



## The audit committee's relationship with the finance organization

### Introduction

The Mid-Atlantic Audit Committee Network<sup>1</sup> met for the eighth time on September 13, 2006. The primary discussion focused on the nature of the audit committee's relationship with the CFO and the finance organization. Audit committee chairs present for this face-to-face meeting, who sit on the boards of 13 public companies among them, were:

- Cynthia Archer, Audit Committee Chair, Mercantile Bankshares Corporation
- Charlie Hopkins, Audit Committee Chair, Charming Shoppes
- Mike Ressler, Audit Committee Chair, Magellan Health Services
- John Schwieters, Audit Committee Chair, Smithfield Foods
- Paul Shapiro, Audit Committee Chair, Toll Brothers
- Larry Small, Audit Committee Chair, Marriott International

Other members participating in the meeting included:

- Mark Bartlett, Managing Partner, Baltimore office, Ernst & Young
- Rich Jeanneret, Managing Partner, Assurance & Advisory Business Services, Ernst & Young

*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

An animated and insightful discussion among the members of the Mid-Atlantic Audit Committee Network unearthed several important themes, all with substantial implications for audit committee chairs. These ideas are summarized below and expanded upon in subsequent sections of this document:

- **Is the CFO role the toughest job in corporate America?** (pages 2-4)

Members said they felt the role of the CFO has become more daunting, more demanding, and less fulfilling since the enactment of Sarbanes-Oxley. CFOs are expected to possess deep expertise in accounting and legal matters, and an increasing portion of their time is taken up by the essential responsibilities of compliance and reporting. Yet at the same time, CFOs are also expected to bring

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<sup>1</sup> The Mid-Atlantic Audit Committee Network is composed 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 audit environment.

*VantagePoint* is a synthesis of some key issues arising from a facilitated discussion among members of the Mid-Atlantic Audit Committee Network. It is intended to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, executives, and advisers who become systematically engaged in this dialogue, the more value will be created for all.



broad-gauged business perspectives to the table as partners to the CEO, and they must serve as inspiring leaders within the finance organization itself.

- **Audit committees have a vested interest in a robust finance organization** (pages 4-5)

The audit committee is well positioned to evaluate the depth and capabilities of the finance function. Accordingly, the audit committee as a whole needs to interact with the leaders of the finance function to gauge its strengths and weaknesses.

- **Audit committees support the finance function in a wide variety of ways** (pages 5-6)

The audit committee's involvement with finance shouldn't stop with evaluation; it can support the finance function by offering valuable help to the CFO and other finance professionals (e.g., being a sounding board for the CFO, getting to know junior finance staff for developmental purposes). For his or her part, the CFO has a responsibility to keep the audit committee engaged and to capitalize on the experience and commitment of audit committee members.

In addition to discussing the audit committee's relationship with the finance organization, the network also discussed three shorter topics during an open session: audit fee negotiations, the challenge of having only four global audit firms, and the audit committee's relationship with general counsel. The open session discussion is summarized in an appendix to this document, beginning on page 7.

## Is the CFO role the toughest job in corporate America?

These days, the myriad skills the CFO is expected to possess fall broadly into two categories: leadership and compliance. One member summed up the emerging dual role of the CFO very succinctly: *"The CFO is the subject matter expert on accounting and finance issues. He's expected to [have the skills of] a CFA [chartered financial analyst] or a CPA [and] to opine with the same weight as an attorney. The finance organization is so large – 3,000 people in our company – that the CFO also has to be a leader and a manager."* It's a hefty mandate that requires an executive with extraordinary skills, and led one member to describe the CFO role as *"the toughest job in corporate America."*

### The CFO as leader and manager

Perhaps the most important change for the CFO role in the last few decades is the diverse skills the role now requires. One member noted, *"The CFO is now a CEO of a business within the larger business."* This is because corporate finance departments can have thousands of employees scattered around the globe. Members feel this represents quite a change from the past, when *"the CFO was neither a good manager nor a subject matter expert."* Nowadays, when comparing the CEO and CFO roles, *"the responsibility levels are relatively similar,"* even though *"the pay differential between the CEO and the CFO is astounding."*

