NORTH CENTRAL
AUDIT COMMITTEE NETWORK
VantagePoint

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# The changing face of the audit committee
# Section 404 update

## About this document

The North Central Audit Committee Network (NCACN) is a group of audit committee chairs from leading companies based in the Lake Erie and Ohio Valley regions. 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 by telephone on October 29, 2004, and it revolved around two central issues. First, members discussed the changing role of the audit committee, including new skills required and techniques for improving committee performance. Second, with four months having passed since the initial meeting, members wanted to continue the discussion of Section 404 they had begun at their first meeting in Cleveland on June 30, 2004.

This document reflects a synthesis of key issues arising from October's telephone meeting among members of the NCACN. 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 members, 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 more than 26 large-, mid-, and small-cap public companies between them, were:

- John Baily, Audit Committee Chair, Erie Indemnity Company
- Jim Boland, Audit Committee Chair, The Goodyear Tire & Rubber Company
- Michael Gellert, Audit Committee Chair, Humana
- Frank Gori, North Central Area Managing Partner, AABS, Ernst & Young
- Mike Losh, Audit Committee Chair, TRW Automotive
- Dave McCammon, Audit Committee Chair, Pulte Homes
- Mary Schiavo, Audit Committee Chair, Worthington Industries
- Bill Smithburg, Audit Committee Chair, Corning

*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.

# The changing face of the audit committee

## Executive summary

NCACN members focused their discussion on the changing role of the audit committee and the impact of this new role on committee composition and performance.

- **Overloaded committees want to focus more narrowly on operational oversight** *(Page 3)*

  New York Stock Exchange listing requirements specify an oversight role for the audit committee with regard to the corporate risk management effort, but many audit chairs said their committees have neither the time nor the capability to take on this role. Some members felt that the full board, not the audit committee, should have responsibility for risk management.

- **Financial expertise is highly valued** *(Pages 3-4)*

  Audit committees benefit from members who bring an analytical perspective to their role. While retired audit firm partners bring deep financial expertise, members said that operating executives also offer an important perspective to the committee.

- **Fair compensation is hard to determine** *(Page 4)*

  Network members agree that audit committee members should not be compensated differently from members of other board committees, but differ on the best way to compensate audit committee members for their increased workload.

- **Qualitative evaluation is seen as more effective than quantitative evaluation** *(Page 4-5)*

  Despite a plethora of quantitative tools for evaluating board and committee performance, members believe that qualitative processes are most effective. They also believe that in some cases informal evaluation processes may be as effective as formal processes.

## Introduction

Members recognized that their role has become increasingly complex, and the scope of their responsibilities has expanded. More frequent communication with external auditors and a more active relationship with internal auditors means the audit committee must make the best use of its limited time.

Members shared several ways in which their committees have been able to improve performance. Some of the methods include:

- Management presentations focused not on *"all the great things they are going to do,"* but instead on *"what keeps them up at night."*
- Asking the external auditor for feedback, since *"they have a lot of experience and a broader perspective."* Although constructive suggestions are helpful, audit committee chairs also take comfort when the auditor offers positive feedback.

- Earlier start times for audit committee meetings, in order to accommodate longer meetings prior to the full board meeting.

## Overloaded committees want to focus more narrowly on operational oversight

New York Stock Exchange listing requirements state, "While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled ... The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken."[1]

While some audit committees are taking a lead role in overseeing enterprise-wide risk management (ERM), others questioned whether their committees have the time and capability to oversee this activity effectively. One member said that following an ERM presentation from the internal auditor, *"We left the committee rather dazed. As we went into executive session we all had the same reaction – this was not our view of what the audit committee, or internal audit, should be doing."*

Many members agreed, stating that while internal audit and/or the audit committee may have an appetite for risk management, they often have neither the time nor the capability to handle it effectively. One audit chair said, *"Risk management, to the extent the term has any validity, is the role of the board and principal concern of management."* Several members reported that their companies have appointed senior executives to oversee risk management, and these executives report to the full board.

