INTERVIEW WITH ALISON CARNWATH

Dame Alison Carnwath is Chairman of Landsec, the UK property company. Among her other positions she chairs the Audit Committees of BASF, the German chemicals concern, and Zurich Insurance. A chartered accountant, she enjoyed a distinguished career in investment banking and corporate finance before developing her career on corporate boards. She talked to Peter Montagnon about the contribution audit committees make to boards and corporate governance.

How can audit committees make themselves useful to the board?

Investors in any company, whether it’s a company owned by one person, or a company owned by a million people, want to have some reliable record of profit and loss and cash flow, strategy and structure.

Yet there is a lot of complex technology surrounding the production of reports and financial statements. Whilst the various jurisdictions round the world have been seeking slowly to harmonise the accounting standards behind financial statements, they haven’t been wholly successful. Where they have been successful, there is still a great deal open to interpretation.
The audit committee has to devote considerable time to ensure that it is content with the preparation of the accounts by the management and is content that the external audit, where one is mandated, has been conducted in a satisfactory manner, and that the shareholders are therefore receiving financial statements which give as accurate a view as possible of the current, historic and, to some extent, the future performance of the business.

**But is this purely about financial reporting? What about non-financial risks like cyber security?**

This has to be looked at through the lens of internal audit. They normally look at controls from a risk perspective, and they always tend to look at emerging risks as well as existing risks. I think it is in that context that cyber security and indeed data generally comes on the radar of the audit committee. My way of handling this is to require the audit committee to ensure that either the board or the audit committee has what I call a deep dive into a subject which is beginning to absorb quite a lot of functional management time. Cyber security would be one which most board or audit committees would have looked at.

Some chairmen of the board would want the audit committee to look at it because they can devote more time. Others would say it’s a board matter. Some boards, of course, encourage all board members to go to audit committees. Therefore all board members have been exposed to the material. The good thing is that these big emerging risks do get identified. Most decent management teams and the chairman of the board would want to ensure that the topic is on the agenda.

They do often reach the audit committee first because audit committees look at emerging risks.

**Including the non-financial risks?**

Yes. Most decent audit committees would do that though I think you have to recognise that different jurisdictions have found different ways of dealing with this. Some companies have separate risk committees. They would be the first people to look at emerging risks, and they may say: we’ve got this emerging risk called cyber-security. Then their first port of call is to ask the audit committee to establish with the internal auditors what controls have been put in place to ensure that the systems are not compromised by something like cyber. Certainly in the businesses I’ve been involved in in Europe, it has come up through the audit committee.

However, there are strategic risks associated with cyber. That is definitely a board matter – the strategic risks that cyber might present to boards. That’s where a longer term solution is going to be needed.

**At what point do you need a separate risk committee? My sense is that with some sectors like banks it’s all too much for one committee....**

I think it’s when the complaints from board members has got to a level that you can’t ignore. It’s when they say that they simply can’t sit there for six hours and the agenda is 2,000 pages and they can’t concentrate. It’s not just the volume. The brain has to engage at very different levels on these committees.

So if you take risk appetite, or the Own Risk and Solvency Assessments required in the financial sector, that basically involves a management team presenting how they’re going to submit these forms or reports to the regulators. They ask board members whether they’ve got commentary, whether they think anything’s missed out, and whether the forms emphasise the right things. Then you get down to looking at, say, the risks of a new line of business, that will require the brain to look at something rather different - how the
product is devised, the controls around that, the marketing that’s gone into it, and some regulatory stuff. And then you’ve got the internal auditors, and how they’ve tested the controls.

So the brain has to engage on these committees in different ways in different subjects and I think, frankly, it’s too difficult to ask people to sit there for six hours doing all these things. I don’t pay any cognisance of people who we’ve just got to get through it. You’ve got to be effective and you can’t just sit there for six hours in those sorts of meetings.

**Are people putting too much weight on all these issues to the point where they ignore the core task of preparation of the accounts?**

I think that’s a very dangerous thing.

**Is it happening?**

It might be. There are two risks. There is a risk that people spend too much time thinking about the current emerging risks and not enough time thinking enough about the strategic risks. There is also a danger that people now think that the accounts department, the financial controller’s department, the technical ability in accounting in businesses is such that they should worry less about the preparation of accounts. But there have been plenty of examples in recent history where that is not the case

**Of course, accounting involves judgement.**

Exactly. It’s immense. You can’t just rely on technology. At Landsec the most important number in our accounts is indeed the valuation of our property portfolio. The valuers look at the latest transactions and work out whether they think our income is secure, but we couldn’t run our business on that basis because it’s not just a question of the security of the income. It’s whether the income is going to go up or down and the valuers don’t opine on that. You’ve got to look at future cash flows properly. That depends on the cycle in the property market. We have to make a judgement, though we rarely change the judgement that the valuers have made.

**Your audit committee report singles out property valuation and revenue recognition as the two main issues for you but this must vary from company to company...**

Yes, the number of key risk items varies from company to company. It’s never more than three or four actually. Pension is often one - pension liabilities because people have different views about the value of the liabilities. Foreign exchange is another - a combination of hedging and transactions and volatility of doing business in certain countries. Then there are quite big macro items which are usually the key risks. Revenue recognition and cost of sales are certainly two as well as adequate disclosure of contingent liabilities, and whether the lawyers think that by disclosing them a case is going to get prejudiced.

