



Lessons for audit committees from high-profile accounting scandals

Introduction

The Southeast Audit Committee Network held its seventh meeting on May 17, 2007, to discuss lessons for audit committees from high-profile accounting scandals. On the fifth anniversary of Sarbanes-Oxley being signed into law, members discussed how legislation and regulation have either increased or decreased shareholder value and identified the leading practices that have emerged for audit committees. This document is a synthesis of insights and comments from the meeting.

Members also identified and discussed in a private session other issues they are currently dealing with, including the relationship with the compensation committee in the wake of completing the Securities and Exchange Commission's new Compensation Disclosure and Analysis (CD&A) requirement. Emerging best practices include either holding a joint meeting of the audit and compensation committees or, for smaller boards, a meeting of the full board, to review the disclosures; extending the review of internal controls to cover the CD&A process; having internal audit verify the numbers and report back to the audit committee; and asking the external auditor to extend their procedures to the calculations and formulas used in the compensation tables to assure the audit committee that no adjustments were made that would increase bonuses for senior executives.

Collectively, members of the network in attendance at the May meeting sit on the boards of more than 25 large-, mid-, and small-cap public companies. Audit committee chairs attending were:

- Denny Beresford, Audit Committee Chair, Kimberly-Clark and Legg Mason
- Kerm Campbell, Audit Committee Chair, SPX
- John Farrell, Audit Committee Chair, Fidelity National Financial
- Renée Hornbaker, Audit Committee Chair, Eastman Chemical
- Doug Ivester, Audit Committee Chair, SunTrust Bank
- Donna James, Audit Committee Chair, Coca-Cola Enterprises
- Warren Jobe, Audit Committee Chair, Wellpoint
- Dean O'Hare, Audit Committee Chair, Fluor Corporation
- Dave Rickard, Audit Committee Chair, Harris Corporation
- Peter Wood, former Audit Committee Chair, Eastman Chemical

Also attending the meeting were:

- Edwin Bennett, Southeast Area AABS Managing Partner, Ernst & Young
- Tom Hough, Vice Chairman and Southeast Area Managing Partner, Ernst & Young

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Executive summary

High-profile accounting scandals in the early 2000s brought to light a number of reporting deficiencies sufficient to destroy hundreds of billions of dollars of market capitalization. The fact that these deficiencies went seemingly unchecked by audit committees has served as a lesson to all audit committee chairs.

Prior to the Southeast Audit Committee Network meeting, members reviewed short case studies on Enron, WorldCom, and Royal Ahold. During the meeting itself, members reflected on how the role of the audit committee has evolved and how its key relationships have been transformed over the last five years since the signing into law of Sarbanes-Oxley. The lessons drawn from the scandals are highlighted below, with more detailed discussion on the following pages:

- **Curious audit committee members make for an effective audit committee** *(page 3)*

While Sarbanes-Oxley strengthened requirements for financial expertise on audit committees, members agreed that curiosity is an even more important characteristic of an effective audit committee member. In addition, audit chairs believe that external information – from audit firms, equity analysts, D&O insurers and others – provides good context for judging the company’s performance against its competitors and can raise red flags that might otherwise get missed.

- **Audit committees must balance compliance with more strategic activities** *(page 5)*

Audit committees, and boards in general, have become more focused on compliance activities in the wake of the accounting scandals. Members are ready and willing to swing back to more value-added guidance roles, while still maintaining their roles as overseers of compliance activity.

- **Internal control discipline adds to shareholder value** *(page 6)*

Many groups have spoken out recently about the problems of complying with the regulatory guidelines associated with Sarbanes-Oxley’s internal control reporting requirements. However, network members believe that the discipline that compliance entails is absolutely essential for quality financial statements and that it has added to shareholder value. Members asserted that tone at the top is the key ingredient for internal control discipline.

- **The audit chair should approach internal and external audit plans differently** *(page 6)*

Post-Sarbanes-Oxley, internal audit is starting to focus on areas outside of Section 404 compliance, while external auditors are expected to provide an essential expert’s opinion on financial statements and internal controls. Therefore, members agree that they need to be more involved in the details of the internal audit plan and that they must have a firm grasp on the scope of the external audit, the level of the resources deployed, and the subsequent fees.



