



Evaluating the CFO and the finance organization

The future of internal audit

Introduction

The Southeast Audit Committee Network's fifth meeting, held on September 20, 2006, covered two topics: evaluation of 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 audit committee's responsibility in determining whether there has been any backdating or spring-loading of stock options, Sarbanes-Oxley best practices in the mutual insurance and nonprofit sectors, and experiences dealing with regulators such as the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB).

Collectively, members of the network sit on the boards of about 20 large-, mid-, and small-cap public companies. Members who attended the meeting were:

- Denny Beresford, Audit Committee Chair, Kimberly-Clark and Legg Mason
- Phil Cox, Audit Committee Chair, Duke Energy
- John Farrell, Audit Committee Chair, Fidelity National Financial
- Doug Ivester, Audit Committee Chair, SunTrust Banks
- Suzanne Labarge, Audit Committee Chair, Novelis
- Dean O'Hare, Audit Committee Chair, Fluor Corporation
- Dave Rickard, Audit Committee Chair, Harris Corporation
- Peter Wood, Audit Committee Chair, Eastman Chemical

Also attending all or part of the meeting were:

- Edwin Bennett, Southeast Area AABS Managing Partner, Ernst & Young
- Tom Hough, Vice Chairman and Southeast Area Managing Partner, Ernst & Young
- Chuck Seets, Principal, 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. Network members' remarks appear in italicized quotes. *VantagePoint* also includes select comments and perspectives that emerged from pre-meeting discussions with members.



Executive summary

There are two functions on which the audit committee must rely and in whom they must have confidence: the finance organization, led by the CFO, and internal audit, led by the chief audit executive (CAE). Members of the Southeast Audit Committee Network addressed the future of both functions at their meeting. The network's discussion is summarized below and expanded upon in subsequent pages.

- **Audit chairs empathize with the CFO** (page 3)

Members believe the job of CFO has become less attractive due to heightened scrutiny and the compliance burden represented by Sarbanes-Oxley. While some CFOs have successfully delegated the compliance burden down to the controller level, the CFO still bears responsibility for the activities of the finance organization. Audit chairs are concerned that this reduces the time the CFO has for strategic and capital market activities that support the CEO's growth agenda.

- **Audit chairs would like a say in the CFO's evaluation** (pages 3-4)

Members agreed that the CEO bears primary responsibility for the CFO's evaluation, but they feel that audit committee chairs should review the CFO's goals, particularly as they pertain to the audit committee, and have some say in his or her performance review. Members agreed that they should also provide feedback to CFOs on an ongoing basis.

- **Audit committees should support the development of the finance organization** (pages 4-6)

Members expect CFOs to build a top-notch finance organization and feel they can support the continuous improvement of the finance organization and its people by ensuring adequate staffing, encouraging better skill bases and education, demanding succession planning, and assessing bench strength. Two ways in which audit committee chairs can become more familiar with their finance organization's depth and strength are by creating opportunities for finance staff to come to audit committee meetings and by attending finance staff meetings.

- **The future of internal audit** (pages 6-8)

Members broadly agreed that internal audit's focus had widened, with a *"slight trend away from just financial audits [as well as operational audits]."* However, members disagreed over whether that broader focus is appropriate, with some members supporting a far more purist approach to internal audit. There was a general agreement that the model internal audit adopts is shaped, in part, by the audit chair's individual background and personal style.

Members talked about their responsibility to help ensure the independence and objectivity of the head of internal audit and the finance function. They agreed that a direct reporting line to the audit committee is essential for internal audit objectivity, but some members were concerned about a potential conflict of interest in the administrative reporting line to the CFO.



Audit chairs empathize with the CFO

At the end of 2005, *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

Members of the Southeast Audit Committee Network, several of whom are current or former CFOs, broadly agree that the job of CFO has declined in perceived importance [due to increased compliance responsibilities]. One member quantified the shift in how the CFO's time has come to be spent, post-Sarbanes-Oxley, saying, *"In the 1980s, [it was] 60% running the investment portfolio, 20% doing deals, and the rest on strategic issues. Now, it's 80% compliance."*

Even when the CFO is able to delegate compliance-related activity, he or she must still oversee and eventually certify the activities undertaken by the finance organization, which reduces the time available for strategic and capital market activities that support the CEO's growth agenda.