It's not easy to be a leader and manager in the current environment, with competing priorities taking up so much of a CFO's time. One expert notes this phenomenon: "CFOs know what they want and what they need to do – be a strategic partner, run a very effective control environment, and reduce operating costs. But the fact is, it is difficult to do all three well, which explains why many CFOs have been able to effectively address the control issue, but have had less success adequately driving forward the business agenda



or dealing with costs.”<sup>2</sup> And to make matters worse, the CFO role is often misunderstood or underappreciated, even at the highest levels in the company. One member said, *“I don’t think some CEOs appreciate what the CFO does.”*

Members mentioned several specific reasons why the CFO needs strong leadership and management skills:

- **The finance organization has increased in size and importance.** With so much riding on the ability of the finance organization to deliver accurate and timely information, the CFO must be able to manage the finance team effectively. This includes the ability to articulate the tone at the top and *“set an example, project the finance function into the organization, and set standards.”*
- **Producing quality financial statements requires a strategic understanding of the business.** One member summed up the consensus view of how important it is for the CFO to understand the industry and competitive dynamics affecting the company: *“In order to issue accurate statements, you have to know the pulse of the business and have technical capabilities. There’s great value in understanding what’s happening.”*
- **The CFO must be able to speak with authority to the financial community.** When the CEO fields questions from the investment community about the company’s progress, he or she can refer questions to others, but *“when the Street talks to the CFO, he [or she] is the last word.”*
- **The CFO must be a “partner in growth.”** One member observed that *“the [merely] good CFO is a bean counter and controller. The great CFO enhances shareholder value.”* Members agreed that their own priorities for the CFO role depend on the role they are performing. Wearing an “audit committee hat,” one member said the primary objective is the integrity of the financial statements, and *“I don’t need to know if the CFO is growing the business.”* However, wearing a “board director hat,” this same member expects the CFO to partner with other senior executives to drive growth.

### The CFO as compliance expert

Since Sarbanes-Oxley, there’s been a general shift from strategic to compliance matters for many CFOs. Instead of spending more time on growing revenue and increasing cash flow, many CFOs find themselves managing the company’s complex efforts to comply with Sarbanes-Oxley.

Even though *“most of [the compliance work] rolls downhill to the controller or to internal audit,”* this shift in focus away from a more strategic role in the organization troubles many audit committee chairs. One member said, *“You heard about [the] CFO [becoming] more of a forecaster of risk, but since SOX 404 surfaced, [things have] moved backwards.”* Members identified many reasons why increased compliance responsibilities can have adverse effects on the finance organization and on the company as a whole:

- **Decreased CFO job satisfaction.** If the CFO is supposed to have a voluminous catalogue of technical and leadership skills, then the role should provide a good opportunity to use this full palette of abilities. But *“this [new role] is less helpful in driving the business. It’s not challenging intellectually.”*

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<sup>2</sup> Stewart Clements, “The Changing Role of the CFO,” *FAO Today*, September 2005. Available at <http://www.faotoday.com/Magazine.asp?artID=1079>.



*Accounting is supposed to be a subset of finance, [but the focus on it is] distancing CFOs from the things that they feel add value.”*

- **Less time for activities that might have a broader impact.** While regulatory compliance is important, a CFO with a well-rounded skill set can probably add even more value to a company by focusing on other issues. Focusing on compliance details *“creates a lot of stress between what he’s doing and what the CEO wants him to do – help the business grow; increase cash flow.”*
- **Employee turnover in the finance organization.** Not surprisingly, the changed focus and decreased job satisfaction are leading to *“a huge amount of turnover [in the finance organization].”* This challenge is especially acute when *“not a week ... goes by when our top finance people don’t get a call [from a headhunter].”*

Although members acknowledged the CFO must balance compliance responsibilities with more strategic priorities, they nonetheless feel it is important to have a CFO who has the skills to drive regulatory compliance.

### **Audit committees have a vested interest in a robust finance organization**

“CFOs today are more engaged with the board, as well as [with] the audit committee and its chair,” asserts a CFO at a large public company.<sup>3</sup> Audit committee chairs, for their part, are engaging not only with the CFO, but also with other finance professionals who give presentations at audit committee meetings. With so much interaction, audit chairs are in a great position to assess the quality and depth of the finance organization.

