



The audit committee's relationship with the finance organization

Introduction

The North Central Audit Committee Network¹ (NC ACN) met on February 22, 2007, to discuss the relationship between the audit committee and the finance organization, including the changing role of the CFO and the challenges and opportunities inherent in assessing the finance organization. The members of the network present at the meeting, who sit on the boards of 16 large-, mid-, and small-cap public companies between them, were:

- Dave Dillon, Audit Committee Chair, Convergys Corporation
- Bill Lawrence, Audit Committee Chair, Ferro Corporation
- Dave McCammon, Audit Committee Chair, Pulte Homes
- Mike Monahan, Audit Committee Chair, CMS Energy
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Paul Smith, Audit Committee Chair, Constellation Brands
- Bill Smithburg, Audit Committee Chair, Corning
- Gary Valade, Audit Committee Chair, Wabtec Corporation

Other participants in the meeting included:

- Frank Gori, North Central Area Managing Partner, Audit and Advisory Business Services, Ernst & Young
- Al Paulus, Senior Client Service Partner, 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.

¹ The North Central Audit Committee Network is a select group of audit committee chairs 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.

VantagePoint 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 *VantagePoint* lies in its power 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, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.



Executive summary

The network's discussion revolved around several important points, summarized below and expanded upon in subsequent pages:

- **CFOs face increasing pressure and scrutiny** (*page 2*)

Members feel that since the enactment of Sarbanes-Oxley, the responsibilities of the CFO have increased, with substantial time required for compliance and control issues, making the job less fulfilling. CFOs also face increasing pressure from external stakeholders, adding to their stress and contributing to increasing turnover.

- **The audit committee can support and enhance the finance function** (*pages 2-3*)

The audit committee can support the finance organization by helping to ensure the internal strength of the organization, setting the appropriate tone on compliance, and facilitating dialogue between the finance organization and internal and external audit stakeholders.

- **Audit committees benefit from a robust relationship with the finance function** (*pages 3-5*)

Members agreed that a deeper relationship with the finance organization benefits not only the finance organization, but the audit committee too. With improved communication, the audit committee can understand critical areas of accounting judgment better, and it gains better insight into the quality and depth of the finance organization.

CFOs face increasing pressure and scrutiny

Network members noted that Sarbanes-Oxley and a variety of other factors have increased both the burden on CFOs and the need for interaction between the audit committee and the finance organization. The increasing workload with an additional focus on compliance and controls, combined with greater transparency and scrutiny, has led to diminished job satisfaction and increased turnover among CFOs. At least 12 CFOs of Fortune 50 companies left their jobs in 2006.² While CFOs are often considered CEOs-in-waiting, "The mounting regulatory weight is forcing CFOs to focus on spreadsheets and audits just as many had begun to broaden their horizons beyond finance alone ... Their hopes of transcending the numbers are increasingly tempered by having to be intimately involved in how financial performance is measured, recorded and reported."³

Network members recognize that the increasing pressure on CFOs has changed the nature of the job. As one network member put it, "*It's not fun [being a CFO] anymore.*" Another added, "*CFOs have always been under the gun, but there are more guys shooting these days.*" At present, CFOs are not only responsible for oversight of the finance organization, strategy and external communication with the investment community, but also for compliance and controls and the required formal certification of

² Telis Demos, "Doesn't anyone want to be a CFO anymore?" *Fortune*, January 22, 2007. Available at http://money.cnn.com/2007/01/22/magazines/fortune/CFO_nopain.fortune/index.htm?postversion=2007012212.

³ Stephen Taub, "The toughest job in corporate America," *Institutional Investor*, February 7, 2007. Available at <http://www.iimagazine.com/Popups/PrintArticle.aspx?ArticleID=1234215>. [Doesn't require a subscription; I was able to access it.]



financials. This pressure can “cascade down so that [other] people within the finance organization will be troubled, if not depleted.” To reduce the pressure on the CFO, some companies have spread some of the burden of compliance and other day-to-day accounting functions to the controller or internal audit, but one member said, “you can share the workload, but you can’t share [the] responsibility,” which still ultimately belongs to the CFO, particularly in an environment where CFOs are expected to respond to internal and external inquiries with intimate knowledge of the issue at hand.

The audit committee can support and enhance the finance function

A strong, trustworthy finance function is crucial to the work of the audit committee. Audit committees can help ease some of the pressures on the finance organization and act as an important intermediary between the finance function and internal and external audit stakeholders. The audit committee can also play a role in helping to ensure the strength of the finance organization, thereby providing mutual benefit.

- **Ensuring the internal strength of the organization.** The audit committee can advise the finance organization and ensure that there is a sufficient focus on career development and succession planning. There were 2,301 CFO changes at public companies in 2006, with twice as many replaced by someone from outside the company as were replaced from within.⁴ Several network members said they have played an active part in finding a replacement CFO, a process that is less disruptive if an internal successor has been identified. One member stated, “Many new CFOs are coming from outside the organization,” a fact that signals that the company should reexamine how it is developing its junior people. Another member observed, “The career development mind-set is often lacking.” This member pointed out that good internal development is “a way to mitigate the risk of turnover.” A member who is currently involved in a search for a new CFO emphasized how hard it is to find candidates with the appropriate skill set: “We are already four months behind in the search ... [with only] two viable candidates after [many] months of searching.” Another member reported monitoring the organization to be sure people in the finance organization are getting exposure to different parts of the company for their own development, and another stressed the importance of having strong finance people in the field: “You have to have people out there that are really skilled.”
- **Setting the right tone on compliance.** The audit committee should be conscious of the pressure being placed on the finance organization and endeavor not to contribute to unnecessary stress. One member witnessed the impact the audit committee can have if they become overzealous in dealing with the finance organization on compliance issues: “The way [the audit committee] was pursuing 404, with the rigid, micromanaging approach they took, caused some people in the finance organization to say, ‘I may not want to be in this job.’” By setting the right tone on compliance issues, the audit committee can also help ensure that negative pressures don’t “permeate to [more junior] people [who are] no longer aspiring to the [CFO] job.”

