

Evaluating the CFO and the finance organization

Introduction

On January 6, 2006, members of the Audit Committee Leadership Network met by telephone for the network's eleventh meeting. During discussions, the network explored the findings of the most recent edition of *InSights*, "The CFO's perspective,"¹ and discussed how audit committees should evaluate the CFO and the financial organization. The discussion focused on three areas:

- **The CFO's leadership role and succession opportunities**
- **The audit committee's role in evaluating the CFO**
- **Assessing the finance organization's quality and depth**

Members of the network who participated in the meeting, or in individual discussions beforehand, sit on the boards of 36 large-, mid-, and small-cap public companies between them.

Members who participated in the meeting were:

- Jim Adams, Audit Committee Chair, Texas Instruments
- Gene Fife, Audit Committee Chair, Caterpillar
- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company
- Steve West, Audit Committee Chair, Cisco Systems
- Doug Yearley, Audit Committee Chair, Lockheed Martin

Members who participated in individual discussions before the meeting were:

- John Clendenin, Audit Committee Chair, The Home Depot
- Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- Sandy Warner, Audit Committee Chair, General Electric Company

Other participants in the meeting included:

- John Ferraro, Vice Chairman, Ernst & Young
- Tom Flannery, Partner and Director, Audit Committee Communications, Ernst & Young

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Comments made during the meeting are shown in italics throughout the document.

¹ Tapestry Networks, "The CFOs perspective," *InSights*, December 22, 2005. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Dec05_InSights.pdf

Executive summary

As *InSights* recently noted, the strategic importance of the chief financial officer has grown over the years. Always critical to public companies' stewardship and performance, the CFO has taken on new responsibilities post Sarbanes-Oxley. Today's CFOs bear more responsibility, have more visibility, and face more pressure than CFOs of the past. The audit committee depends on the work of the CFO and the finance organization. Yet, while audit committees are often involved in assessing the bench strength of the finance organization, they are not often involved formally in evaluating the performance of the CFO.

The specific issues found to be most important to members are highlighted below, with more detailed discussion on the following pages:

- **The CFO's leadership role and succession opportunities** (*Page 3*)

Most members expect their CFO to have the potential to step into the top leadership role of CEO. However, members are concerned that an increasingly compliance-oriented workload and more technical specialization could decrease the CFO's desirability as a candidate for CEO. Network members agree that the CFO's role has had to change in the wake of Sarbanes-Oxley, with the CFO becoming more of a leader in developing the bench strength of the wider finance organization. Members are unconcerned about high CFO turnover levels, except as a potential red flag for problems in an individual company.

- **The audit committee's role in evaluating the CFO** (*Page 4*)

The CFOs recently interviewed for *InSights* and the audit chairs participating in the network meeting both agreed that formal involvement of the audit committee (or the chair) in the evaluation of the CFO is not common today. Indeed, several members said their views were not solicited at all. Other members discussed a number of ways that they contribute their views, ranging from informal conversations with the CEO or the chair of the compensation committee to more formal discussions at a full board meeting. Members are concerned about their ability to get an unvarnished picture of the CFO's performance and recommended discussions with the external auditor's lead partner for an independent perspective.

Members agreed with the CFOs that more formal input from the audit committee is both desirable and likely to be provided more frequently in the future. When considering how they would judge CFO performance, members raised exclusively non-financial questions. [Example of the criteria members recommended can be found on page 5.](#)

- **Assessing the finance organization's quality and depth** (*Page 7*)

For many audit chairs, assessing the quality and depth of their company's finance organization is a more developed practice than participating in the formal evaluation of the company's CFO. Members recommend a number of methods for building knowledge of the finance organization, including formal presentations from the CFO about the group, a program to bring finance staff into audit committee meetings through the year, one-to-one meetings with key leaders who interact with the function, and attending the finance organization's all-hands meeting. [Tips for assessing the finance organization's bench strength can be found on page 7.](#)

The CFO's leadership role and succession opportunities

At the end of 2005, Tapestry Networks interviewed CFOs from some of North America's largest public companies. Most of the surveyed CFOs said the burden of added Sarbanes-Oxley-related compliance is falling primarily on the controller within the finance organization. They also felt their own position has become increasingly less attractive due to the increased scrutiny, pressure, and responsibility involved. One CFO said, "I'm not sure that being CFO is that desirable anymore." Another said that "few CFOs and controllers these days are having fun."²

