

The Audit Committee Impact on Swiss Companies

Research Institute for
International Management



University of St.Gallen

Table of Contents

Editorial	4
Author Team	4
Executive Summary	5
1 The Audit Committee and Corporate Governance	6
Corporate Governance in Switzerland	6
Objective and Scope of the Study	6
Data and Method	6
Statistical Note	7
Structure of the Report	7
2 The Audit Committee in Swiss Companies: Patterns and Trends	8
Audit Committee Incidence and Size	8
Audit Committee Composition	8
Financial Reporting Standards and the Quality of Financial Reporting	11
3 The Audit Committee in Swiss Companies: Process and Behavior	14
Audit Committee Objectives, Priorities and Activities	14
Audit Committee Meetings	16
Information and Communication between Audit Committee, Management and the Rest of the Board	17
Compensation of Audit Committee Members	18
4 The Audit Committee in Swiss Companies: Causes and Effects	19



Ancillo Canepa
Managing Partner
Assurance & Advisory
Business Services
Ernst & Young Ltd, Switzerland

Prof. Winfried Ruigrok, Ph.D.
Professor of International Management
Director
Research Institute for International Management
University of St. Gallen

Editorial

Dear Reader,

Adjusting corporate governance to new rules and regulations doubtlessly poses a major challenge. Well-established bodies and procedures, which provided the foundation for success over many years, may be questioned. Drawing and implementing new frameworks will tie up resources in terms of board and management attention as well as in terms of costs.

New guidelines or legislation in both the U.S. and the EU have, however, set the tone: financial communities worldwide expect corporate governance to match with current best practices – often even if a company is not formally or legally subject to the respective rules. One of the key features of such governance is the establishment of an audit committee that has the power, the skills and the focus to secure the quality of financial reporting.

Several surveys have suggested the number of existing audit committees is increasing. This raises the question whether audit committees do actually enhance the quality of companies' financial reporting and whether and how companies themselves and the wider financial community benefit from the establishment of audit committees.

The present survey gives a first set of answers with respect to characteristics, behavior and effects of audit committees of Swiss listed companies. Findings include that these bodies are becoming ever more professional, and that their work definitely has a positive impact on financial reporting. A well-functioning audit committee will increase a given company's chance of getting a clean audit opinion and mitigate the risk of reprimands from oversight bodies. We trust that learning in more detail about the extent of improvements achieved and about the potential for further progress will make the reading of this study valuable.

Our sincere thanks go to the co-authors of the survey for having intensely analyzed and interpreted the data and to the SWX Swiss Exchange for generously giving us access to anonymized basic material.

We wish you a pleasant reading.

Ancillo Canepa

Prof. Winfried Ruigrok, Ph.D.

Executive Summary

In 2002, new corporate governance-related guidelines were introduced in Switzerland that included recommendations on the establishment, composition, structure and processes of audit committees. This study presents new evidence on audit committee patterns and trends at Swiss listed companies, as well as on audit committee effectiveness. The results of this study are important to individuals and organizations dealing with audit committees, including audit committee members, board members, internal and external auditors, and other professional services firms.

This study documents trends in the establishment and composition of audit committees, as well as regarding external financial reporting subsequent to the 2002 corporate governance guidelines. The report shows that Swiss companies that carefully followed the guidelines were more likely to reap positive effects in terms of quality of external financial reporting than firms that did not follow the guidelines.

The present study has been conducted by Prof. Winfried Ruigrok, Ph.D., and by Katarina Sikavica, lic. phil., a doctoral student of Prof. Ruigrok and an employee at the Research Institute for International Management (FIM), with contributions by Markus Schweizer, Partner, Ernst & Young, Robert-Jan Bumbacher, Partner, Ernst & Young, and Dr Andrea Garnitschnig, Senior Manager, Ernst & Young.

This Report Presents Four Main Findings

1. Audit committees matter. Over the past years a growing percentage of Swiss companies have established audit committees. This study shows that over the period 2002 to 2004, companies that had established an audit committee were more likely to obtain a clean audit opinion (at the group and holding company level) in the year after, and were less likely to be the object of SWX sanctions in the subsequent year.

2. Audit committee members' independence matters. Over the period 2002 to 2004, companies that had established an audit committee with a high ratio of independent directors tended in the subsequent year to be more likely to obtain a clean audit opinion (at the group and holding company level), and less likely to be subject to an official procedure initiated by the SWX Swiss Exchange.

3. Audit committee members' financial capabilities matter. Over the period of 2002 to 2004, financial expertise increased the quality of financial reporting. Audit committees with a higher percentage of financial expert members were positively associated with the quality of financial reporting in the subsequent year (significant at the group level).

4. Audit committee practices vary widely. Swiss companies are gaining experience with audit committees and best practices have yet to emerge. Key aspects to note in running the audit committee are to deliver information well in advance of the next meeting, and to make sure members know in advance how many days they will have to prepare the meeting. ■

1. The Audit Committee and Corporate Governance

Corporate Governance in Switzerland

In 2002, the Swiss Business Federation *economiesuisse* presented a *Swiss Code of Best Practice for Corporate Governance* (Swiss Code) with recommendations applicable to all listed Swiss companies. In parallel, the SWX Swiss Exchange launched its *Directive on Information Relating to Corporate Governance* (SWX Directive) with mandatory regulations for companies listed at the SWX. Both guidelines are similar to, though less far-reaching than, codes in the UK., for instance. One of the most important novelties is that Swiss listed companies are advised to establish an audit committee. The Swiss Code also includes recommendations regarding audit committee composition, structure and processes. It is suggested that audit committees are composed of non-executive and preferably independent members, and that a majority of these members should have significant financial capabilities acquired through education and experience. The guidelines also seek to foster good practices regarding audit committee role and practices, including the working relationship with internal and external auditors.

Objective and Scope of the Study

The purpose of the present study is to understand the patterns and trends regarding audit committees at Swiss listed companies, and audit committees' impact. On the one hand we looked at aspects of corporate governance and on the other hand we addressed the quality of external financial reporting and the application of financial reporting standards of Swiss listed companies. More precisely, we looked at the following questions:

- **Audit committee incidence:** To what extent have Swiss listed companies established audit committees? What has been the trend over the past three years?
- **Audit committee characteristics:** What is the composition of Swiss audit committees, e.g. in terms of members' educational background, financial capabilities, and independence? How has this changed over the last three years?

- **Audit committee process and behavior:** How are audit committee meetings conducted, e.g. in terms of frequency and length of meetings? How do audit committee members communicate with the board and with executive management?
- **Audit committee effects:** Is there any measurable impact of audit committees on Swiss listed companies, e.g. in terms of quality of financial reporting or the likelihood to be subjected to SWX procedures or sanctions?

Data and Method

Our data come from four different sources:

1. Data on audit committee characteristics, financial reporting standards and audit opinions have been collected from annual reports of those listed companies that provided data on, e.g., AC existence, board or AC composition, and directors' backgrounds over the time period 2002 to 2004. As the SWX Directive was only issued in 2002, reliable data was not available to a sufficient degree before 2002 due to non-disclosure by companies. Listed companies that after 2002 failed to supply data as required by the SWX have not been included in this study.
2. In the period of May to June 2005 we conducted a survey among audit committee chairpersons of Swiss listed companies that provided data on audit committee processes and behavior. We identified 167 listed companies that had reported to have established an audit committee. The audit committee chairpersons of all of these 167 companies received our questionnaire. In the few cases where no chair was specified we randomly addressed one of the audit committee members. Almost one third of the audit committee chairpersons participated in the survey (52 returned questionnaires = 31 percent).
3. The SWX Swiss Exchange provided data on the number of SWX reprimands per company and year. This data enabled us to establish the effect of audit committee existence and composition on SWX reprimands. Since SWX data are subject to

strict confidentiality, data analysis was conducted at the SWX under strict SWX supervision. This means, e.g., that neither the research team nor Ernst & Young representatives have seen data in a format traceable to individual firms.

