



Evaluating the CFO and the finance organization

The future of internal audit

Introduction

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Pacific Southwest region of the United States. The network held its fourth meeting on June 15, 2006, to discuss two topics: “Evaluating the CFO and the finance organization” and “The future of internal audit.” This document is a synthesis of insights and comments from that meeting.

In addition, members raised other matters in an unreported open session, including the backdating of stock options, differential compensation for audit committee chairs and members, and the merits of sub-certification as part of Sarbanes-Oxley’s Section 302 certification process.

Collectively, members of the network sit on the boards of approximately 28 large-, mid-, and small-cap public companies. Members who attended the meeting were:

- Frank Biondi, Audit Committee Chair, Amgen
- Ray Dittamore, Audit Committee Chair, Invitrogen Corporation
- David Engelman, Audit Committee Chair, Fleetwood Enterprises
- George Farinsky, Audit Committee Chair, Broadcom Corporation
- Mike Murphy, Audit Committee Chair, Jack in the Box

Also attending the meeting:

- Peter Griffith, Pacific Southwest Area Managing Partner, Ernst & Young
- Bruce Stump, Pacific Southwest Area Senior Client Service Partner, Ernst & Young

In addition, network members who were unable to attend the meeting, but participated in private discussions with Tapestry Networks prior to the meeting included:

- Diana Laing, Audit Committee Chair, The Macerich Company
- Vic Lund, Audit Committee Chair, Borders Group
- Marty Melone, Audit Committee Chair, Countrywide Financial Corporation

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. Network members’ remarks appear in italicized quotes. *VantagePoint* also includes select comments and perspectives that emerged from pre-meeting discussions with members.



Executive summary

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

- **The evolution and evaluation of the CFO** (*pages 2-4*)

In general, audit chairs said their CFOs appear satisfied with their jobs and are not unduly burdened by compliance issues. They report that CFOs are broadening their skills, as the pendulum shifts back from the capital markets orientation of the early 2000s, towards more focus on controllership, financial reporting, and audit committee relationships. CFOs have learned to delegate the compliance work associated with Sarbanes-Oxley and focus more on managing the finance function and developing bench strength.

Currently, audit committees evaluate a CFO's performance informally, often by invitation from the CEO or the chair of the compensation committee. However, several members predicted there would be greater formal involvement in both goal setting and performance review in the future.

- **Assessing the strength of the finance organization** (*page 5*)

Audit committee chairs are more involved in assessing the wider finance organization than in evaluating the CFO. Audit committees are taking a closer look at the depth of talent inside finance organizations and are inviting a wider range of finance staff to their meetings. This exposure to individuals deeper inside the finance organization helps identify rising stars in the function and enables the audit committee to assess bench strength accordingly.

- **The future of internal audit** (*pages 5-8*)

Internal audit is less consumed with Section 404 compliance work than it was a year ago and is now trying to migrate back to conducting more financial and operational audits. Audit chairs report their companies are adding staff to the internal audit function, and several are using "guest auditors" (finance staff who can conduct internal audits in other parts of the business than their own). Members believe the head of internal audit should be a specialized career position, but there is mixed opinion about whether the same should be true of other positions in the function, with some members advocating the rotation of high-potential employees through the function.

Audit committee chairs are not convinced that internal audit should play a lead role in enterprise risk management (ERM) efforts, but they do acknowledge that internal audit should have a seat at the table in risk discussions. Audit committee chairs also recognized their responsibility to help ensure the objectivity of the function.

The evolution and evaluation of the CFO

At the end of last year, *InSights* surveyed CFOs of large public companies and reported that within their organizations, the burden of Sarbanes-Oxley-related compliance was falling primarily on the controller and



on internal audit. However, interviewees also felt the CFO position had become increasingly less attractive due to the heightened scrutiny, pressure, and responsibility involved.¹

Most members feel that the CFOs of the companies on whose boards they serve are relatively happy in their jobs and are highly involved in the business. One member expressed surprise at *InSights*' report of CFO unhappiness and attributed part of it to the timing of the research: *"If you occupied that role at the beginning of [Section] 404, you would be stressed."* Members agreed that Section 404 was less of an issue for CFOs in the second year.

