MID-ATLANTIC
AUDIT COMMITTEE NETWORK
VantagePoint

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The changing face of the audit committee

Introduction

The Mid-Atlantic Audit Committee Network (MAACN) is a group of audit committee chairs drawn from leading companies based in the Mid-Atlantic region of the United States. 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.

The second meeting of the network was held in Washington, D.C., on December 13, 2004, and focused on the changing role of the audit committee, including the new skills and evaluation techniques required for improving committee performance.

This document reflects a synthesis of key issues arising from the December MAACN meeting. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues. Anyone who receives this publication may share it with those in their own network. The more board directors, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The members of the network present at the meeting, who sit on the boards of 19 large-, mid-, and small-cap public companies between them, were:

- Mark Bartlett, Partner, Ernst & Young
- Jim Brady, Audit Committee Chair, Constellation Energy Group
- Charlie Hopkins, Audit Committee Chair, Charming Shoppes
- Mike Ressner, Audit Committee Chair, Magellan Health Services
- John Schwieters, Audit Committee Chair, Smithfield Foods
- Larry Small, Audit Committee Chair, Marriott International
- John Tierney, Partner, Ernst & Young
- Ken Wolfe, Audit Committee Chair, Bausch & Lomb
- Doug Yearley, Audit Committee Chair, Lockheed Martin

VantagePoint 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 attributed to individuals or corporations.

Executive summary

MAACN members agree that the role of the audit committee has become broader and deeper, requiring committee chairs to blend financial expertise with an appreciation for both financial and non-financial risks and compliance. The discussion centered on the changing role of the audit committee and the impact on committee composition and performance.

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

- **The role of the audit committee should include oversight of risk management** *(Pages 2-3)*
  In the wake of Sarbanes-Oxley, audit committees have begun to focus more on risk management instead of simply *"editing the financials."* MAACN members believe this increased emphasis on risk is an appropriate expansion of the audit committee's role. On the other hand, despite a clear reporting relationship and open communication with the chief audit executive (CAE), members think it is impractical for the audit committee chair to actively manage the CAE on a day-to-day basis.

- **Directors with general management experience are required, but tough to hire** *(Pages 3-4)*
  While members believe basic financial literacy is a requirement for any audit committee member as well as for other board directors, they would prefer to have more directors with general management experience available to the audit committee. However, it is becoming increasingly difficult to recruit active corporate executives given the time commitment associated with audit committee membership.

- **Audit committee self-evaluation is beneficial, auditor feedback invited** *(Pages 4-5)*
  Members reported positive experiences with committee self-evaluation exercises, observing that written (qualitative) data from committee surveys is generally more helpful than numeric (quantitative) data. In seeking to understand best practices, members also invite informal feedback from the external auditor.

The role of the audit committee should include oversight of risk management

Most members say their committees are spending more time on risk management post Sarbanes-Oxley. One member reported a significant shift in audit committee priorities, observing that *"audit committees have more of a risk management orientation [since Sarbanes-Oxley] versus an 'editing the financials' mentality."* Another member commented, *"As a matter of principal, for the audit committee not to focus on risk management, in some fashion, is crazy."* Members believe this increased focus on risk management is a fundamental responsibility of audit committees and a positive outcome of the Sarbanes-Oxley legislation.

Many companies are developing an enterprise-wide risk management (ERM) framework. But, members feel that ERM frameworks have not been sufficiently defined in the market; members do not have a shared understanding of what is included in ERM implementation.

One member has asked management, internal audit, and the external auditor to develop a consolidated "Top 10" list of the primary risks and their potential impact on the business. At every committee meeting, management gives the audit committee an update on the list, setting out what has changed and what issues are emerging. Another member said management reports on key risk areas to the audit committee with "stoplight" indicators (red, yellow, green).

While some members questioned whether non-financial risk oversight should be included in the audit committee's scope of responsibility, others pointed out that the 10-K includes a comprehensive listing of risks, both financial and non-financial. In order to approve the 10-K, audit committee members must be satisfied that this filing accurately describes all significant risk areas, including non-financial risks.

Much has been said of the evolving relationship between the audit committee and internal audit staff, and the Institute of Internal Auditors has recommended that the chief audit executive (CAE) report directly to the audit committee.[1] While most members do have a reporting relationship with the CAE, they do not believe audit chairs can play a hands-on role managing the CAE on a day-to-day basis. One member said a direct management relationship was impractical: *"The idea of the audit committee managing internal audit is preposterous – it can't happen."* Another audit chair pointed out, *"If [the internal auditors] were reporting to us, we'd [become] full-time employees."*

Members broadly agreed that whether or not the CAE reports to the audit committee, the audit committee must help make the CAE feels comfortable about approaching it with any problems (including disagreements the CAE might have with his or her manager). Some members have made it clear to management that the CAE's salary or bonus cannot be cut without the audit committee's approval, thereby offering a measure of career protection to an internal auditor who identifies issues that might be uncomfortable for management.