4. We collected accounting-based financial performance data, e.g. Return on Assets (ROA) and Return on Investments (ROI) of all listed Swiss companies from the Thomson-ONE database for the period 2000 to 2004.

Statistical Note

The data presented in chapter two are based on all listed Swiss companies which provided data as required by the SWX Swiss Exchange. These data are of a descriptive nature and refer to the period 2002 to 2004, or (if few changes occurred over these three years) only to 2004. The numbers reported in chapter three are based only on those companies of which the audit committee chairperson returned the questionnaire.

The results shown in chapter four are based on regression analyses. This technique allows researchers to estimate how one variable (e.g. the existence of an audit committee) affects a «dependent» variable (e.g. the probability of obtaining a clean audit opinion). Significance is the chance of concluding that we have a relationship when in fact we do not, i.e. if we took another sample we would find no relationship. In this paper we report three levels of significance, indicated by the number of asterisks:

- *** .01 level the probability is 1 percent or less that a relationship identified is due to chance
- ** .05 level the probability is 5 percent or less that a relationship identified is due to chance
- * .1 level the probability is 10 percent or less that a relationship identified is due to chance

Put simply, the more asterisks, the more robust the result. Researchers often use the .05 level as a cutoff: if the probability is 5 percent or less that a relationship identified is just due to chance, we conclude the relationship is real. It has become good practice also to report results at the 0.1 level (meaning that the probability is 10 percent or less that a relationship identified is due to chance), yet it should be noted that such results are less robust.

Structure of the Report

The structure of the report is as follows. Chapter two deals with audit committee incidence and provides information on external financial reporting standards and the quality of financial reporting. Chapter three is based on our survey and presents current audit committee processes and behavior at Swiss listed companies. Finally, chapter four discusses how audit committees have affected the quality of financial reporting at Swiss firms. ■

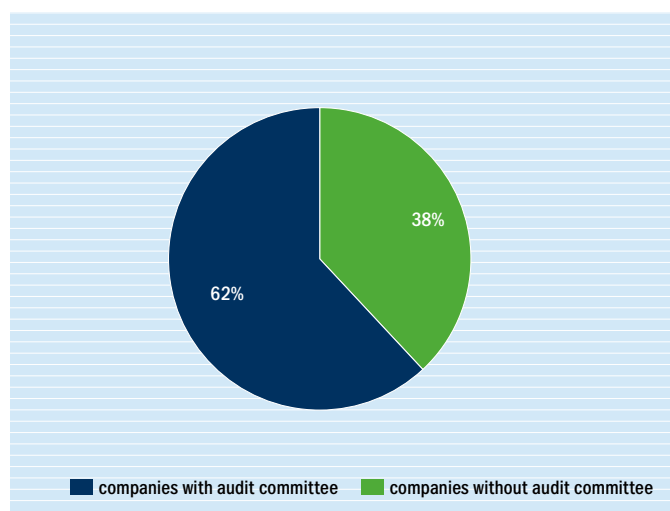
2. The Audit Committee in Swiss Companies: Patterns and Trends

Data on audit committee characteristics, financial reporting standards and audit opinions has been collected from annual reports of those listed companies that provided data on, e.g., AC existence, board or AC composition, and directors' backgrounds over the time period 2002 to 2004. As the SWX Directive was only issued in 2002, reliable data was not available to a sufficient degree before 2002 due to non-disclosure by companies. Listed companies that after 2002 failed to supply data as required by the SWX have not been included in this study.

Audit Committee Incidence and Size

International codes of best practice as well as the Swiss Code recommend that corporate boards should establish an audit committee. Many Swiss listed companies have indeed followed this recommendation: over the period 2002 to 2004 there has been an increase in audit committee incidence. In 2004, 167 out of all 270 listed companies (62 percent) reported to have an audit committee. The larger the company, the more likely it was to have an audit committee (***). However, the company's degree of internationalization did not impact the likelihood to have established an audit committee. While overall audit committee incidence has risen by about 10 percent over the last three years, the data also suggest that it may still take several years until all Swiss listed companies have established an audit committee.

The average size of Swiss audit committees has grown from 2.9 members in 2002 to 3.3 in 2004. Most Swiss listed companies have an audit committee consisting of three members. In a few instances we found that the audit committee was composed of up to seven members, i.e., at these companies the entire board were on the audit committee. Such practices are at odds with corporate governance recommendations which suggest that a division of tasks amongst board members will increase the quality of audit-related (as well as of remuneration and nomination-related) activities.



Graph 1: Audit committee incidence 2004

Audit Committee Composition

We investigated the backgrounds of individual audit committee members, looking at their formal education, financial capabilities, and the executive positions held in the same company, as well as the number of directorships at other companies.

Education

In 2004, just over half of the Swiss audit committee members had studied business or economics (Graph 2). In addition, about 22 percent of audit committee members had a law degree, while some 19 percent were natural scientists or engineers. Only 8 percent of audit committee members had a different disciplinary background (e.g. languages, social sciences, or no first degree). These numbers remained quite stable over the period 2002 to 2004.

Over 83 percent of audit committee members in 2004 held a master degree or more (we took the Swiss *licentiatus/licentiata* degree as equivalent to the master degree). Almost 38 percent even held a doctoral degree. As foreign nationals become audit committee members more often, we may expect the latter percentage to decrease.

Financial Capabilities of Audit Committee Members

Financial Literacy:

Financially literate means having a professional qualification in accounting, auditing or controlling, with the title of Certified Public Accountant (CPA), Chartered Accountant, dipl. Wirtschaftsprüfer, or equivalent.

Financial Experience:

Financial experience is acquired through practical experience in positions such as Chief Financial Officer (CFO), Head Internal Audit, Public Accountant, or equivalent.

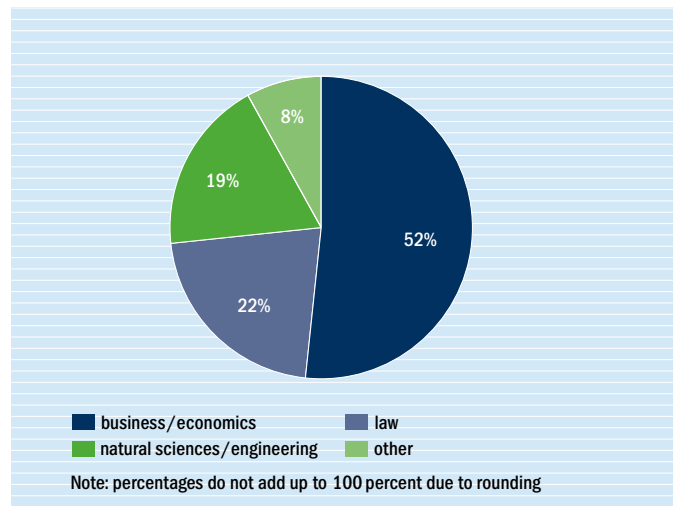
Financial Expertise:

Financial experts are audit committee members who are financially literate and have acquired their financial experience at a listed company.