Speaking prior to the meeting, one audit chair said, *"The skill set has changed: the CFO can't just be a capital markets person anymore."* However, members broadly discounted the assertion that before Sarbanes-Oxley, CFOs were primarily capital markets specialists. One member said, *"I was a CFO for [many] years and never had the luxury of just dealing with capital markets. Our CFO is a very strong adviser to the CEO."*

When the Audit Committee Leadership Network discussed the same topic in January, *ViewPoints* reported, "Network members agree that the CFO's role has had to change in the wake of Sarbanes-Oxley, with the CFO becoming more of a leader in developing the bench strength of the wider finance organization."²

Pacific Southwest audit chairs agree that CFOs have taken on more of a management role by successfully delegating much of the Section 404 compliance work. One member outlined his CFO's broad responsibilities: *"The CFO did not feel the heat of Sarbanes-Oxley; that was handled by the controller and internal audit. The CFO handles finance, banking relationships, [and] investor relations, while the controllers handle the accounting and compliance load."*

When asked what attributes make for a strong CFO, another member commented, *"It is about knowing your business and being somebody who understands the people and resources he or she will need three to five years from now."* Additionally, members had a high regard for non-finance-related skills, such as team building, planning, and establishing and maintaining working partnerships with business unit heads.

However, there was an acknowledgment that the role has not necessarily changed for the better. One audit chair framed the current challenges of the CFO's job, and in particular the concerns brought about by Section 302 certifications: *"The scope has now changed. It now has a 100% downside potential."*

Succession planning

Members of the Audit Committee Leadership Network expected their CFO to be able to step into the top leadership role of CEO. As one audit chair noted, "Most CFOs are natural candidates to be considered for CEO. The great CFOs have the skills to be a CEO."³

¹ "The CFO's perspective," *InSights*, December 22, 2005. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Dec05_InSights.pdf

² Audit Committee Leadership Network, "Evaluating the CFO and the finance organization," *ViewPoints*, January 20, 2006, 2. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Jan06_View11.pdf

³ *Ibid.*, 4.



Clearly, a CFO's ability to broaden his or her skill set beyond finance influences audit committee chairs' opinion on whether the CFO could be a possible CEO successor. One Pacific Southwest member gave an unequivocally strong assessment of his CFO's possibilities: *"He delegates well and hires well. It's much more of a management job ... He will be a serious candidate for CEO."*

Other audit chairs indicated they would try to foster up-and-coming talent by *"moving [them] quickly through an accounting/controller role. We want to move them to operations."* The desire to rotate rising stars through the company reinforces members' view that a well-rounded CFO is better prepared to succeed the CEO. However, not all members feel their CFOs are natural candidates for the top position, either because they may lack the requisite operational experience, or because the CFO would prefer to focus on finance.

CFO evaluations

According to *InSights*, "Many CFOs say their performance is ultimately evaluated based on their relationship with the CEO and on the company's financial results. The audit committee rarely plays more than a marginal role in assessing the CFO's performance, but this may evolve over time."⁴

However, the majority of members do contribute to the CFO's performance review, with varying degrees of formality. One member, speaking before the meeting, said his committee conducts an in-depth review of the entire executive team, including the CFO. Another audit committee chair receives feedback from both internal and external auditors about the CFO in the executive session after each committee meeting.

Members often work with their CEOs or compensation committee chairs informally to review CFOs' strengths and weaknesses. As one member said, *"I offer no audit committee perspective, only a personal perspective."* Nevertheless, one member stressed that his audit committee *"has a clear idea if the CFO is doing a good job,"* but was concerned that *"we don't have a sense of how he is developing his team."*

Several members predicted there would be greater formal involvement in both goal setting and performance review in the future. One member felt that *"audit committee chairs will be more involved than they were previously. Before it was just a void."*

However, another member felt that evaluations for Section 16 officers should remain within the compensation committee: *"Why have a compensation committee at all, if you are going to do this from an audit committee?"*

Sometimes when the audit chair is a sitting or former CFO, he or she may adopt the role of mentor for the CFO. One member reported having an *"informal and anecdotal"* relationship with the CFO in which the member regularly discusses the CFO's time allocation and how the role might evolve. This audit chair also spends time with other members of the company's finance organization to assess bench strength.

⁴ "The CFO's perspective," 8-9.