This much is clear to members: *“As audit committee chair, you have to understand bench strength.”* Members described how to get a feel for the finance organization:

- **Make sure the CFO is bringing people from finance to board and audit committee meetings.** Most members report having other finance staff at their meetings. One member’s CFO takes a very proactive approach: *“In terms of assessing talent, the CFO has other people present to the audit committee – the head of tax, the CAE [chief audit executive], controller. During a year, we see a presentation from each of them.”* One member pointed out that the problem with that method is that *“we know who the top team is, but we don’t go much below that.”* In other words, it is a great way to get to know the function’s leadership, but other methods are required to get a general sense of the culture and talent at lower levels in the organization.
- **Interact with finance staff in their “natural habitat.”** One member observed that *“everything looks very nice as a policy, but you wonder if it’s happening [in reality].”* Several members use routine visits to the finance team’s home turf to assess what’s happening and to get to know high-potential employees. One audit chair attends the finance organization’s annual meetings. *“You get a chance to get to know these people further down in the organization, both formally and informally... I can learn so much about the company, where the hot buttons are, what people are talking about.”*

<sup>3</sup> Ernst & Young and Tapestry Networks, “The CFO’s perspective,” 5.



- **Develop an understanding of finance leaders' personalities.** While it's important to evaluate current and future leaders' skills and experience on paper, it's at least as important to get a good feel for their personalities. One member observed, *"You never know if the CFO has [the ability to stand for important principles] unless you get close to a person – it doesn't have anything to do with their accounting skills."*
- **Understand the finance organization's composition and structure.** Finance professionals are often distributed throughout operating units, and few members said they had a clear view into "rolled-up" staffing levels. *"If you ask board members how many people are in each business unit, they know. But if you ask them how many are in finance, they don't."* A concise report or presentation – complete with staffing numbers, organizational structure, and geographic breakdown – could help the audit committee to better understand the priorities and resources of the finance function.

### Audit committees support the finance function in a wide variety of ways

There's a fine line between management and board oversight, but this shouldn't affect the board's ability to add value to the finance organization when it's appropriate. As one member stated, *"The CEO has a lot of things on his mind ... as far as giving suggestions, you can make a real contribution."* Another member feels the audit committee has *"carte blanche"* when it comes to making recommendations to improve the finance function.

Network members suggested supporting finance's ongoing improvement in the following ways:

- **Provide a private sounding board for the CFO.** *"One of my CFOs comes to me for advice – he knows we can have a private conversation,"* noted a member who has a trusting, confidential relationship with the CFO. While audit chairs may not have the expertise to advise the CFO on highly technical matters, CFOs may very well appreciate the chance to tap into the audit committee chair's experience and to *"bounce ideas off of someone."*
- **Use audit committee presentations as "teachable moments" to set the tone at the top.** The audit committee should set and communicate their expectations for thoroughness and professionalism. However, one member noted that providing constructive support and feedback is crucial, *"because word gets out [about how you treat them]."*
- **Allow the CFO to reach into the audit committee chair's own personal network.** There are many situations when the CFO needs to tap into resources the company just doesn't have, especially outside the company. When appropriate, the audit committee chair can facilitate connections to people in his or her personal network.
- **Provide a halo of credibility and authority to the finance organization.** This can be particularly helpful for an internal change requiring the CFO to "borrow" the board's credibility to get buy-in from executives around the company when finance is embarking on a particularly important (and perhaps contentious) initiative.



- **Encourage the spreading of accountability, so the CFO isn't overburdened.** *“Obviously [CFO] is a hard job, but accountability [should be] spread around. The burden should not be so onerous. You just can't put all that accountability on one person.”*
- **Acquire a good understanding of the succession planning process.** One member mentioned a good succession process: *“We get a report each year from HR, which gives us candid information on who we should be showering with love and affection ... maybe they [could be a leader] in three to four years.”* This process involves *“the whole organization,”* not just finance, which is key, because there's *“great value”* in letting high-potential finance professionals *“go out and do things that are exciting to them”* with hopes of bringing them back later on. *“It's very positive”* for up-and-coming potential leaders to see this happening.