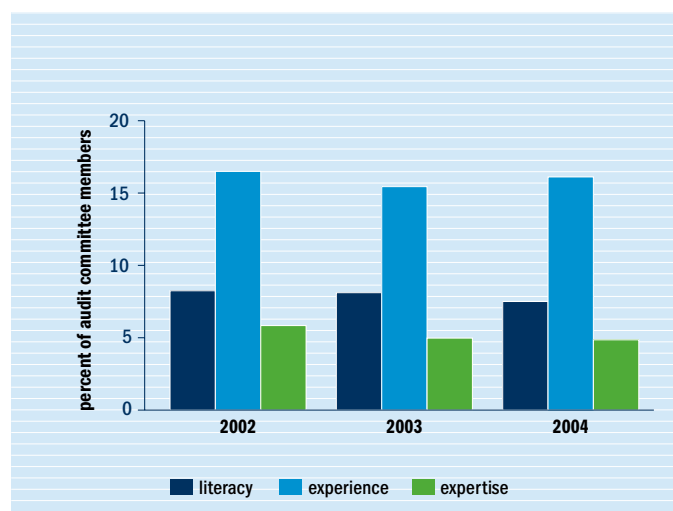
Financial Capabilities

Audit committee members need to be able to evaluate and supervise any issue of internal auditing and external financial reporting. As chapter three shows, many audit committees are also responsible for overseeing risk management. Therefore, it is essential that audit committee members have the financial skills and capabilities to carry out these activities adequately. We collected available information on audit committee members' financial capabilities using three distinct groups of indicators (cf. box).

Over the period of 2002 to 2004 we find that the percentage of audit committee members with any of the three financial capabilities has not risen (Graph 3). This finding suggests that while audit committee incidence has increased at Swiss listed companies, a relatively small number of audit committee members appear to have the formal financial capabilities to carry out their tasks adequately.



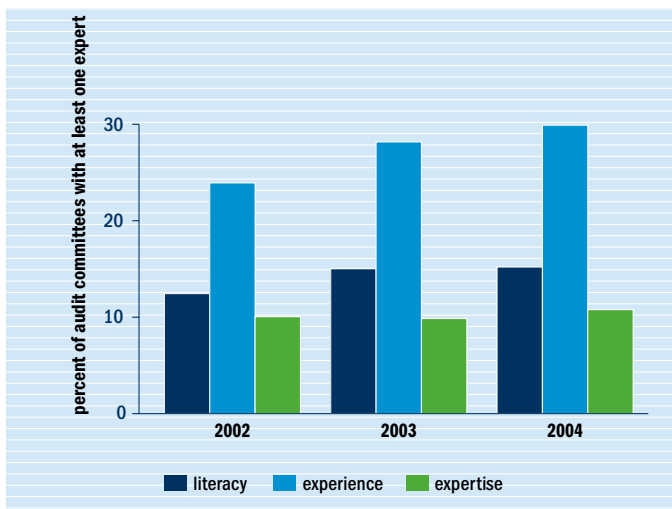
Graph 2: Education of audit committee members



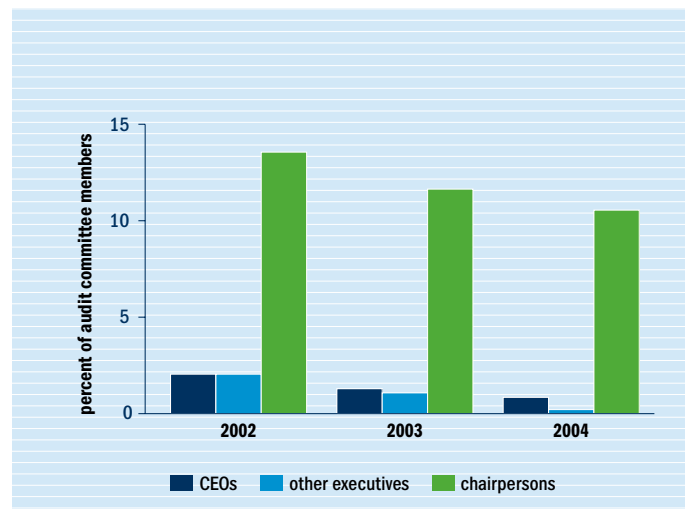
Graph 3: Financial capabilities of audit committee members 2002 to 2004

The picture is not all bleak, however. First, since both audit committee incidence and audit committee size increased between 2002 and 2004, the absolute number of audit committee members with adequate financial capabilities also increased. Second, when looking at the percentage of audit committees with at least one member having any of the three financial capabilities, a more positive picture emerges (Graph 4). Thus, the share of audit committees that have at least one member with financial literacy went up from over 12 percent in 2002 to 15 percent in 2004, while the share of audit committees that have at least one member with financial experience rose markedly from 24 percent in 2002 to 30 percent in 2004. This suggests that whereas previously scarce financial capabilities were concentrated at a smaller group of companies, more recently there has been a certain diffusion of financial capabilities to the wider population of Swiss listed companies and audit committees.

All in all, audit committee members with identifiable financial capabilities remain a scarce resource at Swiss listed companies. The level of audit committees' financial capabilities in 2004 was



Graph 4: Financial capabilities per audit committee 2002 to 2004



Graph 5: Chairpersons and executives on audit committees 2002 to 2004

less than expected and there remains scope for improving individual audit committee members' financial capabilities.

N.B. Our data do not rule out the possibility that individual audit committee members received additional training without an official degree or diploma (e.g. a certificate course provided by a professional services firm or a business school), or that companies provided incomplete information on board members' backgrounds.

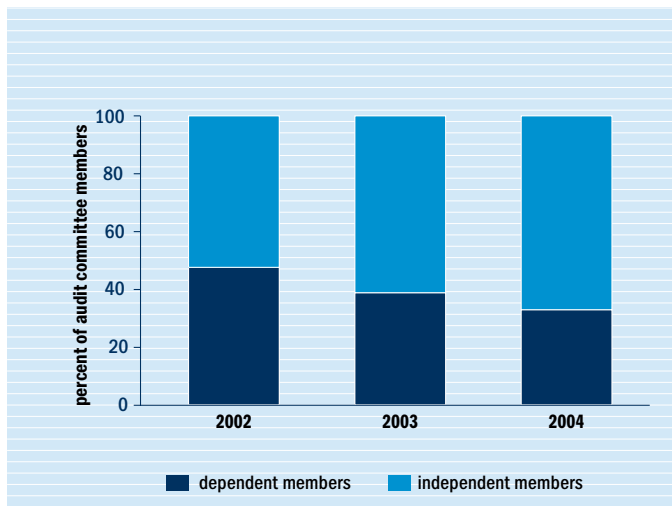
Non-executive and Independent Audit Committee Members

Corporate governance codes recommend that board committees are composed of non-executive and preferably independent members. Non-executive directors are board members who do not at the same time serve as members of the management board. Independent directors are individuals who are not affiliated with the company, whether in a shareholding, supplier, customer, consulting, family, or current or recent employment capacity.