Another by-product of the compliance burden has been a perceived tightening in the CFOs' operating style, sometimes resulting in an overly risk-averse stance. According to one member, *"The job is becoming so uptight – everything must be perfect. [So the CFO says,] 'Let me take a low-odds line of thinking to make sure it's perfect.'"*

Audit chairs would like a say in the CFO's evaluation

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."²

Members made a distinction between having a formal role in the evaluation process and having "some say" in the evaluation itself. Members agreed that the CEO, who typically sets and monitors goals for the CFO, should retain primary responsibility for the CFO's evaluation, but they feel that audit chairs should *"be able to review [the CFO's] goals and performance."* This involvement has become necessary because, as one audit chair put it, *"Sarbanes-Oxley automatically rejiggered the role of the CFO. CFOs are much closer to the audit committee than they used to be."*

Several members suggested that the audit committee's review of the CFO's goals should be selective: *"Acquisition strategy and deals are not audit committee business; internal controls and succession [are] audit committee business."* One member estimated that 20-25% of the CFO's goals pertain to the work of the audit committee and should be reviewed by the committee or its chair.

Members support providing ongoing feedback to CFOs rather than focusing strictly on performance or control deficiencies: *"You have to give the accolades too!"* Members suggested that if an audit committee

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

² Ibid., 8-9.



chair is concerned about the performance of the CFO, then the best course of action is to *“make sure the full audit committee shares this view, then take the concern to the CEO.”*

Members noted that the external auditor can provide useful feedback during executive sessions of the committee by identifying red flags from its dealings with the CFO, such as an unhealthy focus on managing up, a lack of succession planning, or a lack of concern about the finance organization’s bench strength.

Occasionally, members are asked to help evaluate candidates for the CFO role or other senior finance organization positions. Members see their involvement as adding value to the process, but stressed the limits of their participation: *“[I] gave feedback but didn’t make the [hiring] decision.”*

Audit committees should support the development of the finance organization

Today, the CFO is expected to build and develop a top-notch finance organization, complete with succession plans for all key roles. Audit committees are looking for ways to support that process, and members identified four practical ways to help:

1. Ensure adequate staffing levels
2. Urge the CFO to focus on improved skills and education in the function
3. Demand thorough succession planning
4. Assess bench strength

1. Ensure adequate staffing levels

The first step in building a blue-chip finance organization is to ensure that the department is resourced correctly. Audit chairs see this as part of their responsibility: *“Audit committees should challenge whether a company has enough people to do the job.”* One member volunteered that CFOs often *“want help in crafting the finance organization and looking at best practices and benchmarking.”* This member did not feel that in offering that assistance he was overstepping his mandate in the audit committee charter.

Audit chairs are also worried about the number of unfilled positions in the finance function. One member instituted a direct approach to achieve total transparency and accountability for finance organization staffing: *“Mid-year I asked for a list of open positions and a plan for filling [them]. I then asked for periodic reports. We addressed [the question of vacancies] up front.”* The company had to add specialists in finance hiring to the human resources department.

2. Urge the CFO to focus on improved skills and education in the function

Just getting bodies to fill positions is not enough. Members said that the overall skill level in the finance organization has improved over the last few years and said they were exploring ways to support that trend. One member commented, *“I’ve noted a significant increase in the intelligence of the finance organization’s people. We made a conscious decision to spend more money on them.”*

Ideas on how audit committees could help improve the quality of the finance organization included having the CFO offer regular education on core issues as well as hiring people from better schools, with more



advanced degrees. To achieve the necessary breadth of experience in the finance organization, one strategy is to “*move people around. You give them a fresh perspective.*”