Members were asked: What changes made over the last five years have had the most positive impact on shareholder value?

- Increased sensitivity on the part of the board, audit committee, management, and internal auditors to the importance of quality financial statements
- Improved accountability of the CEO and CFO through the attestation process
- Creation of an explicit reporting relationship between the external auditor and the audit committee
- Increased focus on internal controls throughout the company, with resources to match
- Institution of protections for whistleblowers and the availability and rigor of ethics hotlines

Which changes have had the most negative impact on shareholder value?

- The perception of an increasingly regulatory mind-set at the SEC, which could undermine the competitiveness of U.S. capital markets and smaller companies in particular
- High-powered CEOs spending more time on compliance activities, rather than on growing earnings
- Increased paranoia and concern over compliance trivia, which has distracted boards, audit committees, and management from corporate strategy – “*When do we to do the real work?*” – and led to longer and more numerous audit committee meetings

Curious audit committee members make for an effective audit committee

The accounting scandals certainly raised the question, “What makes a good audit committee?” Sarbanes-Oxley stipulates that audit committees must have at least one “financial expert” with a minimum, defined level of financial expertise.¹ In practice, results vary widely. According to a November 2006 global study by Ernst and Young, 69% of audit committees have two or more financial experts.² However, another 2006 global study of listed companies showed that “37% of audit committee financial experts appeared to have neither an accounting nor finance background.”³ Audit chairs have expressed their own view that the definition of financial expert is too liberal. While preparing for the recent Audit Committee Leadership Summit, one audit chair said a lack of deep technical expertise meant, “I am a financial expert [according to the SEC definition], and I don’t believe I am.”⁴

¹ SOX Section 407 requires that a financial expert have (1) an understanding of generally accepted accounting principles and financial statements; (2) experience in both (A) the preparation or auditing of financial statements of generally comparable issuers and (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves; (3) experience with internal accounting controls; and (4) an understanding of audit committee functions.

² Ernst & Young, *Audit Committee Perspectives: 2006 Audit Committee Survey and Industry Insights* (New York: Ernst & Young, 2007), 40. Available at [www.ey.com/global/download.nsf/Luxembourg_E/Audit_Committee_Perspectives_06/\\$file/EY_Audit_Committee_Perspectives%202006.pdf](http://www.ey.com/global/download.nsf/Luxembourg_E/Audit_Committee_Perspectives_06/$file/EY_Audit_Committee_Perspectives%202006.pdf).

³ Huron Consulting Group, *2006 Audit Committee Research Report* (Chicago: Huron Consulting Group, 2006), 4. Available at www.huronconsultinggroup.com/uploadedFiles/Huron_AuditCommReport%20Email%20Version.pdf.

⁴ For more information on the summit, see http://www.tapestrynetworks.com/networks/net_audit_summit.html.



While members generally agree that the financial-expert requirement has been good for audit committees, they identified an even more important trait shared by the best audit committee members: *“The most important thing for an audit committee member is to have a curious mind with an understanding of finance. You could have a CPA who’s incurious, and that would be a disaster. You could also have a CEO who knows how a balance sheet is put together, and he or she could ask good questions.”* So, members view curiosity – leavened with financial literacy – as the key ingredient in an effective committee member.

Financial expertise is only part of the equation

To enhance the overall inquisitiveness of the audit committee, members recommended not relying strictly on financial expertise as an indicator of a director’s suitability for the audit committee. One member noted, *“It is important to have diversity of skills on the audit committee. You can’t have all CPAs.”* Maintaining diverse skill sets on the audit committee, including non-financial expertise, improves the audit committee’s ability to perform its oversight role. One member commented, *“People who aren’t experts in GAAP ask different kinds of questions.”*

Nonetheless, members do not believe an audit committee is complete without a high level of accounting expertise. One audit chair said, *“It’s helpful to have someone who can speak out and have an understanding of the accounting regulations. I hope we can get people who are curious and have the background to understand the accounting in depth.”* However, audit chairs are also wary of having one person singled out to carry the full technical load for the committee. *“You should have more than one financial expert on the committee. On some of my committees, I’m the only one, and that’s not smart. What would happen if the proverbial truck came along? Two or three experts would be ideal.”*

Members noted that although financial expertise may be among the set of skills that makes an ideal audit chair, this is not a sufficient or even a necessary requirement. Instead, the audit chair should be capable of managing the committee’s work and making sure the resources and relationships are in place to do it as efficiently as possible.