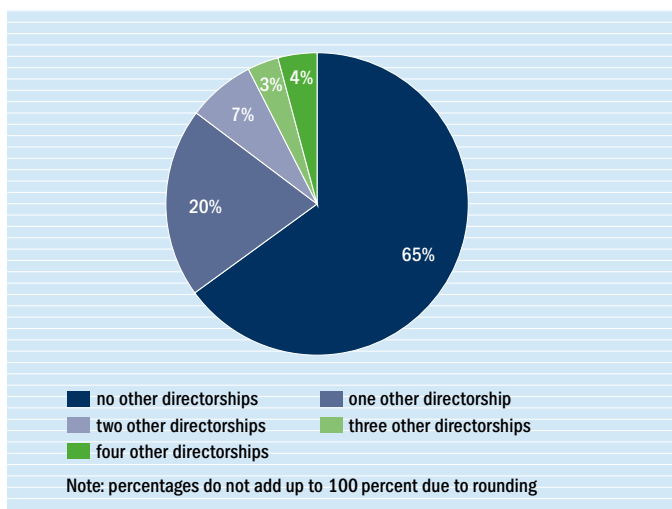
Graph 5 provides an overview of executives and chairpersons of the board of directors on Swiss audit committees. In both respects, Swiss audit committee composition is closely in line with international best practices. Two conclusions may be drawn from this graph.

First and most importantly, only few executives serve as formal audit committee members in Switzerland. If anything the share of executives declined over the period 2002 to 2004. In 2004, less than 1 percent of audit committee members were CEOs, and only 0.2 percent were other executives (mostly Chief Financial Officers – CFOs).

Second, in 2004, less than 11 percent of audit committee members were at the same time chairpersons of the board of directors of that company. Again, the trend has been downward. Possibly, board chairpersons have occasionally been involved at the early stage of establishing the audit committee, e.g. securing audit committee members' access to relevant information. As boards acquired more experience with running audit committees the



Graph 6: Independence of audit committee members 2002 to 2004



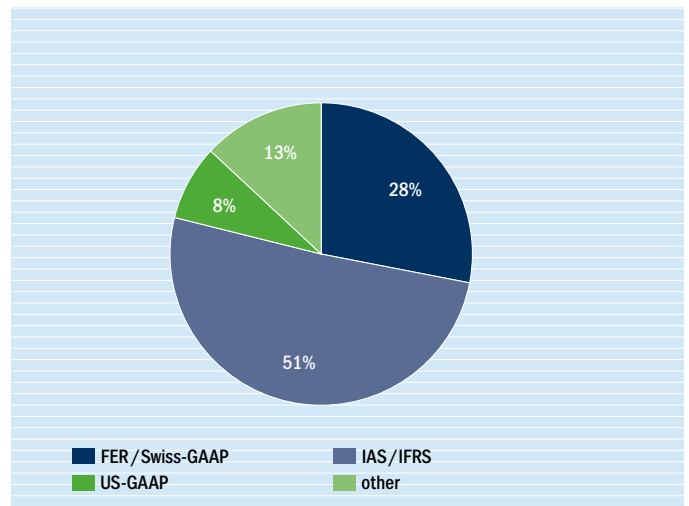
Graph 7: Directorships of audit committee members 2004

necessity for chairpersons to be directly involved may have diminished.

Chapter three provides further details on the extent to which chairpersons, CEOs and CFOs attend audit committee meetings.

Graph 6 shows that the share of independent audit committee members has increased from 52 percent in 2002 to 67 percent in 2004. Also in this respect, Swiss companies are moving towards internationally recommended patterns – yet again, there is scope for improvement. Non-independent members are mostly former executives, members of a founding family, or major shareholders. Consultants figure less frequently as audit committee members.

Finally, Graph 7 exhibits the number of board memberships at other listed companies held by audit committee members. Almost 65 percent of audit committee members in 2004 did not have any additional board mandates at listed companies, while over 20 percent were a member of only one other listed company's board. In



Graph 8: Financial reporting standards of Swiss companies 2004

view of the scarcity of financial capabilities and the demand for qualified audit committee members, the relatively low number of additional directorships is remarkable. Overall, audit committee members do not seem to dilute their time and attention to a large number of boards. The fact that some audit committee members of a listed company serve on more than only one board may be evaluated positively since these persons will help to distribute audit committee expertise and innovative practices.

Ultimately, audit committee composition depends on many contextual variables. Companies are learning how to deal with a range of corporate governance stipulations. They also face a tight market for independent audit committee members with adequate financial capabilities. If a board cannot find the ideal audit committee candidate, it may still be better to take on a person who does not meet all wish list criteria than no candidate at all.

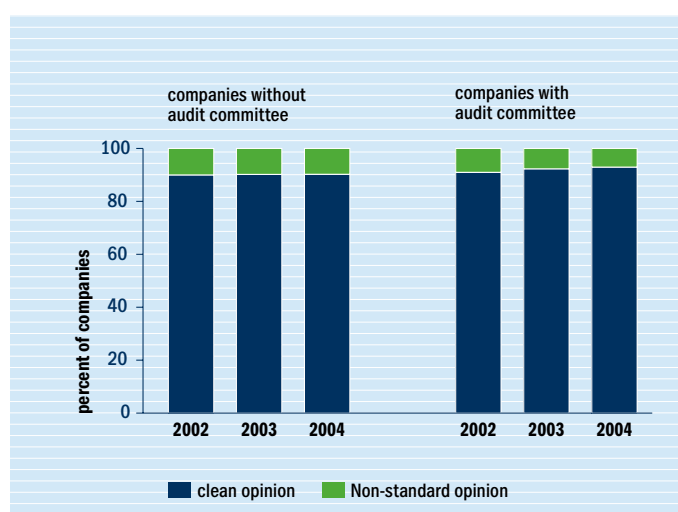
Financial Reporting Standards and the Quality of Financial Reporting

Financial Reporting Standards of Swiss Companies

In 2004, 51 percent of listed Swiss companies used the IAS/IFRS financial reporting standards (Graph 8). A much lower proportion (28 percent) of companies in 2004 was attached to FER/Swiss-GAAP, while only 8 percent of companies had implemented US-GAAP. The remaining category «other» (13 percent) refers mostly to banks which often follow different financial reporting standards. We found only few cases of companies over the period 2000 to 2004 upgrading from FER to IAS/IFRS or from IAS/IFRS to US-GAAP. The distribution of financial reporting standards has remained fairly constant over the same period.

Frequency of Clean Audit Opinions

A key task of the audit committee is to ensure the quality of external financial reporting. One way of measuring the quality

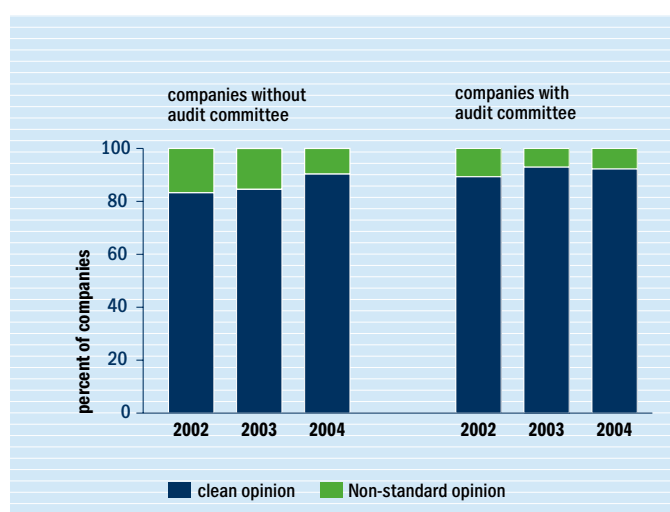


Graph 9: Audit opinion: group reporting 2002 to 2004

of financial reporting is to evaluate the audit opinion given by the external auditor and published in the annual reports. In general, the audit opinion can be classified into two categories. A *clean opinion* means that the external auditor believes that the financial statements are materially correct in accordance with the underlying financial reporting standards. However, an external auditor may also state reservations, leading to a *non-standard opinion*. There may be three types of auditor reservations: a qualified opinion (the most severe type of reservation), a reference to a legal violation or a matter of emphasis.