The changing nature of the CFO's role

Network members agreed that the CFO's role had changed in the wake of Sarbanes-Oxley. One member said, *"The CFO's job was never a fun job, and it has become bogged down in more detail, although much [of the work] has been handed off to the controller's office. The CFO has had to become more of a leader in developing the bench strength ... of the [finance] organization, rather than taking on [more of] the work ... The pressure is on them as managers."*

Another audit chair agreed: *"There is a higher level of attention on the financial organization. The pressure is on the CFO ... to get better qualified people into finance roles ... They need better management skills, better knowledge of the regulatory environment, and more global experience."*

Members also believe the need to develop a talented global team within the finance organization has evoked mixed feelings in many CFOs. One member commented, *"There is a change in the way the CFO interacts with the board and the audit committee. [The CFO] used to be the principal interface, now there are a larger number of people being exposed."* This member observed that everyone is torn between the desire to delegate and the desire to retain control and believes that many CFOs have not yet fully accepted the consequences of delegation.

While companies need to attract and retain talented executives willing to serve as CFOs, total turnover among the CFOs of Fortune 500 companies is on the increase.³ However, members are largely unconcerned about higher CFO turnover. They noted, in the words of one audit chair, that *"CEO turnover is higher too, as well as other important positions in the company."* However, audit chairs are concerned that when a CFO leaves, from any part of the company, *"you want to make sure there is no underlying problem. We have used exit interviews to check."*

Another member stated, *"Boards, and audit committees in particular, have little tolerance for error at the CFO level. If the job is not done right and there is turnover, so be it. I want to make sure the CFO has support from the audit committee and all the resources needed to get the job done. CFOs may be unhappy with turnover and the fact the job is less fun, but I'm not concerned as there is very little room for error."*

² Ibid., 3-4.

³ Russell Reynolds Associates, *The CFO Turnover Study* (New York: Russell Reynolds Associates, 2005), 1. Complete pdf file available at <http://www.russreyn.com/post/publications/CFOTurnoverSurvey.pdf>

Compliance focus may undermine CFO ability to succeed to the CEO role

Over half the CFOs interviewed for *InSights* have responsibilities that extend beyond the CFO's traditional role as head of the finance organization. They serve as de facto or formally designated chief administrative officers, chief operating officers, or managers of line divisions. In general, CFOs see expanding their role beyond finance as essential to their career development. However, the increased compliance burden has restricted opportunities for many CFOs. One CFO described Sarbanes-Oxley's impact on the CFO's position as "significant. The CFO's strategic role hasn't lessened – these have been add-ons."⁴

Most members expect their CFO to be able to step into the top leadership role of CEO. As one member noted, *"Most CFOs are natural candidates to be considered for CEO. The great CFOs have the skills to be a CEO."* Members were concerned, however, about how increasing compliance work and technical specialization would affect CFOs' leadership potential. As one audit chair put it, *"The CFO heads business planning and has a role in strategy. Sarbanes-Oxley's focus on controls and risk management has changed the nature of the job."* Other members agreed, cautioning, *"If the CFO role becomes too specialized, they are not [going to be] right for the CEO role,"* and, *"We expect our CFO to be a CEO, to have a broad perspective and not specialize."*

However there was a dissenting view that the new focus of the CFO role might be additive and better equip the CFO for the CEO role: *"[The CFO needs] financial skills and the potential to be the CEO. As the CFO job expands in depth and scope, they will have the capability to be the CEO."*

The audit committee's role in evaluating the CFO

Although many CFOs have both financial and non-financial objectives, they say their performance evaluation depends more on their relationship with the CEO, and on the company's financial results, than on formal performance metrics. In their view, the audit committee rarely plays more than a marginal role in assessing the CFO's performance, but this may evolve over time.⁵ One CFO commented, "I'm not sure how meaningful [the formal metrics] are. The real question is 'Is the CEO happy?'"

