

Audit committee priorities and performance

About this document

The Audit Committee Leadership Network is a select group of audit committee chairs from some of America's leading 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. *ViewPoints* is a synthesis of key issues arising from a facilitated discussion among members of the Audit Committee Leadership Network. It reflects the questions and perspectives of individuals who are charged with helping bring about the new governance environment. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

Initially, *ViewPoints* will be distributed to network members who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will also be distributed by Ernst & Young to its partners. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The Audit Committee Leadership Network met for the first time by teleconference on August 27, 2003. The members of the network present at the meeting were:

- Mr. Jim Adams, Audit Committee Chair, Texas Instruments
- Mr. Dan Akerson, Audit Committee Chair, American Express
- Mr. John Clendenin, Audit Committee Chair, The Home Depot
- Dr. Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- Mr. John Ferraro, Vice Chairman, Ernst & Young
- Mr. Gene Fife, Audit Committee Chair, Caterpillar

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 during the meetings are not attributable to individuals.

Executive summary

Network members who attended the meeting expressed the following viewpoints:

Composition: Attracting and retaining the right people for the business, and to ensure compliance *(Pages 2-4)*

- The definition of ‘financial expert’ has produced many positive outcomes. It has opened up board searches to more women and minorities. However, other well-qualified candidates, such as active partners of venture capital firms, may be overlooked.
- The requirement for one financial expert on each audit committee is far too limited (two to three being preferred). Ironically, the requirement may make it harder to recruit CFO and former CFO candidates for the audit committee, if they feel they are being hired simply to fill a quota.
- Audit committee members require industry understanding, not just accounting policy knowledge. The critical contribution of the inquisitive non-expert member must not be overlooked.
- Board directors should attend a board education course at least once every five years.
- Succession planning is critical for the audit committee and the whole board, but it is not necessary to appoint vice chairs for committees.

Performance: Ensuring the right people do the right things at the right times *(Pages 4-5)*

- Formal annual review processes and informal peer pressure can deal with underperforming members effectively. These methods are preferable to the intervention of the chair or annual elections.

Compensation: Recognizing the differential time commitments and risk profiles associated with audit committee membership *(Page 5)*

- Audit committee chairs and members should not be compensated differently than other board colleagues due to role differences. Instead, they should be fairly compensated for the increased amount of time spent on audit committee business.

Composition

? Are you having difficulty finding qualified individuals to serve on the audit committee? What approaches have been useful in overcoming objections?

Members of the network agreed there should be a minimum of two to three financial experts on the audit committee, not just one as required by Sarbanes-Oxley. Ideally, these experts should be former CFOs or CPAs. Nominating committees must take into account the definition of a financial expert when recruiting and rotating members of the board onto the audit committee.

There was concern that mid-size companies are having more trouble than larger companies in filling audit committee requirements since the available talent pool is not large enough. Many smaller listed companies

will likely find themselves exposed, whereas larger companies often exceed the requirements. Some discovered that their entire audit committee qualifies as financial experts.

However, CFO candidates for board appointment are starting to question whether they are being brought onto the board simply to fulfill the role of financial expert. As one audit committee chair pointed out, *“They feel they have a target painted on their back unless there are others fulfilling that role.”*

The financial expert qualification also takes no account of the *“smart, inquisitive, asker of hard questions.”* Non-expert directors can ask penetrating questions that cause the experts to stop and think outside their frame of reference. It would be a mistake if Sarbanes-Oxley led to audit committees and boards being dominated by former audit partners.

The definition of a financial expert continues to evolve. The recent SEC rule change enabling CEOs to qualify as a financial expert if they have a CFO reporting to them has expanded the pool of available candidates. It has also raised worries that real expertise is being watered down since not all CEOs are equally qualified. For instance, the CEO may have risen through the sales or marketing function without developing the levels of expertise seen as essential by the SEC, the board, or investors.

One category of expert being overlooked for audit committee membership is the active partner in a venture capital (VC) firm. These candidates have great skill and a track record in examining the fine print in financial documents. Indeed, smaller listed companies are removing VC partners from their audit committees since they are disqualified though the nature of their ownership position by Sarbanes-Oxley.

One unintended benefit of the financial expert requirement has been to force nominating committees to look beyond the usual candidates, opening up new talent pools that happen to contain more women and minority candidates.