⁴ Stephen Taub, “CFO turnover up 50 percent,” *CFO.com*, August 24, 2006. Available at http://www.cfo.com/article.cfm/7849155/c_7849253?f=TodayInFinance082506_h.



- **Acting as a facilitator.** The audit committee can help facilitate better communication among the CFO, controller, and internal and external audit. One network member commented on a case in which the external auditor and executives from the finance organization “*weren’t meshing well.*” The audit committee chair facilitated a joint meeting of the audit partner, the CFO, and the controller that ultimately resolved the problem. Another member’s audit committee outsourced some of the company’s Section 404 compliance work to another accounting firm to relieve some of the pressure on the finance staff.

Audit committees benefit from a robust relationship with the finance organization

Through formal and informal interactions, the audit committee can develop relationships with the finance organization that can improve communication and give the committee insight into the strengths and weaknesses of the organization and into key aspects of financial reporting. Although network members acknowledge the importance of developing relationships with key individuals within the finance organization, many are still at the stage of considering the best ways to build those relationships.

Strengthening communication through regular interaction

While members are conscious of the “bright line” between management and the board, they see direct interaction with the finance organization as essential to their role in monitoring and overseeing financial reporting. Members described varying levels of interaction with key personnel in the finance organization, but broadly agreed that more formal and informal interaction would be beneficial. Several members’ audit committees hold private sessions with the head of internal audit, controller, and CFO on a routine basis, partly so that it doesn’t seem unusual if those people need to request a meeting with the audit committee and so “*when an issue comes up, it doesn’t get magnified.*” Members who didn’t meet regularly with the controller in private sessions said they would consider doing so in the future.

Noting that informal conversation is an important part of interaction on the board of directors, network members suggested that it could be similarly effective in dealing with the finance organization. They stressed the benefits of informal ways of establishing communication with members of the finance organization. One member reported intentionally “*blow[ing] up the chain of authority*” so that the audit chair could speak to people independently and added that this access to the audit chair is “*an internal control.*” Several members said they have found ways to introduce themselves to the finance organization when they are assembled for a regular meeting, and one said he is considering “*a pizza lunch with the organization to say, ‘I’m available, here’s how you find me.’*” One network member who has fewer informal communications with the finance organization said, “*I’m impressed with the importance of informal dialogue with the CFO and others in the finance organization, and I need to focus on opportunities to do that.*” Frequency is also important; one member said, “*I don’t have a two-week period go by without hearing from the head of internal audit or the controller.*”



Understanding critical judgments and estimates

A network member stated, *“One major responsibility of the audit committee is to understand where estimates are being made and where they are coming from.”* Several members agreed that it was important to have the finance organization identify the most critical judgments and estimates, where they are being applied, how they impact the financials, and who is making them. One way to approach this is to have leaders from areas in which critical judgments and estimates are made present to the audit committee. That allows the audit committee to better understand the work being done, build confidence in the outcomes, and develop relationships with key people in the finance organization with whom they might not otherwise interact. It is a way to *“broaden the role of the audit committee [in] a non-threatening way.”* The audit committee should also have a strong enough relationship with the finance organization to be able to test the tone at the top by getting a sense for what kind of pressure management is placing on the finance organization to improve earnings.

The external auditor can also provide an assessment of the quality of accounting policies. One member asks the auditor to provide assessments of the most critical judgments individually because *“then you know, based on a benchmark [how conservative or aggressive the judgments are]. It helps educate the audit committee.”*

Evaluating the finance organization

Network members reported varying levels of involvement in assessing the quality and depth of the finance organization. Some provide feedback informally, based on their contacts with the finance organization throughout the year. In most cases, the audit committee gives the CEO feedback on the CFO and people *“two to three levels below the CFO.”* Most agreed that *“below that, there is only so much we can know.”* One member was asked by management to assess whether there was a suitable in-house successor for a departing CFO, and others also reported being involved in succession planning. Several members agreed that a complete assessment of the finance organization was often a full-board responsibility.

The external auditor can be a key source of insight into the quality of the finance organization. While internal audit often provides input into the audit committee’s evaluation of the finance organization beyond the top executives with whom committee members have regular contact, members emphasized the importance of having the external auditor provide regular feedback on a variety of functions and levels in the organization as well. External auditors have benchmark data *“that can serve as the basis of a non-threatening, more objective conversation”* between the audit committee and people in the finance function and can *“help the audit committee see what they don’t see”* deeper in the organization.

One point of agreement among several members was that they did not get much feedback on the treasury function and would appreciate additional input from the external auditor. The treasury function can be a significant source of judgment and risk if, for instance, the company is involved in significant hedging activities.



Members agree that a strong finance organization:

- Has a “passion for leadership”
- Makes a broad contribution to the company beyond financial reporting
- Proactively address strategic issues
- Understands that corporate strategy and risk are related
- Is respected by the CEO and other key operating executives
- Communicates well with external stakeholders and investors
- Recognizes and embraces transparency as a requirement for success

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. Members came away from this discussion with a clear sense that it is essential for audit committees, and audit committee chairs in particular, to find ways to have regular formal and informal interactions with key personnel in the finance organization. By doing so, audit committees can develop deeper relationships with the people they rely on for critical financial information, ensure the finance organization does not labor under undue stress, and better prepare both the audit committee and the finance organization to deal with situations when they arise. A robust relationship also allows the audit committee to better assess the quality and depth of the finance organization and plan for succession.

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