Graph 9 and 10 show the frequency of clean audit opinions at Swiss listed companies. Two conclusions may be drawn from these graphs.

First, the quality of financial reporting by Swiss companies generally seems to meet external auditors' expectations. Over the period 2002 to 2004 the frequency of clean audit opinions has remained largely constant: in 2004, 88 percent of all group re-



Graph 10: Audit opinion: holding reporting 2002 to 2004

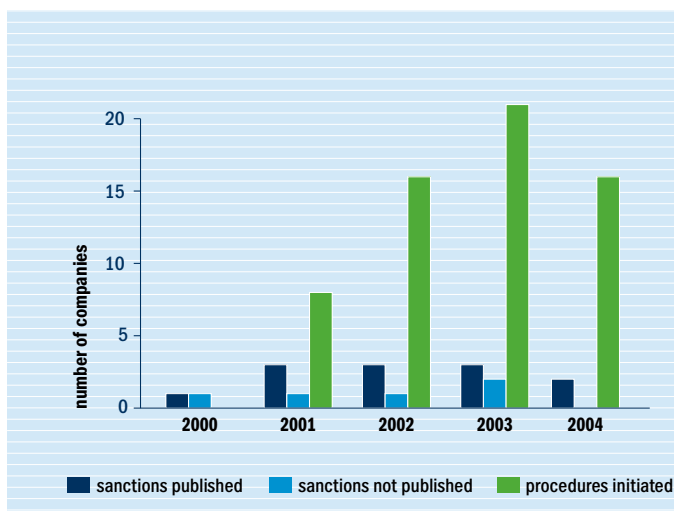
ports obtained clean audit opinions. At the holding company level, the proportion of clean opinions went up from 85 to 88 percent.

Second, over the period 2002 to 2004 the percentage of companies with audit committees that received clean audit opinions at the group level was only marginally higher than companies without audit committees. The difference was bigger at the holding company level. On average, companies with audit committees received more clean opinions (87–90 percent) than companies without audit committees. However, companies without audit committees have been catching up, with the ratio of clean audit opinions climbing up from 80 to 90 percent over the three years.

Chapter four looks at the question whether there is a relationship between audit committee presence and composition on the one hand and obtaining a clean opinion on the other hand.

SWX Swiss Exchange Reprimands

Listed companies are required to disclose sufficient, accurate and comprehensible information in order to allow investors to



Graph 11: Reprimands initiated and executed by the SWX Swiss Exchange

evaluate the company’s financial situation and outlook, and to take independent investment decisions. The SWX routinely inspects annual reports in order to evaluate whether companies meet the requirements set, and, where necessary, asks companies to provide additional information. If the information provided by the company does not satisfy the SWX, it may take further steps in order to enforce compliance with the listing rules. It may initiate an official procedure that potentially leads to a sanction if issues cannot be satisfactorily resolved. The SWX may impose a sanction with or without publishing it. As an ultimate resort, the SWX could decide to delist a company. However, in practice, this sanction is applied extremely rarely.

Graph 11 shows the number of initiated procedures, non-published sanctions and published sanctions by the SWX in the period of 2000 to 2004. The number of initiated procedures increased significantly in 2002 and 2003, possibly due to a stricter regime by the SWX. In 2004, the number of initiated procedures and of published and non-published sanctions decreased again, sug-

gesting that Swiss companies are learning how to deal with the enhanced information disclosure requirements.

Chapter four looks at the question whether there is a relationship between audit committee presence and composition on the one hand and SWX reprimands on the other hand. ■

3. The Audit Committee in Swiss Companies: Process and Behavior

Data in this chapter has been obtained through a survey administered from May to June 2005. Almost one third of audit committee chairpersons addressed responded to our survey (52 returned questionnaires or 31 percent).

Audit Committee Objectives, Priorities and Activities

Corporate governance codes provide the basic framework for board and audit committee actions. The purpose of our survey was to identify information on a range of audit committee objectives, processes and activities.

Audit Committee Objectives in 2004

Audit committee chairpersons were asked to rank specific audit committee objectives. Table 1 presents the results. We found that audit committee chairpersons disagreed amongst themselves on the importance of the six objectives, and that rankings varied widely.

The objectives that obtained the highest average score in 2004 were «ensuring the effectiveness of the internal control system» (rank 1) and «ensuring the adequacy of the risk management» (rank 2). These were also the two objectives with the lowest standard deviation, i.e. audit committee chairpersons seemed to be in most agreement on the importance of these two objectives. This finding indicates that audit committees in 2004 were extending their agenda to new areas such as risk management.

Conversely, more conventional objectives such as «ensuring the external compliance with norms, acts and directives» (rank 5) and «controlling and ensuring the protection of assets» (rank 6) received the lowest average score. These objectives had the highest standard deviation, implying that audit committee chairpersons found it most difficult to agree upon these latter objectives.

Audit committee objective	Overall rank	Mean
Ensuring the effectiveness of the internal control system	1	2.90
Ensuring the adequacy of the risk management	2	3.07
Ensuring the quality of accounting principles	3	3.25
Ensuring the adequacy of external financial reporting	4	3.67
Ensuring the external compliance with norms, acts and directives	5	3.80
Controlling and ensuring the protection of assets	6	4.07

Table 1: Audit committee objectives in 2004

Note: 1 = most important, 6 = least important

Task of audit committee	Rank	Score
Evaluating the effectiveness of the external audit	1	89
Assessing the risk management	2	78
Examining the operability of the internal control system	3	77
Evaluating the effectiveness of the internal audit	4	71
Assessing half-year and year-end reports	4	71
Checking the independence of the external audit	6	68
Checking the independence and resources of the internal audit	7	65
Evaluating and ensuring the quality of accounting principles	8	64
Evaluating the compliance with norms, acts and directives	9	63
Assessing interim reports	10	52
Securing the coordination between internal and external audit	11	51
Checking the appropriateness of rewards to external auditors	12	42

Table 2: Tasks of audit committee

Note: Total scores were obtained by assigning -2 to «very unimportant», -1 to «unimportant», 0 to «neutral», 1 to «important» and +2 to very important

Audit Committee Priorities

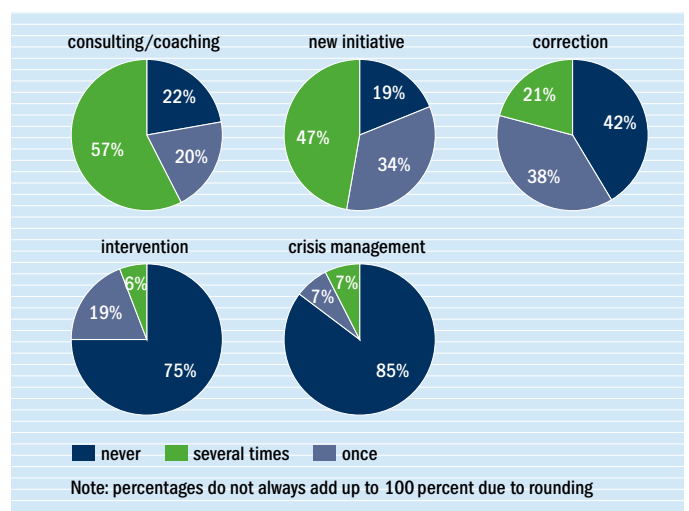
Our survey contained a list of audit committee tasks which the audit committee chairpersons were asked to rank according to their perceived importance (using a five-point scale ranging from very unimportant to very important). Table 2 provides an overview of the scores (which were obtained by summing up the scores, see note to Table 2). This table confirms the findings presented in Table 1. Audit committee chairpersons identified «evaluating the effectiveness of external audit»; «assessing risk management»; and «examining the operability of the internal control system» as the most important audit committee tasks.