The Conference Board Commission on Public Trust and Private Enterprise has stated that "in fulfilling its oversight function, boards must monitor management's operating performance as well as ethical and legal compliance."⁶ One of the CFOs interviewed recognized the value of audit committee input into his evaluation: "My main evaluator is the CEO, which is appropriate, but the board, audit committee, and compensation committee should have input too."

One network member expressed concern over tone at the top in cases in which the CEO alone evaluates the CFO. *"One thing we as a board and audit committee need to be careful about is the CFO's relationship with the CEO. If you look at the recent problems in corporate America, it's often cronyism between the*

⁴ Tapestry Networks, "The CFOs perspective," 4.

⁵ Ibid., 8-9.

⁶ The Conference Board Commission on Public Trust and Private Enterprise, *Findings and Recommendations, Part 2 – Corporate Governance: Principles, Recommendations and Specific Best Practice Suggestions* (New York: The Conference Board, 2003), 9. Complete text available at <http://www.iasplus.com/resource/confboard.pdf>

CEO and CFO that makes it possible. You need to look at the degree of professionalism and the nature of the relationship between the CFO and CEO.”

Members could clearly see a role for the audit committee chair in contributing to the evaluation of the CFO. One member commented, *“The CFO has other roles that don’t concern us [as an audit committee], but I do depend on him.”* Members discussed both the criteria they would use to evaluate the CFO and the process by which their input is currently provided.

Criteria for CFO evaluation

When considering the criteria they would use to judge CFO performance, most audit chairs chose non-financial metrics. One member commented, *“We do not put the emphasis on narrow financial metrics like EPS – we look to the financial organization to report it and interpret it, not to deliver it. That’s a role for operations people.”* Members outlined a set of criteria for guiding CFO evaluation (see box below).

Criteria audit chairs recommend considering

- Does the CFO oversee the creation of good processes for financial reporting and internal control? *“When you look at a problem with a subsidiary CFO, there is usually an attendant process or control issue.”*
- Is the CFO an independent thinker who speaks up and challenges the CEO? *“If the CEO is very domineering and doesn’t get questioned, that should be a red flag for the audit committee.”*
- Does the CFO have integrity? *“If you don’t have trust in the CFO, you don’t have anything.”*
- Does the CFO have a cooperative attitude towards the audit committee and a commitment to transparency in financial statements to ensure that audit committee members can understand them? *“If we get quick and dirty answers [that are] not explaining things properly, that is a warning sign.”*
- Does the CFO have a good track record in recruiting and managing bench strength in the finance organization? *“We judge them by the quality of their staff and the opportunities the CFO provides to them.”*
- How involved is the CFO in international operations? *“Those with less experience tend to pay less attention to it. That’s where problems occur, so you need to monitor their involvement [in international operations].”*

The CFO evaluation process

As the CFOs noted, many audit chairs are currently only peripherally involved in CFO evaluation. One member pointed out the reality for many: *“CEOs are used to doing the evaluation, so I have to go to them and offer my views ... The CEO has not sought my views. I don’t know whether [they are] appreciated. I have never had the compensation committee chair approach me either; I have had to approach them.”*

Members described a variety of ways in which they currently provide their input to the CFO's evaluation:

- **Informal input to the CEO or compensation committee.** *“The audit committee should definitely be involved in evaluating the CFO, internal auditor, tax director, and others who present regularly to the committee. We give input to the compensation committee chair.”* Another audit chair agreed: *“We do it through the compensation committee. We attend the meeting when they do the evaluation once a year, but we are in contact through the year as required. I am an invited guest of the compensation committee as my interest is in a few people in finance.”*
- **Discussion of senior management performance at a meeting of the full board.** One member said, *“It is fairly systematic. The board does the evaluation for senior management. We also use a 360-degree appraisal process, and audit committee members can use that to input to the CFO's evaluation.”* Another audit chair noted, *“The whole board gets involved, as the CFO presents to the board regularly and participates in all the meetings. The [compensation committee] chair leads a board discussion of some depth.”*
- **Involvement in developmental conversations, but not evaluation.** One audit chair described how *“we comment annually on the quality of the work, and this is shared with the CEO, but is not linked to the compensation committee's or CEO's evaluation [of the CFO].”*