Beyond the financial expert qualification, there are other barriers to recruiting members for the audit committee. The most obvious being the time commitment involved – with many audit committees doubling the amount of time involved in performing their duties. One audit committee chair commented, *“It’s not a good reason [for members not to join], but it is a reality.”*

Directors are also being advised not to join the audit committee by personal and corporate counsel in order to mitigate the risks of serving on a board. Members of the network were adamant that they would prefer not to serve on boards with directors who refused to join the audit committee. This situation reduces the opportunity for the rotation and development of board members, and introduces unwanted rigidities to committee membership. In any case, they argue, the audit committee takes its findings to the whole board, and individual directors cannot abdicate their responsibility. Typically, it is the whole board that is sued by disgruntled investors, although that may change.

One method of overcoming the anxiety board members have about serving on the audit committee is greater use of board education programs. It is essential to tackle initial reluctance. One network member reported receiving over 20 calls a year from CEOs wanting to talk to him to determine whether they should attend board education courses they believe to be beneath them.

Members of the network agreed that each board director should attend one board education course at least every five years. Among this elite group of audit committee chairs, individuals have in fact attended between one and three courses each in the last year alone. Leading-edge boards are also insisting on development plans for each director – building in a broader look at the interventions available for each committee role rather than just attending board education courses.

? How should succession be managed? Should audit committees have a vice chair?

There are practical ways of ensuring that succession planning takes place. One board has developed an “heir apparent” for each committee. This individual may be ready to take over as chair in three to five years, as part of an overall rotation plan for each board director. In this example, a percentage of each committee rotates off every year to provide for continuing fresh perspectives.

Network members felt that appointing a formal vice chair was not necessary. Some members had implemented the concept to cover for absences due to ill health. However, with many audit committees having around five members, adding a layer was deemed impractical and overly hierarchical.

Performance

? What actions are you taking to ensure that audit committee members are performing effectively?

There are always talented people who develop personal problems which impede their performance on a committee. Often, these members recover and go on to make a powerful contribution. However, most boards are not large enough to carry passengers and can suffer an overall deterioration in performance. The “dead wood” issue does not occur frequently. When it does, it has to be dealt with *“promptly and straightforwardly.”* There are a number of different approaches to dealing with underperformance:

- **Ensure the terms of membership are clear at the beginning.** At one company, the chair makes the attendance issue very clear: since compensation is paid annually, members have already been paid for their attendance.
- **Involve the governance committee chair or the board chair.** Whether this is accomplished through a quiet word behind the scenes or a formal reprimand, making the performance issue into a governance question can help even the most recalcitrant members see the error of their ways. One member felt that the recent push for annual elections could hamper the chair, leaving no room for either personal development or transitioning the individual off the board over time in a dignified way.
- **Use peer pressure to take corrective action.** Other members of the board are left to carry the weight of non-performing directors. They have a vested interest in solving the problem. They can initiate a conversation directly or at the request of their chair. They can then approach the wayward director to share their observations, and make constructive suggestions for how the individual can make a better contribution in the future. As one audit chair put it, *“Directors don’t want to be embarrassed; they want to be productive.”*

- **Institute regular peer reviews.** One network member's governance committee uses a simple, non-confrontational system that has enabled all directors to improve their performance. Each year, members of the board are reviewed by each other, using a non-attributable feedback process and numerical scoring. The regularity of the process means issues never get too difficult to deal with and behavioral issues (such as leaving meetings early) disappear shortly after the feedback is given to each individual. In another example, feedback on the board and individual members is reported verbally to the full board, by the chair of the governance committee.

Compensation

- ? **Given the enhanced risk profile and the increased time commitment, should audit committee members and chairs be compensated differently from other board members?**

The issue of compensation is certainly under frequent review by all boards. It is complicated by the question mark hanging over stock options. Members of the network took the view that audit committee members could be compensated differently from their board colleagues based on the time they contributed, rather than the role they performed. The latter was seen as a potential threat to the collegiality of the board.

The key is to have a transparent process for reviewing and paying compensation. However, compensation data is often out of date as it uses information published in the previous year's proxy statement. Getting at fresher data may mean setting up a consortium of like-minded companies to share information.

Time-based compensation is typically calculated by attendance and time spent in committee meetings. In one audit committee, a double meeting fee is paid if the meeting goes over the time allotted. While some members of the committee may be dependent on their income from board directorships, most members are more concerned about using their time well. Being compensated for the investment of time is preferable to being compensated for a role that every board member ought to share through rotation.

The views expressed in this document represent those of the Audit Committee Leadership Network, a group of audit committee chairs from North America's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the view nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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