Audit Committee Activities

In a further question audit committee chairpersons were asked to indicate the frequency of their actual activities. For that purpose they were given a list of five activities and were asked to mention whether in 2004 they had performed them never, once or several times. Two were non-punitive, forward-looking activities («consulting/coaching» and «new initiative»). Three were retrospective, rather punitive activities («corrections», «interventions» and «new initiative»).

As shown in Graph 12, the two forward-looking non-punitive activities dominated the three retrospective ones. A majority of the surveyed audit committee chairpersons (over 57 percent) indicated to have provided some coaching and consulting several times. Only 22 percent of the respondents stated not to have provided any consulting/coaching at all in 2004. Similarly, almost half (over 47 percent) of the respondents had started several new initiatives, whereas only 19 percent of the respondents indicated not to have done so at all in 2004.

Audit committees had to engage less frequently in retrospective, punitive activities. About 21 percent of the chairpersons surveyed indicated to have carried out a «correction» several times in 2004, though almost 42 percent of the respondents stated they had never carried out such activities in 2004. Most respondents



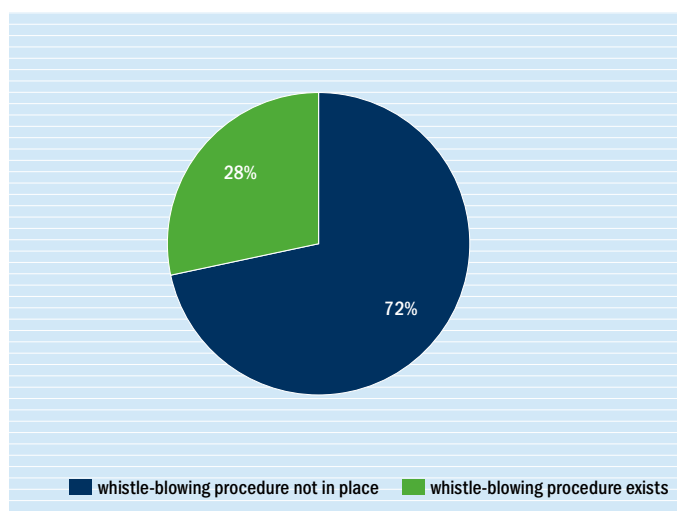
Graph 12: Audit committee activities 2004

reported not to have carried out any intervention or crisis management exercise at all in 2004 (75 and 85 percent, respectively).

Whistle-blowing

Whistle-blowers are people who internally or externally sound the alert on scandal, danger, malpractice, or corruption. The term is used to refer predominantly though not exclusively to alerts on illegal activities such as bribery, theft, or fraud. The term originates from Anglo-American countries, where large organizations today are required to establish formal whistle-blowing procedures.

We asked audit committee chairpersons whether whistle-blowing procedures had been set up at their companies. Graph 13 shows that about 28 percent of companies reported to have established whistle-blowing procedures. Larger companies (**) and more international companies (*) were more likely to have initiated whistle-blowing procedures. The data suggest that while many Swiss companies do not feel it necessary at this point to initiate whistle-blowing procedures, larger and internationally oriented companies have responded to the growing importance of this issue.



Graph 13: Whistle-blowing procedures 2004

Audit Committee Meetings

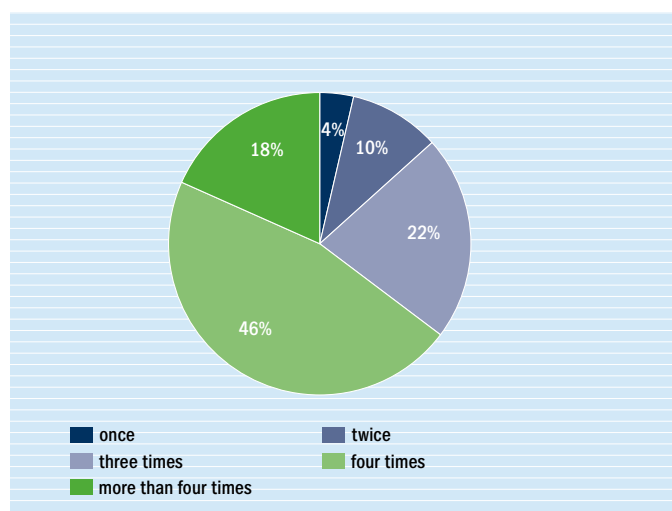
The survey included several questions regarding the frequency of audit committee meetings, their average duration, and the preparation time allowed to audit committee members.

Meeting Frequency, Length of Meeting and Preparation Time

Graph 14 exhibits the audit committee meeting frequency. Over 46 percent of surveyed audit committees met four times in 2004, while 18 percent met even more frequently. In total almost two thirds of the audit committees (64 percent) met at least four times in 2004.

Some audit committee chairpersons reported to have conducted conference calls in addition to face-to-face meetings. In most cases this was limited to one or two instances over the year.

As shown in Table 3, the average duration of audit committee meetings in 2004 was just over 3 hours. Responses varied from 1 to 7 hours, with 3 hours being the most often mentioned duration. Preparation time also varied greatly. The average preparation



Graph 14: Meeting frequency of audit committee members 2004

	Length of meetings	Preparation time for meetings
Minimum	1 h	0.5 h
Maximum	7 h	24 h
Median	3 h	4 h
Mean	3.27 h	6.24 h

Table 3: Length of meetings and preparation time

time was just over 6 hours, yet some audit committee members needed as little as half an hour while others reported to have a preparation time of up to 24 hours. The most frequently given response regarding preparation time was 4 hours.

Later in this chapter we will return to these numbers.

Meeting Attendance

In the survey we asked who was present at audit committee meetings in 2004.

Graph 15 provides an overview of individuals attending audit committee meetings. The CFO was most frequently present at all audit committee meetings (in more than 81 percent of the cases). In addition, the chairperson of the board of directors, the head of internal auditing and the CEO often attended audit committee meetings. (Graph 5 showed that in 2004 just over 10 percent of audit committee members were at the same time chairpersons of the board of directors. This indicates that in 2004 most chairpersons attending audit committee meetings had a visitor status.)

Due to the recurrent presence of inside managers (CEO, CFO, and other executives) at audit committee meetings, so-called «private meetings» may be organized to be attended only by the actual audit committee members. Representatives from internal or external audit might be invited to such private sessions to openly discuss any matters that might arise without the presence of any executive management.