Assessing the strength of the finance organization

CFOs who participated in the *InSights* research reported a range of practices at their companies to help the audit committee gauge the skills of finance staff below the CFO and controller level. Broadly speaking, all these practices foster regular interaction between junior finance staff and audit committee members, in both formal and informal settings.⁵

Audit committee chairs are more involved in assessing the wider finance organization than in evaluating the CFO. While responses varied across companies, there was overall agreement that a wider range of finance staff were attending audit committee meetings and that a greater transparency exists regarding people and activities at the deeper levels of the finance organization.

Members reported using the following practices for assessing the strength of the finance organization:

- **Members of the finance organization are invited to audit committee meetings.** One member highlighted the change: *“What is more prevalent today is the audit committee bringing in people they didn’t [invite] before, such as tax and IT, to quarterly meetings.”* Another member said of his audit committee’s focus, *“A good portion of the meeting is dealing with people issues.”*
- **Audit chairs seek the external auditors’ input** to determine the staff’s strengths and weaknesses, a practice that gives one member’s audit committee *“a good sense”* of the personnel under the CFO.
- **Some audit chairs have access to the company’s peer review process.** *“We do 360-degree reviews twice a year, so you get a good handle on the pipeline weakness. We also get a good view of what internal people think of folks.”* In addition to the peer review, this audit chair has conversations with the CEO and gets staff feedback on an “exception” basis: *“Who is a ‘comer?’ Who needs help?”*
- **Other audit chairs attend offsite finance organization meetings.** One member attends a finance meeting every year and takes a half hour to brief the staff on what the audit committee is doing. While another member worried that attending offsite meetings could *“confuse the troops”* about who is the boss, a third audit chair responded that *“management has been encouraging us to do this.”*

The future of internal audit

According to the *Final NYSE Corporate Governance Rules*, companies listed on the New York Stock Exchange (NYSE) “must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control.”⁶ However, companies have significant latitude in meeting this regulatory requirement.

While all internal audit groups deliver a mix of assurance and compliance-related services, there is far less uniformity in the choice of additional value-added services related to risk management or operational improvement. Senior management or the audit committee can decide that the function should deliver each of these services in the same way as the baseline services, in a different way, or not deliver them at all.

⁵ Ibid., 6.

⁶ New York Stock Exchange, *Final NYSE Corporate Governance Rules*, 13. Available for review at: <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>



The impact of Section 404

In order to meet the requirements of Section 404 during 2004 and 2005, many companies enlisted internal audit's support, diverting this group from other planned activities. Internal audit professionals generally thought this would be a temporary shift.⁷

Now, as Section 404 moves into its second and third year, audit chairs are eager to see internal audit return to a pre-Section 404 focus. One member commented, *"We had a three-year internal audit plan that was interrupted by Section 404. Most of the interruptions affected operations audits. Now we are moving back to an operations focus."*

However, Section 404 has not disappeared from the finance organization's radar, and one member wants to see internal audit move up the experience curve: *"[Internal audit has] spent too many hours into year two of Section 404 [work]. If they don't pull back, then the organization hasn't 'baked in' the lessons of Section 404."*

Resourcing the internal audit function

Members believe the head of internal audit should be a specialized career position, but there is mixed opinion about whether the same should be true of other positions in the function. One member said, *"We encourage others to rotate, but the top three [senior staff] are career internal audit folks."* Rotation can work in both directions. Another member revealed, *"A statement of quality is the business unit people requesting internal audit people for their staffs."*

Management has to contend with the fact that the employment market for internal auditors is strong, and many audit committee chairs worry about their companies' ability to retain good internal auditors. One member confirmed this by stating before the meeting that *"it used to be a boneyard, but now [internal auditors] are impossible to find and impossible to keep."*

Members say their companies are increasing internal audit staff. One member said, *"[The audit committee wants] the tone from the top. When we talk about staffing for internal audit, I want the CEO on our side."* Other ways to increase resources include:

- **Using guest auditors from within the company** for the Sarbanes-Oxley work. This frees up internal audit to focus more on operational issues. One member said the guest auditor program offered additional benefits by *"providing a window into the larger organization and training a lot of people in the audit function."*
- **Outsourcing some or all internal audit work to third parties, such as independent audit firms.** According to one member, *"We have outsourced the IT audit function and then supplemented the internal audit [function] with people on the outside."* However, one audit committee chair said, *"when you outsource, you lose all the training value."*

⁷ For example, in May 2004, one corporate audit executive described 2004 as the "Year of Finance." Eighteen months later, this executive reported, "We did return to a more traditional role for the company, however [Sarbanes-Oxley] is still an important part of our overall work. The biggest surprise of '05 is the cleanup required on the non-SOX processes. We are actually having to spend time on these areas even though they have very little material risk to the company, because no one wants any surprise adjustments."