3. Demand thorough succession planning

Members said that a clear succession plan for senior finance positions is one indication of a well-run department and strong CFO leadership; part of the CFO’s evaluation should focus on how well he or she has undertaken succession planning. Network members cautioned, however, that automatically conducting external searches for senior-level jobs may be unwise: “*Other [audit committee] members don’t want to promote from within; they want to go outside, [but it’s] always better to promote from within. If ... you [always] fill a position from the outside, it says [to junior finance staff], ‘You have no future here.’*”

4. Assess bench strength

Members said that truly understanding the finance organization’s capabilities requires going beyond the CFO. One member suggested, “*If you ask the CFO about the finance organization, you get [information on people’s] academic background. You don’t get a real sense of what people are good at.*” In other cases, an audit committee chair may be provided with a description of an individual’s role and specific responsibilities and accountabilities.

Members identified two important ways in which audit chairs can get a better sense of the depth and quality of their company’s finance organization:

- **Create opportunities for finance staff to come to audit committee meetings.** One audit chair said, “*We ask that two people in the finance function whom we would not normally see be brought to each audit committee meeting. It helps to elevate people and creates a buzz. It lets people see what we are really doing.*” Another member asked the CFO to allow high-potential finance organization staff to lead key projects: “*You learn by demanding ... that someone from finance staff head [each project] ... [That person] then has to report to the audit committee. More people [come] in front of the audit committee, and you can assess the real talent.*”
- **Witness finance staff in their natural habitat.** In order to get a better picture of who in the finance organization are rising stars, some members attend group finance meetings. This allows audit committee chairs to see, firsthand, who demonstrates natural leadership qualities. One member said, “*You get to see, through their interactions, the two or three that emerge as informal leaders – the people everyone gravitates toward.*” Equally important was determining if an individual had the ability and insight to ask good questions.

The group setting also combats the phenomenon of “*isolated excellence,*” whereby an individual rises to the occasion during formal audit committee presentations, but is weaker in day-to-day performance. One member felt very strongly about the positive benefits of face-to-face meetings: “*I spend a few days a year meeting with the audit group and finance organization. It builds a good spirit, and they are glad you are spending time [with them].*”

By attending finance meetings, audit committee members can also minimize the possibility that a poorly performing finance leadership team will attempt to use the audit committee as a scapegoat. One



member saw this as a clear benefit: *“A lot of companies position the audit committee as the [bad guys] in the background. When you are up in front [of them], they discover you are not an ogre.”*

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.”³ Prior to 2002, most internal audit functions focused on financial and operational audits, with business process improvement a by-product of their work on operational audits. Since 2002, internal audit functions have been focused largely on Section 404 compliance.

In July 2004, *InSights* explored the evolving role of internal audit and concluded, “Internal audit’s role will likely become even more important as corporate governance continues to evolve. Instead of solely evaluating process controls, internal audit is also taking a lead role in advocating higher levels of accountability throughout the organization.”⁴

Members focused on two questions in their discussion:

- What is the nature of internal audit’s mission: pure, broad, or hybrid?
- Do reporting lines preserve objectivity? Disrupt the balance of power?

What is the nature of internal audit’s mission: pure, broad, or hybrid?

Members broadly agreed that internal audit’s focus had widened, with a *“slight trend away from just financial [audits].”* However, members disagreed over whether that broader focus is appropriate, with some members supporting a far more purist approach to internal audit. There was a general agreement that the model internal audit adopts is shaped, in part, by the audit chair’s individual background and personal style.