The CFO has a responsibility to keep the audit committee engaged and to capitalize on the experience and commitment of its members. CFOs who take the initiative to keep the audit committee chair apprised of all material events and topics and who maintain a high degree of transparency regarding the finance organization gain the most from the audit committee.

## Conclusion

A strong and effective finance organization provides an audit chair with the resources and confidence she or he needs to carry out the audit committee charter in a fully effective manner. No audit committee can compensate for a weak finance organization. Because their interests are so intertwined, audit chairs and CFOs benefit from substantial and frequent interaction and mutual support. Arm's-length, perfunctory relationships do not work. Therefore, it behooves audit committee chairs to evaluate the depth of the finance organization and to play an active role supporting it.



## Appendix: Open-session discussion topics

In addition to discussing the audit committee's relationship with the finance organization, the network also discussed three shorter topics during an open session: audit fee negotiations, the challenge of having only four global audit firms, and the audit committee's relationship with general counsel. The discussion is summarized in this appendix.

### The audit committee's role in negotiating audit fees

Most members agree that the audit committee's role in negotiating audit fees should be limited. *"I get involved with the CFO [to understand] where they are, but I don't do any direct negotiations,"* explained one member, which summed up members' feelings well.

Members agreed that their need for a comprehensive, independent audit sometimes conflicted with management's desire to contain costs. Consequently, members did not believe the audit committee should seek to minimize audit fees. The audit committee's perspective on the audit scope is often an important counterbalance to management's.

Members also pointed out that management can control some of the variables that impact audit cost: *"It's not just hourly rate; it's efficiency. Hourly rates are driven by the economy. Efficiency is driven by the people managing the process on both sides. That's where there's room [to reduce fees]."* If the audit committee has a perspective on how to maximize the effectiveness or efficiency of the audit, it should share those views with the CFO and the audit partner.

### The challenges posed by having only four global audit firms

When it comes to choosing or negotiating with an audit firm, members need to be aware of the unique challenges for large companies in an environment in which there are only four global firms left standing. One member voiced concern, noting that *"most companies deal with more than one firm. If we have to move to another firm, have we kept our powder dry?"* [i.e., is there at least one firm that would not be disqualified from serving as our auditor due to its involvement in providing other professional services?] *I want to make sure there are two firms we can talk to."* Other members agreed that *"keeping the powder dry"* was important, and they had varying processes and checks to deal with the issue. *"On our audit committee, we do a test to see if we have an emergency firm,"* one member reported. Another admitted that, at one point in the past, his company had been working with all four firms in some capacity. Added to this challenge is the fact that *"you may even be deselected by the firm auditing you,"* which is an issue that has affected some smaller public companies.



## General counsel: a resource for the audit committee

A strong relationship with corporate counsel can be critical to the audit committee's effectiveness. Members mentioned several ways that general counsel works with the audit committee, including:

- **Agenda review.** Several attendees involve general counsel in agenda development. *"It's not uncommon for [general counsel] to add something"* in the course of review, recounted one member. Another relies on general counsel, as keeper of all the board's charters, to review agendas *"to make sure they're consistent with our charter."*
- **Review of Sarbanes-Oxley-related compliance documents.** General counsel often manages disclosure requirements. As such, *"general counsel should see all the [related disclosures]."*
- **Attendance at key meetings.** One member's audit committee convenes regularly to discuss things *"that were bothering audit committee members ... we have people who are knowledgeable present to the audit committee. General counsel sits in on [these meetings]."*
- **Monitoring of the fraud reporting structure.** *"General counsel monitors our fraud line,"* one member said. The overwhelming majority of the calls to the fraud line are HR-related complaints and issues, but general counsel monitors it to be sure that any whistleblower-type complaints get forwarded to the audit committee.
- **A "second set of eyes" on financial matters.** One member *"pushed to have general counsel and finance closer together ... general counsel sees things from a different perspective."*

*The views expressed in this document represent those of the Mid-Atlantic Audit Committee Network. They do not reflect the views 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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