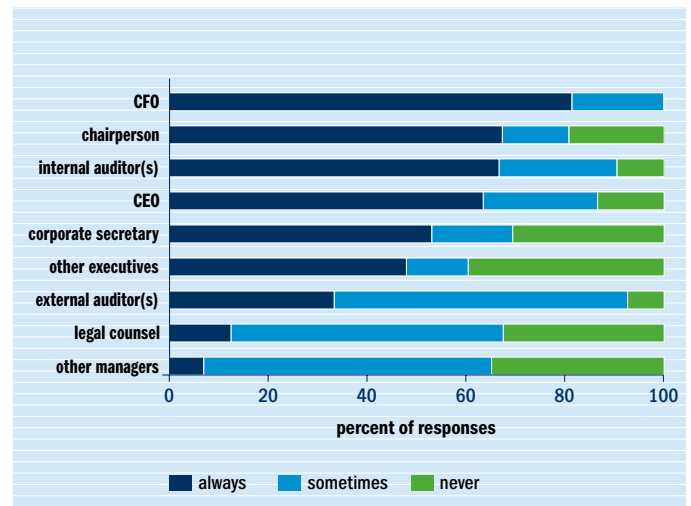
In Chapter four, we will report the effects of a higher ratio of independent audit committee members.

Information and Communication between Audit Committee, Management and the Rest of the Board

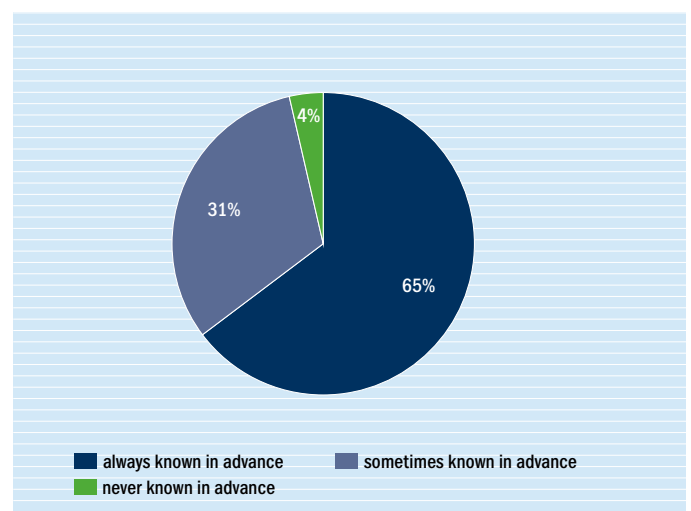
Audit Committee Meetings and Information Forerun

The nature of audit committee meetings will also depend on the run-up to these meetings. Audit committee members will have a better chance to prepare well if they receive the right documents at the right time, and know in advance when these documents will arrive.

As shown in Graph 16, almost two thirds of the audit committee chairpersons always knew when they would receive the docu-



Graph 15: Persons present at audit committee meetings 2004



Graph 16: Audit committee meetings and information forerun 2004

ments for the next meeting. Only a very small proportion indicated they did not know when documents would arrive.

Our respondents indicated they received the relevant documents on average just over 6 working days in advance of the audit committee meeting. The spread was quite wide, ranging from 0 to 15 working days, i.e. three working weeks. The most frequently provided answer was 5 working days of forerun.

*Searching for «best practices», we tested for the correlation between the length of the meeting, preparation time, and days of forerun. We found that the length of audit committee meetings was positively and significantly associated with longer preparation time (***) and days of forerun (*). Of course, lengthy meetings do not necessarily make better meetings. However, these correlations suggest that audit committee chairpersons are advised to allow for adequate preparation time and forerun.*

Mode of Communication

Audit committee chairpersons were also asked to provide feedback on the form in which they receive information from management, and their communication mode to the board of directors as a whole.

Almost all respondents (96 percent) indicated they received an annual standardized financial reporting package from management. Some 88 percent received such a reporting package on a half-yearly basis, 70 percent on a quarterly basis, and 55 percent on a monthly basis. Furthermore, 76 percent of the respondents indicated also to receive additional analyses. Spontaneous ad hoc information is also provided widely. Data rooms, by contrast, appear to be used by only 2 percent of those surveyed.

Communication modes between the audit committee and the board of directors vary widely. Most audit committee chairpersons do not provide their fellow board members who are not on the audit committee with either the agenda or the documents prior to the audit committee meeting. Instead, over two thirds of audit committee chairpersons report that non-audit committee board members receive the agenda plus all documents after the audit committee meeting. Furthermore, 92 percent of audit committee chairpersons provide relevant oral information and perspectives to the wider board.

Thus, at one third of the companies surveyed, non-audit committee board members did not receive audit committee documents even after the meeting. This procedure is not in line with good practice, which stipulates that all board members should receive such relevant information.

Audit committee chairpersons...	
...receive additional fee for services as audit committee president	62%
...receive higher fee than other audit committee members	35%
...receive higher fee than chairs of other committees	6%
Audit committee members...	
...receive higher fee than members of other committees	10%

Table 4: Compensation of audit committee members

Compensation of Audit Committee Members

Audit committee members face a complex and demanding task. Financial capabilities are in high demand. Therefore, we asked whether audit committee chairpersons and members received any remuneration additional to their fee as members of the board of directors. Table 4 shows the results.

Over 62 percent of audit committee chairpersons reported to have received additional remuneration for their services in 2004. However, almost two thirds (65 percent) stated that the additional pay was not higher than the fee received by the other audit committee members. Furthermore, 94 percent of the audit committee chairpersons indicated that their fee did not exceed the pay received by other committee chairs. Audit committee members usually do not receive a higher compensation than members of other committees. Until 2004, the scarcity of competent audit committee members did not appear to have led to considerably higher remuneration structures. ■

4. The Audit Committee in Swiss Companies: Causes and Effects

The previous chapters provided information on the existence, composition and processes of audit committees at Swiss listed companies. The key patterns and trends identified are in line with international developments, e.g.:

- the incidence and size of audit committees has increased;
- audit committees increasingly consist of independent members;
- a growing percentage of audit committees include at least one member with distinct financial capabilities.

This chapter assesses whether these above patterns and trends had any measurable effects. Using regression analyses (see statistical note) we tested the effect of specific audit committee characteristics and processes on companies' overall accounting performance (return on assets and return on investment), financial reporting standards, and the quality of financial reporting. Graph 17 illustrates the type of relationships tested.

Most of the tests we carried out referred to the period of 2002 to 2004. The conclusions of our analyses are the following.