Internal audit and enterprise risk management

When members of the North Central Audit Committee Network discussed internal audit's role in the management of enterprise-wide risk, *VantagePoint* reported, "Some members worry about a lack of focus and wonder whether a broader scope will distract internal auditors from delivering on their core mission."⁸

This skepticism was echoed in the Pacific Southwest network. One member said, "*Some don't want internal audit there. We will outsource [the ERM job]. It saves the company from hiring a specialized role.*" However, members felt it was important for the internal audit function to be involved in the risk management process and to conduct risk-based audits. According to one member, internal audit "*will have a seat at the table*" in risk discussions.

Ensuring internal audit objectivity

NYSE listing requirements include a specific reference to internal audit: "The audit committee must have a written charter that addresses the committee's purpose – which, at minimum, must be to assist board oversight of ... the performance of the company's internal audit function."⁹

Audit committee chairs are aware of their responsibility to help protect the head of internal audit and ensure the objectivity of the function. Members understand that the head of internal audit is in a sensitive position and could potentially present findings counter to what senior management wants to hear. So how can audit committees ensure they are getting unfiltered reports from the head of internal audit?

The answer, in part, has to do with reporting lines and organizational structures. Audit committees need to be aware of a potential conflict of interest before a problem occurs. One member said, "*Years ago, internal audit reported to the treasurer. We didn't like that. We talked to external audit [about solutions] and offered the CEO the option of internal audit reporting to him or the general counsel.*" The member went on to say that the reporting line was established with the CEO.

Indeed, most network members stated that the head of internal audit reports to the audit committee chair, but there is also a dotted, or administrative, line of communication to a member of management. In most cases that executive is the CFO, but in several cases members involve the general counsel as the administrative report.

- **Dotted line to the CFO.** Prior to the meeting, one member said internal audit "*theoretically*" reports to the audit chair, but actually reports to the CFO. Another member said, "*There is no problem [reporting to the CFO], as long as there is oversight.*"
- **Dotted line to the general counsel.** A third member said the head of internal audit reports to the general counsel to keep the function completely independent of financial management. When an internal audit issue arose in the legal department, the work was outsourced to a law firm to avoid any conflict of interest.

⁸ North Central Audit Committee Network, "The future of internal audit," *VantagePoint*, January 6, 2006, 5. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_NCentral_ACN_Jan06.pdf

⁹ New York Stock Exchange, *Final NYSE Corporate Governance Rules*, 10.



Members also report that they are formally involved in the evaluation of the head of internal audit. Several members conduct a programmatic review of internal audit's work. One member described the process: *"I see the internal audit evaluations and outside reports prepared by the CFO. I also have a one-on-one with the internal audit head."*

Most of the members said they were not aware of their internal audit function conducting self-evaluations, but they were interested in finding ways to encourage that practice, perhaps in conjunction with practices developed by the Institute of Internal Auditors (IIA). The IIA also suggests that external assessments should be conducted at least once every five years by a qualified, independent reviewer. Reviewers can include audit firms, as long as there are no independence issues.

Conclusion

While audit chairs are involved in helping set the direction for the internal audit function, ensuring its objectivity, obtaining necessary resources, and evaluating the head of the function, they are not yet playing a similar role for the CFO and the finance organization (except, perhaps, in some rare cases where as a current or former CFO, they can provide a mentoring relationship). Instead, the CFO is primarily evaluated by the CEO, with occasional input from the compensation committee.

Yet audit chairs know that if management's override of internal controls is to be avoided and good tone at the top established, the behavior of the CFO is critical. The emerging trend for more, and more formal, involvement in setting the goals and evaluating the performance of the CFO will provide audit committee chairs with the comfort of knowing that they can both influence, and provide oversight of, the tone at the top of the company.

About this document

The Pacific Southwest Audit Committee 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 this document 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.

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