Outside perspectives can be very valuable

The audit committee relies heavily on management to report what is going on within the company, and it is equally important for the audit committee to have a solid understanding of the wider industry environment. Members agreed that there are many valuable independent sources of information that can help the audit committee understand the company’s comparative performance.

Equity analyst reports were the most popular source of outside perspective for network members. One audit chair reported how they are used: *“All analyst reports go to the full board.”* Another member asks management to compile analyst data covering important industry metrics specifically for the audit committee. *“We have quarterly reports comparing our results to our competitors. We instituted it for the audit committee, because a lot of times [this data] can tell the audit committee to raise its antennae and ask, ‘Is it possible something might happen?’”*



What some leading audit chairs do to acquire useful outside information⁵

- Ask management for benchmark data from across a variety of sectors to gain better insight into how the company is doing.
- Ask the external auditor for comparative data on accounting principles in the industry.
- Contact their directors' and officers' (D&O) insurance provider to gain access to software-based analytics developed for comparative insurance risk.

Audit committees must balance compliance with more strategic activities

Since the Sarbanes-Oxley Act was passed, boards have become more active in making sure their companies are doing business ethically and reporting their financial health accurately. One member explained the change: *“It’s clearer who is working for whom. [In the past,] too many boards let the CEO dictate the agenda. In this circumstance, problems arose before the board woke up. Now the CEO works for the board.”* Boards are being more assertive in their oversight role, especially with respect to compliance, and much of this work is falling to the audit committee.

This focus on compliance has brought forth a tension in the role of the board of directors. In a recent *Wall Street Journal* opinion piece, the venture capitalist Tom Perkins noted an evolution from “guidance director ... whose emphasis was on performance” to “compliance director ... who listens to consultants and attorneys, before deciding matters ... [and who is] focused on the regulatory aspects, which are largely industry independent.”⁶

Network members broadly agreed that directors have become more compliance focused, at the expense of overseeing the creation and execution of strategy, although they believe the pendulum is starting to swing back. Members discussed two specific topics relating to this tension: the audit committee’s role in compliance, and when (or if) the audit committee should cross the bright line between oversight and management.

The audit committee’s role in compliance

The audit committee often takes the lead on oversight of the company’s compliance with a variety of rules and regulations. One member lamented, *“To me, the audit committee feels like a compliance committee ... When do we get to do the real work? We could be focusing on strategy and growing the business.”* Another member recounted a joint meeting with the company’s compliance committee: *“We track compliance on 425 items! The cumulative effect has been a real drain [on the board].”*

While members were careful not to ascribe these negative consequences to legislation, one member felt uneven enforcement of new legislation was the culprit. *“The cause of much of this was a lack of organization and direction from the SEC. They didn’t know what they wanted from us, but they wanted it*

⁵ Ernst & Young and Tapestry Networks, “Four lessons for audit committees from high-profile accounting scandals,” *VantagePoint*, April 6, 2007, 6. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Summit_View2_Apr07.PDF.

⁶ Tom Perkins, “The ‘Compliance’ Board,” *Wall Street Journal*, March 2, 2007. Available to subscribers at http://online.wsj.com/article/SB117280725006124469.html?mod=opinion_main_commentaries.



now! If the SEC had taken a deep breath and figured it out beforehand, it would have been much different.” Again, members opined that as the regulatory pendulum starts to swing back to the middle, the compliance burden will return to being more reasonable.

One member noted that there are ways the compliance burden can be managed more effectively: *“There are some things that can make the box checking go faster: carving out time around board meetings, continuity of committee membership, and building a shared mind-set.”* These types of actions – together with increased pre-reading and consent agendas – let audit committee members know what is expected of them, so they are able to make decisions much more quickly.