The CFOs interviewed for *InSights* and the audit chairs participating in the network meeting agree that the audit committee is likely to be more formally involved in the evaluation process in the future. As one member noted, *“I have never been asked my opinion on the CFO, and we can change that!”*

The external auditor's perspective

Concerned about their ability to get a sense of how the CFO is performing, members turn to the external auditor as a key source of information. One member said, *“We struggle as an audit committee to get an unsanitized view of how the CFO is doing. One source is the external auditor. They are professional in this area. They ... will give you an honest appraisal. It is independent, and you can't find it elsewhere.”* Another member agreed, saying, *“We rely on the opinion of the audit partner quite extensively.”*

One member has established regular informal meetings built on a relationship of trust with the audit partner. *“I sit down with the external auditors and dig deep on the CFO and ask follow-up questions. They are protected as it's not going anywhere. I ask the external auditor, if they were in sole charge of the financial affairs and the financial reporting of the company, would they do anything differently, and why? We don't do this as a full committee. When I see a problem, I'll bring that up to the next audit committee executive session without the external auditor present.”*

Most members were aware that the external auditor also has a formal process, developed to aid the auditor in deciding whether or not to reaccept the company as a client, for evaluating the CFO as part of the audit firm's assessment of factors that could lead to financial misstatements. The evaluation is based on the CFO's attitude, the environment, financial conditions, the depth of function, and the CFO's relations with employees and related parties.

Assessing the finance organization's quality and depth

CFOs who participated in the *InSights* research reported a range of practices at their companies to help the audit committee gauge the skills of finance staff below the CFO and controller level. Broadly speaking, all these practices foster regular interaction between junior finance staff and audit committee members, in both formal and informal settings.⁷

For many audit chairs, this is a more developed practice than evaluating the CFO. One member noted, *"Our concern is more with the people below the CFO. We used [the implementation of] Sarbanes-Oxley as an opportunity to develop people. We pushed [the work] onto the controllers, but this forced them to [take a] broader view across the company and to work with people they would not normally work with."*

Members described different ways in which they get to know the bench strength of the financial organization (see box below).

Tips for assessing the finance organization's bench strength

- Ask the CFO to get the key staff people in front of the audit committee during the year, both to present and answer questions from the committee.
- Have the CFO make a presentation on the finance organization to the audit committee each year and talk about the people, their backgrounds, strengths and weakness, and how the CFO is responding to them.
- Spend time with key individuals who regularly interact with the finance organization, including the CFO, controller, the head of the internal audit function, and the external auditor.
- Attend the finance organization's all-hands meeting. *"I address the group, answer their questions, and go to dinner with them. It is very helpful in getting to know more people from the organization, and they like meeting with someone from the audit committee."*
- Visit different parts of the finance organization, such as the tax department, to understand more fully the information they produce, and use site visits to keep in touch with the CFOs of different business units. *"[These visits help] build morale and assess bench strength."*

Succession within the finance organization is also an important issue for audit committees. One member explained, *"The audit committee [has] spent time on succession issues for our [country-based finance leaders]. We agreed [on a key set of roles] around the world. Candidates for [corporate] CFO [rotate] through those situations. It is an important part of developing the international experience of the CFO."*

Another member talked of the power that the audit committee has to influence the behavior of country-based finance leaders throughout the organization: *"If we have a problem in [a particular subsidiary], we*

⁷ Tapestry Networks, "The CFOs perspective," 6.

bring that [finance leader] into the audit committee and, a few days later, [finance leaders in divisions around the world] hear about that.”⁸

Conclusion

Given the evident stresses of the CFO role, the continuing importance of tone at the top in public companies, and the desire to have CFOs who are ready to step into the CEO role, audit committees must ensure that their CFOs are being motivated to take a long-term perspective and are not focusing purely on short-term results. Yet few audit committee chairs are directly and formally involved in evaluating the performance of the CFO today. The good news for corporate America is that both CFOs and audit chairs want to see this situation change and are actively working to make it happen.

About this document

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

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

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⁸ For another example of reinforcing accountability for the purpose of risk mitigation, see European Audit Committee Leadership Network, “Audit committees: converging roles, diverging practices?” *ViewPoints*, July 15, 2005, 10. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_EuroACLN_Jul05_View3.pdf