However, a few members felt it would be harder for the full board to deal with risk management than for the audit committee, in part because of the financial and analytical acumen present on audit committees, and in part because *"boards do their work through committees. If you want a substantive discussion, usually committees are the place to do it."*

In an environment where every decision is subject to scrutiny, an increasingly active role for the audit committee may be motivated by the *"fear that no matter what you do, someone will say you could have done more."* One member said that Sarbanes-Oxley has made it easier for corporate directors to step over the bright line between oversight and management, observing, *"Directors are people who want to take already crowded agendas and wade into topics."*

## Financial expertise is highly valued

While there is sometimes value in bringing a fresh perspective to the audit committee, one member said, *"As a chairman, I would rather have stability."* Members were opposed to formal term limits, preferring to maintain flexibility.

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[1] *Final NYSE Corporate Governance Rules* 303A.07(c)(iii)(D), Commentary, http://www.nyse.com/pdfs/finalcorpgovrules.pdf

Members noted that in forming the audit committee, only a subset of directors have the skills required under Sarbanes-Oxley and are also willing to accept the additional scrutiny associated with membership on the audit committee. Some members wondered whether it would be more difficult to recruit new members given increased liability concerns, but one member said that this had not been a barrier when his committee recently recruited two new board members with strong finance backgrounds.

With greater scrutiny now being placed on financial expertise, new audit committee members increasingly come from financial functions. Although the Audit Committee Leadership Network (ACLN) has said, "It would be a mistake if Sarbanes-Oxley led to audit committees and the board being dominated by former audit partners,"[2] several North Central members said an audit background was highly desirable. However, one member was concerned that the relationship between a retired audit partner and the audit firms could get awkward, especially if the company was to consider changing its external auditor.

Another member said that audit committee members with nonprofit or academic backgrounds tend to focus narrowly on compliance, while those who run companies are more *"practical"* in interpreting the role of the audit committee, and tend to *"ask questions that others might not ask."* Current or former CEOs are seen as especially good audit committee members, given that they also meet the financial expert test.

While members did not agree on the profile of an ideal audit committee member, there was, ironically, one point on which many members agreed: *"Nobody else wants to be chairman."*

## Fair compensation is hard to determine

When they met in September 2003, the ACLN "took the view that audit committee members could be compensated differently from their board colleagues based on the time they contributed, rather than on the role they performed."[3] North Central members agreed with this principle, and said that differentiating compensation based on roles is not helpful in fostering positive board interaction. There was also some question regarding what constituted differential compensation.

Audit committees often meet eight to ten times a year, while other committees meet only four times. As a result, members thought audit committee compensation should reflect this increased workload. Some members suggested that equity could be best achieved with per-meeting fees that are uniform across committees.[4] However, other members said phone calls and other responsibilities outside formal meetings have clouded the definition of a meeting, so that some companies have moved toward a flat fee arrangement.

## Qualitative evaluation is seen as more effective than quantitative evaluation

Members felt that committee self-evaluation forms were *"more and more becoming lawyer checklists,"* and they shared a general sense that it was not necessary to motivate members to take their role seriously, given that *"accountability feels pretty high right now."*

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[2] Audit Committee Leadership Network, *ViewPoints,* "Audit Committee Priorities and Performance," September 10, 2003: 2.

[3] Audit Committee Leadership Network, *ViewPoints,* "Audit Committee Priorities and Performance," September 10, 2003: 4.

[4] Leading board compensation experts have reported higher levels of meeting-based compensation in recent years.

While members generally discounted the value of quantitative rating scales used in self-evaluation surveys, they agreed that there is often valuable insight to be gained by discussing the unattributed written comments that are typically compiled and synthesized by the general counsel.

Despite the attention given to formal feedback mechanisms, several members felt that sometimes the most effective evaluations were informal. In contrast, members said performance issues can often be identified and addressed during informal discussions with other members.

### Conclusion

Audit committees are struggling to balance an expanding scope of responsibility against the capabilities and time required to fulfill their mandate. While the full board is ultimately responsible for overseeing the corporate risk management agenda, the audit committee is likely to play an expanding role in this effort. Audit committees will need to clearly define their role in overseeing regulatory compliance and enterprise-wide risk management, and then align committee memberships and operating procedures so that they are consistent with the requirements of these roles.

## Section 404 update

### Executive summary

At their June 30, 2004, meeting, North Central Audit Committee Network members were proud of the effort to date but were critical of Section 404, noting significant disruption with only nominal apparent value to shareholders. Four months later, members shared additional perspectives and noted that while the first Section 404 cycle is nearing its end, the story is far from over.