Directors with general management experience are required, but tough to hire

Despite a trend toward increased financial expertise on the audit committee[2], members felt that the committee should not become single-mindedly focused on financial statements. In order to address broader risk areas, members believe the committee should include directors with general management experience alongside the financial expert(s).

Observing that some of the best contributions in audit committee meetings come from such directors, one audit chair said, *"Achieving the right balance is very tricky … The worst possible [situation] is to have a committee of bean counters."* While many members thought it could be helpful to include a retired Big Four audit partner on the committee, they agree that *"one is enough,"* and prefer to see active or retired CFOs filling the financial expert role.

[1] The IIA believes "the CAE should report functionally to the audit committee or its equivalent. For administrative purposes, in most circumstances, the CAE should report directly to the chief executive officer of the organization." See Institute of Internal Auditors, *Practice Advisory 1110-2: Chief Audit Executive (CAE) Reporting Lines* (Altamonte Springs, FL: Institute of Internal Auditors, 2002). Downloadable at http://www.iia.asn.au/pdf/CombinedAdvisories.pdf

[2] According to the *Spencer Stuart 2004 Board Index,* "Among the 154 financial experts new to the audit committee, 47% are new to the board, suggesting that boards are adding directors who satisfy the financial expert requirements." See Spencer Stuart, *Spencer Stuart 2004 Board Index,* 8 (pdf p. 10), downloadable at http://www.spencerstuart.com/research/articles/801/

Although it may be helpful for audit committee members to have specific expertise dealing with the primary risk areas identified by the company, members did not think this was critical. One member described several risk areas, including environmental liability, in which no audit committee member could claim deep expertise. However, with regular reports from internal and external experts, audit committee members have *"learned to understand [the risks] over time."*

Even as members seek more general management representation on their audit committees, they recognize that *"it's getting tougher and tougher to recruit general management people."* Active CEOs are taking on fewer board roles,[3] in part because of the increased time required to adequately exercise their fiduciary responsibility. As one member said, *"It's not the party it used to be. It's a lot of work."*

While members agreed that the workload has increased, there was less agreement on whether potential directors might be deterred from serving because of increased personal liability. One member wondered if concerns about liability were simply anecdotal and said that in his experience *"nobody has identified [liability] as a reason to resign or not join the [audit] committee."*

Members reject the idea that differential compensation is a factor in a director's decision to serve on the audit committee. As one member said, the *"resistance is workload related, not money [related]."* Members agreed that most directors are comfortable with compensation that reflects the differing workloads of the various standing committees of the board. With the audit committee clearly undertaking more work and meeting more often than other board committees, one member described the higher level of compensation for the committee as *"deferential rather than differential."*

Audit committee self-evaluation is beneficial, auditor feedback invited

Although audit committee chairs might like to start with a blank slate and handpick their fellow members, they are rarely afforded this luxury. More often, they need to develop techniques to support and enhance the performance of current committee members. One member described an orientation day that was planned for new audit committee members, during which the internal auditor, external auditor, management, and audit chair helped get new members up to speed quickly. This event helped minimize the amount of time spent reviewing basic concepts later, during audit committee meetings.

Members feel that their committees benefit from committee self-assessment surveys. One member said, *"I've never been in [a committee self-assessment process] that wasn't helpful."* Another said, *"It might sound like [the committee self-assessment survey contains] motherhood-and-apple-pie questions, but it's interesting the responses you get."* Members agreed that while many self-assessment tools include numerical scales, *"the more you have written responses, the better off you'll be."* Several members said their committees discussed the survey results in executive session, where they were able to elicit additional detail and resolve performance issues.

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[3] According to the *Spencer Stuart 2004 Board Index,* "The average number of outside directorships for CEOs fell below one this year to 0.9" (Spencer Stuart, 7 [pdf p. 9]).

While members praised the audit committee self-evaluation process, they said it was also helpful to seek outside perspectives. Members said that external auditors can be a valuable source of informal feedback and suggestions, and many draw upon their audit partners' experience to identify best practices.

Conclusion

The audit committee's role has evolved as a result of Sarbanes-Oxley, and it will no doubt continue to evolve in the coming years as boards determine how to allocate responsibility for risk management and non-financial compliance. It remains to be seen whether audit committees will need to add members with more specialized skills or whether in fact an increasing emphasis on risk will place a premium on general management experience. Since form often follows function, audit committee composition may evolve to fit the needs of key stakeholders, including investors and regulators who are responsible for the broader financial markets.