**You need real experts for this.**

You need experienced people. You obviously have a couple of experts in the room because you’ve got the finance director who is answering the questions and because you’ve got the chairman of the audit committee who is almost always a chief financial officer or a former chief financial officer or a former partner in a firm of accountants. You’ve almost always got that in unitary boards, but you need people who have seen these things before. They might, like me, have just been around long enough to have seen some very troubled episodes or there might be people who have seen audit committees that are just too high level or audit committees that are just too forensic. If an audit committee is too forensic, you stand a chance of missing the big picture and, perhaps just as bad, of frightening the management into not being as open as they should be.
But someone who is not a financial expert can be fobbed off with sophisticated technical answers. They can but that’s where the chairman comes in asking the questioner who’s been fobbed off whether he feels entirely satisfied with the answer that he’s got. Or – and this is what I would do – by extending the question a little more saying that’s a very good point and then someone with a bit more technical experience can get stuck in. The psychology of this is all very interesting. The psychology of how you get the most out of all these experts in the room is very interesting.

You also need to bring in some people who’ve never sat on an audit committee before so they can learn, and develop some role models. You also need to vary the management that comes into these meetings or you get a standing committee of about 40 people. You don’t really need a lot of the technical people. You don’t really want to end up with a highly technical debate.

So what sort of new people do you want?

Curious people. People who can ask without shame what might appear to be a dumb question. Even people who want to learn so the management might think they’re teaching them but actually they’re telling them things rather than teaching them.

The ability to ask the ignorant question doesn’t last, does it?

No, but you can gain some sort of reputation as somebody who might come in left of field. So the management would be wary of that. Willingness to challenge, curiosity, unpredictable. An audit committee can be a very predictable event if it’s just a series of presentations with people asking the odd questions and nodding. A little bit of unpredictability is no bad thing.

What you haven’t mentioned is independence, although these are the qualities of independence.

Yes they are, I think they are the qualities of independence. They probably are most appropriate on the audit committee. On a board, strategic capabilities, industry capabilities may be as important if not more important than independence. I’m not a great fan of the UK’s six year rule, cum possibly nine-year rule, but I do change the composition of the audit committee every now and again.

Is that where it could get a bit too cosy?

A bit. Particularly if you’ve had the same finance director for a long time and the same head of internal audit. It’s good to have people with a fresh pair of eyes preparing the stuff as well as reviewing it.

You talked about internal audit quite a lot. What sort of relationship does internal audit need to have with the committee?

People running internal audit departments these days in most western jurisdictions report to the chairman of the audit committee and they have an administrative or some sort of functional line into the senior management. It might be the chief financial officer, it might be the chief risk office, or it might be the CEO. It varies by jurisdiction, but they are often the backbone of an audit committee.

Trust is important isn’t it?

Very important. They are the people I talk to most outside of the finance director when I’m chairing an audit committee. It will be the internal auditor and the finance director.
That means reaching the stage where they’re using judgement and the judgement is trusted.

It takes time to build that trust. It’s going to take at least twelve to 18 months to build and then it can be valuable. It’s valuable where the head of internal audit isn’t simply trusting the audit committee to handle this snippet of information. It’s also where the head of internal audit provides some value as well to the executive management. It’s fine to point out errors in controls and write a report that says “needs improvement” and setting a timeline with management for dealing with it. Actually what the management wants to know is: what was the root cause of this problem? Not just that these controls were not adhered to, but were these the wrong controls? And can you think of a way in which the business can operate more effectively?

But the value to the audit committee is that internal auditors know where things are not working.

They’ll know where the wheels are falling off, yes. They’ll know that from general chit-chat. At the coffee machine sort of stuff.

So audit committees have an enormous task - preparing the accounts, the landscape for risk, internal audit and so on.

I haven’t even got on to compliance. At the end of the day that is a line of defence in most countries. So compliance with regulations matters.

Are we asking too much of one committee to do all this?

It depends how slick it is, how well it’s chaired. How good the papers are. How open the discussion is. It depends. We might be asking too much. When I try to find my compass on this, I say to myself whenever something comes up on audit committee papers which I hadn’t expected, I ask if this is something that is absolutely important in terms of the production of our financial statements, because that is what the investors are looking for.

And some of the material ought to be a full board matter.

Some of it can be. But how does a board discuss regulatory risks? Would your average board be interested in discussing data protection?

Some companies in the Gulf are very large but not listed. Do you need to do all of this in the same way if you’re not listed.

Not necessarily in the same way.

Another way of looking at it is to ask what any external source might want to do in terms of due diligence on us, if we were going to be bought or if we were going to raise some more money or if we were negotiating with an overseas supplier. What is the sort of due diligence that people might do? If you’ve got a committee that looks at the business through those eyes.

So it’s how others might see us.

Yes that would be a way of demonstrating to private companies that there is value of having an audit committee.