Internal control discipline adds to shareholder value

One of the most controversial changes brought about by the Sarbanes-Oxley Act was the auditing and attestation of internal controls over financial reporting. Though many stakeholders – from small registrants to stock exchanges – have pointed out the exorbitant costs and effort necessary to comply, members of the Southeast Audit Committee Network agreed that *“it’s really important that people understand control discipline is worth funding.”* One audit chair described Sarbanes-Oxley’s effect on his organization: *“SOX [established] throughout the organization the importance of control and discipline.”* This focus on control discipline is extremely important, as it *“gives investors a lot of confidence in the numbers.”*

Any focus on control discipline will be for naught if it is not supported by strong tone at the top. One member commented, *“I keep thinking about tone at the top. The appropriate attitude has to be communicated from the CEO on down. Now, internal audit is much more alert to tone. There’s an expectation of ethical behavior from the CEO.”* With solid tone at the top, *“people understand that financial engineering is not OK,”* and all the mechanisms for catching material weaknesses or deficiencies – from internal controls to whistleblower lines – become more effective than they would be in the absence of good tone at the top.

The audit chair should approach internal and external audit plans differently

Sarbanes-Oxley dramatically altered the audit chair’s relationship with both the internal and external auditors: now, both report to the audit committee. Both also have mandates to ensure the company’s internal controls operate well and financial information is accurate. One member explained, *“There’s more overlap now than before,”* particularly with the forthcoming changes to the Public Company Accounting Oversight Board’s (PCAOB’s) Auditing Standard No. 2.

Members recognized the very different roles they must play when managing internal audit and the external auditor, and they agreed the audit committee cannot treat audit plans the same way for each.

Members stated that in dealing with the external audit plan, the audit committee is primarily *“concerned with scope”* and fees, whereas it has broader focus on *“plans and activities”* in the internal audit group. One member contrasted the way the committee handles the internal and external audit plans:



- **The internal audit plan.** *“You need to look carefully at the way the internal audit plan is constructed, so it doesn’t just cover high-risk areas, because it needs to cover medium- and low-risk things too.”*
- **The external audit plan.** *“We’re relying on real professionals to prepare a plan that is not at the same level of granularity [as the internal audit plan]”* Commenting on audit committee members’ ability to assess the external auditor’s report, the audit chair added, *“We can’t expect audit committee members to have sufficient knowledge to understand [all the details of] what a CPA does.”*

Members offered these insights into handling the external audit plan:

- **Zero-based plans are only helpful in certain limited circumstances.** Although members were uncomfortable with the idea of developing a zero-based audit plan each year, one member shared an important situation that warranted such an approach: *“Since we’ve been acquisitive recently, we have to approach [the plan] differently each year.”* Members agreed that a bottoms-up approach that identifies all that changed in the company in the previous year is useful.
- **It is wise to ask why certain elements are included in the plan.** While it may not be important to question every detail, there is room to ask why or how the scope was determined in certain areas. One member described how the company’s Costa Rican operations had been added to the external audit plan several years previously and had not been questioned since. *“Sometimes things get into the audit plan because someone asked the [external] auditor to put it in one year, and it’s just stayed in. Sometimes it’s useful to ask the auditor, ‘Is there anything that someone asked you to include in the plan that we don’t really have to do?’”*
- **Management increasingly expects the audit chair to be involved in fee negotiations.** One member reported being involved more this year than before. Another member spends *“a lot of time on fees.”* The member takes a detailed look at the seniority of the audit team and reported *“being knee-deep in scope.”* Members also felt that the audit firms are more forthcoming regarding fees now than they have been in previous years. However, one member cautioned, *“The least important part of the relationship [with the external auditor] is how much I pay. If I’m comfortable with the processes and testing the auditor is using, and the reports are good, I’m happy. Management may want to get into it, and why not? They understand the details. But it’s not important for me to do that.”*

Conclusion

Five years since Sarbanes-Oxley was signed into law in the wake of high-profile accounting scandals at companies like WorldCom and Enron, members agree that no longer are boards or audit committees complacent about how well-run their companies are. Members believe that the best practices that have emerged go beyond the demands of legislation and regulation and may well have had greater impact. Three of the four lessons members drew from the scandals, namely, the importance of intellectual curiosity, the need to balance compliance with more strategic activities, and the necessity of being more involved in the development of internal and external audit plans, do not appear in Sarbanes-Oxley. Furthermore, and bucking conventional wisdom about audit chairs’ views on Sarbanes-Oxley, the remaining lesson concerned the shareholder value created by Sarbanes-Oxley’s increased focus on internal control discipline.



About this document

The Southeast 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.

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