Members outlined three types of internal audit functions:

- **Pure.** Internal audit functions with a purist mission conduct financial audits, work on internal controls, and do not get involved with operational audits and improvement, risk management, or other special projects. One member who supported the idea of a purist function said, *“I had one internal audit head who wouldn’t even know [what] an internal audit [was]. Management used this person as a swing staffer.”* What this member wanted was a dedicated internal audit function that focused on *“an audit plan, controls testing, transaction validity, systems analysis, and time in the field.”*
- **Broad.** Internal audit functions with a broad mission are not so restricted. One member said, *“I come from a background where internal audit was much more involved in consulting and strategy.”*
- **Hybrid.** Internal audit functions can be said to have a hybrid mission if they are generally purist, but are also deployed elsewhere as needed. One member noted, *“We have 10% overstaffing to [enable the*

³ New York Stock Exchange, *Final NYSE Corporate Governance Rules*, 13. Available for review at <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>

⁴ Ernst & Young and Tapestry Networks, “The internal auditor’s perspective,” *InSights*, July 6, 2004. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_July04_InSights.pdf



function to] take on special projects, such as enterprise risk management work.” Advocates of this approach pointed out that it helps staff to develop their skills.

Members discussed the impact of using the function as a development tool for finance staff. Several members spoke about their interest in the model adopted by General Electric since at least the early 1990s. GE’s internal audit function has long been considered one of the best in the country.⁵ Typically, members of GE’s corporate audit staff spend two to three years learning the intricate details and functions of the company and being inculcated in a control environment before they rotate out into the company in a variety of leadership positions that, unlike in other companies, are not limited to the finance organization. Members reflected on the fact that the more purist their internal audit function was, the less likely it would be able to support a broader management development mission.

Do reporting lines preserve objectivity? Disrupt the balance of power?

The fact that internal audit findings may reflect badly on other senior managers puts the head of internal audit in a sensitive position. Members talked about their responsibility to help protect the head of internal audit and ensure the independence and objectivity of the function. How can the audit committee be certain it is getting unfiltered reports from the head of internal audit? The answer, in part, has to do with reporting lines and organizational structures.

Network members stated that the head of internal audit now reports directly to the audit committee or to the audit chair, but there is also a dotted, or administrative, reporting line to a member of management. In most cases that executive is the CFO, but in several members’ companies, the dotted line goes to the general counsel:

- **Administrative report to the CFO.** One member said that internal audit reports to the audit chair, but has a dotted line to the CFO, *“just for administrative matters.”* Another member stated that it was *“important that [the internal auditors] have a reporting line that speaks the same language and has the time to deal with [them].”*
- **Administrative report to the general counsel.** Members have noted some instances of moving internal audit out of the finance function it is auditing. Some internal audit heads now report to the general counsel for administrative purposes.

The direct report to the audit committee is essential for internal audit objectivity, but there is still potential for conflict of interest in the administrative reporting line. One member solicited the opinion of two legal counselors to review a potential issue. The defense attorney said that the reporting lines for internal audit were not significant: “If you have a problem, you have a problem – wherever the [reporting] lines go.” However, the second counselor, from the plaintiff’s bar, looked at the reporting structure and cautioned, “If I see you have [internal audit reporting to the CFO], and I’m on the other side, you’re dead.”

There is also the question of whether having internal audit report to the audit committee chair gives the head of internal audit too much power and influence in the internal dynamics of senior management. One member asked, *“Does this undermine the CFO?”* Another member countered that if internal audit did not

⁵ John Pancoast, “How audit earns plaudit,” *Financial Executive* 11, no. 6 (November 1995), 30.



have this direct access, then the role would be “*rendered useless.*” With regard to the reporting structure and lines of authority for internal audit, one member observed, “*There is no right way forever. You have to keep stirring the pot.*”

Conclusion

Most audit committee chairs have a limited role in evaluating the CFO and a larger role in the performance review of the head of internal audit, who reports to them directly. Such is the importance of the CFO in the life of an audit chair that many audit chairs say they are likely to become more involved in CFO evaluations in the future. Audit chairs are also increasing the amount of time they spend with high-potential staff in both the finance and internal audit functions. This approach enables the audit chair to judge bench strength, helps boost morale, and demystifies the role of the audit committee. Audit chairs say they must have trust in both functions; developing relationships with staff will build trust in both directions.

About this document

The Southeast Audit Committee Network (SEACN) is a group of audit committee chairs drawn from leading companies based in the Southeast 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.

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 directors, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the Southeast 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.

This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.