- **Disclosures likely in Q3, but limited market reaction expected** *(Page 6)*

  Members say large audit firms are sending status update letters to their clients; members feel that some companies may need to disclose the contents of these letters in their third quarter 10-Qs. However, they do not expect the market to react negatively to these disclosures.

- **Current-year uncertainty is undermining 2005 planning** *(Pages 6-7)*

  Although audit committees are devoting significant time to the current Section 404 cycle, uncertainty over regulator and auditor expectations has delayed planning for the next cycle. This may contribute to inefficient resource allocation in 2005.

While the benefits from Section 404 are still unclear, members agreed that relationships with audit firms have been positive and cooperative. One member said, *"If nothing else, the auditors are much more involved,"* claiming that the auditors had written their best management letter in 25 years. With management letters getting longer, members disagreed about whether they were well thought out or simply filled with boilerplate language.

## Disclosures likely in Q3, but limited market reaction expected

Members said their Section 404 effort is generally going well, and many reported that they expect to complete the process successfully by year-end. However, with regulators offering little guidance on specific compliance standards, Big Four audit firms have recently sent letters to their clients. These letters are intended to help a company's management and board determine its ability to fulfill Section 404 requirements. They also indicate whether any adjustments to the company's work schedule are necessary to meet the reporting deadline. Members report hearing anecdotally that only 20% of companies are receiving positive feedback, with another 65% falling into a broad category where the auditors are unable to provide assurance that the assessment and report on internal control over financial reporting will be completed by the filing deadline. Given the current status of their Section 404 activities, the remaining 15% of companies are unlikely to meet the SEC's requirements within the reporting deadlines.

Members generally agreed that audit committees should consult with legal counsel and their disclosure committees before deciding whether to disclose the contents of auditors' letters in their third-quarter 10-Qs, or wait until the 10-K to report internal control weaknesses that are not resolved by year-end.[5]

Regardless of timing, members did not feel the market would react negatively to Section 404 disclosures, given that there has been little reaction to date. One member was aware of a company issuing debt despite material weaknesses in their Section 404 compliance. The company's investment bankers were not concerned with the Section 404 status, requiring only that management disclose the issue with a discussion of remediation activities.

## Current-year uncertainty is undermining 2005 planning

Even though 2005 is fast approaching, members are not yet focused on next year, with one member asserting, *"The big job is right now."*

While members agreed it was difficult to predict the cost or time required next year, many concurred with the member who said, *"I don't see any reason it should be more difficult next year."* It remains to be seen whether this is a one-time event, with companies getting back to "business as usual" in 2005, or whether this year reflects a long-term structural shift in the cost of both internal and external audit. Given a wide range of estimates, audit chairs are taking a wait-and-see approach, with one member saying, *"I'm not sure how to evaluate either of those extremes."*

Because of the uncertainty around the current Section 404 cycle, companies have not been able to accurately budget the time or resources required during the next cycle. Some companies are likely to over-budget, setting aside resources that could have been used more productively elsewhere in the business. Others will under-budget and find themselves paying a premium for additional resources required next year. Either way, the uncertainty will lead to inefficient resource allocation during the coming year.

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[5] For more information, consult *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions*, Securities and Exchange Commission, October 6, 2004, http://www.sec.gov/info/accountants/controlfaq1004.htm.

Over the longer term, audit committees may need to adjust their goals if internal controls continue to occupy a sizeable portion of the audit committee's time and attention. As one member said, *"audit committees are focused almost solely on this topic. [Strategy] is taking a back seat right now."*

## Conclusion

Although a new analytical framework[6] developed by representatives of nine audit firms and a professor at Georgia State University may help to provide direction around exceptions and deficiencies, members felt the Section 404 work to date had been completed without clear guidance from regulators or auditors.

Looking into the future, members recognize that while the first Section 404 cycle is nearing its end, the story is far from over. As one member observed, *"There are still several chapters to be written."*

*The views expressed in this document represent those of the North Central Audit Committee Network, a 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. 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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[6] *A Framework for Evaluating Process/Transaction-Level Exceptions and Deficiencies*, Version 1, October 28, 2004, http://www.aicpa.org/cpcaf/download/framework.pdf