- Whether the Audit Committee’s charter needs modification.

The questionnaire should focus on matters that require qualitative judgment. It should avoid asking compliance-oriented, conclusory questions, such as whether the Committee meets regulatory requirements or has an “audit committee financial expert” among its members. These questions can be answered objectively, presumably by the attorney assisting in the process, and there is no need to solicit views.

Finally, the questionnaire should avoid questions that are, by their nature, likely to produce responses that could be used against the institution, the Board or the Committee in civil litigation. A self-assessment need not ask for particular instances of internal control failures, and it should not ask ultimate questions such as, “Do you believe the Company’s internal controls are adequate?” It should focus instead on identifying areas for discussion and improvement.
Most questionnaires have a rating scale. It is probably safest to use a scale that goes from “Strong” through “Adequate” to “Not as strong,” and to avoid (for example) a scale that ends with “inadequate” or “weak.” Since the purpose of the exercise is to identify areas for discussion, the former suffices and the latter is dangerous. Some questionnaires are cast as a series of statements, with which the respondent is asked to strongly agree, agree, disagree or strongly disagree, or indicate that he or she doesn’t know. If this structure is used, great care must be taken with the questions, in order to avoid answers that create unnecessary and potentially damaging evidence. Whatever the scale, adequate space should be left for comments. These can be at least as helpful as the ratings.

Who should fill out the questionnaire? Certainly all of the members of the Audit Committee should do so. It can also be useful to ask other Board members to respond, especially to the sections that deal with the Committee’s responsibilities for reporting to the Board. The Committee will also get helpful information if key members of management – the officers who play an important role in Committee meetings, such as the CFO, the Controller, the Internal Auditor and, in some companies, the CEO --fill out the questionnaire, since they have an informed but different perspective.

Some commentators recommend having the independent auditors fill out the questionnaire as well. At least for public companies, however, the independent auditor will have a separate responsibility to evaluate the Committee, as part of its work under PCAOB Auditing Standard No. 2, so its views will be or become known. In any event, a response to the self-assessment questionnaire from the independent auditor may unduly influence the Committee’s discussions, which is, after all, intended to be a self-assessment.

Once the questionnaires are completed, counsel for the Committee should summarize them and, in collaboration with the Chairman of the Audit Committee, prepare an issues agenda for the Committee’s self-assessment meeting. At the meeting, the Chairman should lead the Committee through a discussion of the agenda items, being sure to elicit a decision whether action is required with respect to each item. If it is, the action agreed upon should be clearly identified, responsibility for taking it should be assigned (typically to a member of management), and a timetable for follow-up should be agreed upon.

Counsel should prepare minutes of the meeting that reflect each item discussed, any changes agreed upon, and any assignments for implementing those changes. The minutes should include enough of the tenor of the discussion of each issue to give an accurate impression of the depth of the consideration given to it by the Committee, but they should not attempt to capture the entire discussion or be any more detailed than necessary. They should leave no loose ends – the minutes should explain the resolution of any issue identified or the fact that a solution has been agreed upon and assigned for implementation. Once drafted and approved by the Committee, the minutes become the formal record of the self-assessment. They can be circulated to respondents with the next year’s questionnaire, to prompt an evaluation of how well changes previously agreed upon have been implemented.

Should the questionnaires be retained? Committee members will probably give more candid comments if they know that the questionnaires will not be retained once the process is complete and minutes of the self-assessment meeting have been approved. For the same reason,
it also makes sense to instruct counsel not to disclose the identity of persons making particular comments in the summary of the questionnaire results, and to let Committee members know this approach will be followed.

There are circumstances under which it may be necessary to retain some or all of the questionnaires, however, and counsel should be asked to review them to determine whether any of those circumstances exist. For example, if litigation or an investigation to which the questionnaires would be relevant is pending, they should of course be retained. In addition, the Sarbanes-Oxley Act significantly expanded the coverage of criminal statutes designed to prevent the destruction of records with the intent to impede, obstruct or influence any matter within the jurisdiction of any department or agency of the United States or any case under the Bankruptcy Code, or impair the availability of records for use in an official proceeding. Although these provisions should not be read to create an obligation to keep every document produced, there may be situations in which particular questionnaires should be retained – such as where a director volunteers information about an internal controls failure or other specific situation in which bank or other regulators are likely to be interested. The self-assessment protocol adopted by the Committee should reflect its decision whether the questionnaires should normally be retained (and if so, for how long), the rationale for that decision, and the fact that there may be exceptions to the normal practice.

Alternatives

There are many possible variations on the self-assessment protocol just described. Some of the principal ones, and why a particular institution might wish to use them, follow.

*Interviews.* Instead of questionnaires, the Committee can use an interview process to solicit views and identify issues for discussion. If conducted by the institution’s attorney, or an attorney retained by the Committee, interviews would increase the probability that the information accumulated would be protected in civil litigation by the attorney-client privilege. Interviews may also elicit more candid responses than a questionnaire and – because follow-up questions are possible – responses that are more complete. Interviews are also a good technique if the Committee wants to take on the somewhat delicate task of evaluating the performance of individual members.

*Checklist.* Another alternative to a questionnaire is a list of the duties and responsibilities of the Audit Committee, taken principally from the Committee’s charter. Respondents would be asked simply to indicate any areas in which they wish to discuss how the Committee carries out the particular duty or responsibility. This technique minimizes the possibility of receiving questionnaire responses that contain potentially damaging information, while still creating a relatively broad base of information from which to construct the agenda for a self-assessment meeting.

*Opinion Poll.* The process can be moved almost entirely to the questionnaire, so that respondents are asked to complete a more detailed questionnaire and grade their answers more finely. The compilation of questionnaire responses becomes the centerpiece of the self-assessment – an opinion poll, in effect – and not simply an aid to setting the agenda for a discussion. The meeting would then focus on changes needed in light of the responses. This
method should reduce the time spent in the self-assessment meeting but, for the reasons indicated earlier, alters the risk-reward calculus of the process.

**Performance Evaluations.** A different and more extensive questionnaire could be used to solicit views on the performance of individual directors. This takes a great deal of care, but could be useful if there are real differences in individual performance that are interfering with the Committee’s effectiveness. If a questionnaire is used for this purpose, the results should be shared selectively – probably just with the Chairman, or perhaps the Chairman of the Corporate Governance or Nominating Committee, who would then hold individual sessions with each member. As noted earlier, the process of individual evaluation may be easier if interviews and not questionnaires are used.

**Conclusion**

For NYSE-listed institutions, Audit Committee self-assessments are here to stay. For others, they are something well worth considering. A proper self-assessment can increase the Committee’s effectiveness and so benefit the institution and its shareholders. There are some pitfalls, however, and it is important to invest the time in planning and execution that is necessary to conduct a self-assessment in the right way.

**About the Author**

Peter L. Rossiter is a member of the Financial Institutions and Corporate and Securities Groups of the law firm Schiff Hardin LLP. He returned to Schiff Hardin in 2004 after eleven years as an Executive Vice President of Northern Trust Corporation, where he served successively as General Counsel, President of Northern’s Corporate & Institutional Services Business Unit, and Head of Corporate Risk Management. Mr. Rossiter has written and spoken frequently on corporate governance topics. He is a 1973 graduate of Yale Law School, and a former law clerk to U.S. District Judge Alvin B. Rubin and Chief Justice Warren E. Burger. Mr. Rossiter may be reached by e-mail at prossiter@schiffhardin.com.