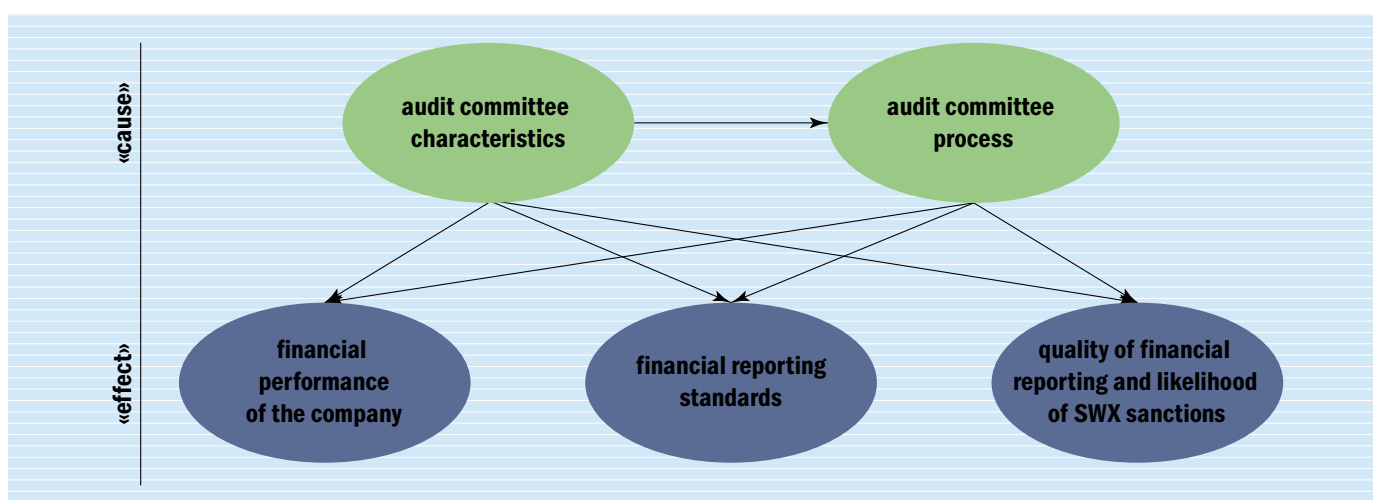
1. Audit Committees Matter

The first and most important question is whether it pays for a company to establish an audit committee in the first place. Our findings indicate that over the period of 2002 to 2004, companies with an audit committee were more likely to reap some important benefits than companies without an audit committee.

The existence of an audit committee tended to affect the quality of external financial reporting. Over the period 2002 to 2004, companies that had an audit committee were more likely to obtain a clean audit opinion in the subsequent year.

This finding holds both at the group level (*) and at the holding company level (*) of financial reporting.

Audit committees also tended to reduce the likelihood to become the object of SWX sanctions. Over the period 2002 to



Graph 17: Measuring audit committee «causes» and «effect»

2004, companies that had an audit committee were less likely to be the object of SWX sanctions in the subsequent year. This finding takes into account both published and non-published sanctions (*).

2. Audit Committee Composition Matters

If the existence of an audit committee tended to have positive effects, did it also matter what type of people were audit committee members? Once again the answer tends to be yes. We found that in the period of 2002 to 2004, audit committee composition appeared to have had measurable effects on the quality of external financial reporting.

Independent audit committees tended to increase the chance of a clean audit opinion. Over the period 2002 to 2004, audit committees with a higher ratio of independent members were positively associated with the likelihood to get a clean audit opinion.

Again this finding holds both at the group level (*) and at the holding company level (*) of financial reporting.

Independent audit committees tended to reduce the likelihood of SWX instigating an official procedure. Over the period 2002 to 2004, audit committees with a higher ratio of independent members were negatively associated with the likelihood that the SWX initiated a procedure.

This finding (*) provides additional support for audit committees to consist of independent members.

Financial expertise increased the quality of financial reporting at the group level. Over the period 2002 to 2004, audit committees with a higher ratio of financial expert members were positively associated with the quality of financial reporting.

This finding holds at the group level (**), but not at holding company level (where the 10 percent significance cut-off point was not met).

3. Audit Committee Practices Vary, yet Some Good Practices Are Emerging

To what extent do audit committee practices matter? Earlier we documented that Swiss audit committee practices vary widely. Partly due to the relatively small survey size we have been unable to establish major significant patterns here. In chapter three it was reported that there is a correlation between length of the meeting, preparation time, and information forerun. A further finding was the following:

More financial competencies led to lengthier meetings. In 2004, audit committees consisting of more financially capable members tended to conduct longer meetings.

This finding (**) underlines that professional audit committee meetings attended by members possessing adequate financial capabilities will affect the way these meetings are prepared and conducted.

4. The Adoption of US-GAAP Brings Important Benefits

Finally, we tested whether audit committee members' financial capabilities are associated with the likelihood to adopt IAS/IFRS or US GAAP. We did not find any results regarding IAS/IFRS. However, we reached several interesting findings regarding the antecedents and consequences of adopting US GAAP.

Companies that had adopted US-GAAP were more likely to have financially experienced members on their audit committee.

This result (***) should not come as a surprise, since the decision to adopt US-GAAP will compel companies to identify audit committee members who can deal with its complexities.

Companies that had adopted US-GAAP reported a higher average Return on Assets (ROA) and Return on Investment (ROI).

There are different ways to interpret these findings (both **). They may suggest that US-GAAP obliges companies to disclose value that has been generated more accurately. These results were not affected by company size. In fact, company size was negatively associated with ROA and ROI (both **).

Companies that had adopted US GAAP were more likely to have established a whistle-blowing procedure.

This result (*) is not surprising, since companies reporting under US GAAP often have a secondary listing in the US. Companies listed in the US are required to establish whistle-blowing procedures.

How to Interpret These Results?

The results presented in this chapter are based on statistical tests, and in that sense they are «neutral». The evidence suggests that over the period from 2002 to 2004, companies that had established an audit committee were more likely to obtain specific advantages. Likewise, over the same period companies that had more independent or financially capable members were more likely to reap certain advantages.

The patterns and trends on audit committees as well as their effects identified in this chapter correspond with international developments. Moreover, they are fully in line with the way leading theories and prominent corporate governance scholars understand the audit and other board committees. Therefore, even though some results are more robust than others, we are confident that the findings presented in this report are sound and meaningful.

Ultimately, it is the privilege of every audit committee and board member to define the best way to handle audit-related matters in

the context of their company. This report contains important evidence to support and guide audit committee and board members in doing so.

In conclusion, this study suggests that there are best practices in Switzerland regarding the establishment and composition of audit committees that companies, board members, audit committee members and chairs, as well as external advisors should consider carefully. Developing professional audit committees will help Swiss companies further foster a culture of internal and external transparency and accountability, and to reap advantages such as those reported in this study. Audit committees are an important vehicle to help boards create and sustain value. Forward-looking boards will not stop looking for mechanisms to make their audit committees perform even better. ■

Publication data

Editor

Ernst & Young Ltd
Markus Schweizer, Partner
Robert-Jan Bumbacher, Partner
Bleicherweg 21, Postfach, 8022 Zurich
markus.schweizer@ch.ey.com
robert-jan.bumbacher@ch.ey.com
www.ey.com/ch

Research Institute for International Management
University of St. Gallen
Prof. Winfried Ruigrok, PhD
Dufourstrasse 40a
9000 St. Gallen
winfried.ruigrok@unisg.ch
www.fim.unisg.ch

Ordering/changes of address

www.ey.com/ch/publications
sms.publications@ch.ey.com

Design

Schminke & Team Ltd, Zurich

Printing

Goetz Ltd, Geroldswil

© Copyright

Ernst & Young Ltd 2005
Reprinting – even reprinting of extracts – is only permitted if source is stated. We request that you send us a copy.

Important note

The authors of this study accept no liability for decisions relating to this study or the consequences thereof. The study should not be viewed as a substitute for professional advice. The statements and interpretations expressed in this study relate exclusively to the opinions of the authors and do not necessarily represent the opinions of the companies by which the authors are employed.



ERNST & YOUNG LTD

www.ey.com/ch

© 2005 Ernst & Young.
All Rights Reserved.
Ernst & Young is
a registered trademark.