SOUTHEAST
AUDIT COMMITTEE NETWORK
VantagePoint

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The changing face of the audit committee

Introduction

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 new audit environment.

The first meeting of the network was held in Atlanta, GA, on June 14, 2005, and focused on the changing role of the audit committee, including the challenges facing audit committees and the skills and capabilities required to meet these challenges.

This document reflects a synthesis of key issues arising from the network meeting on June 14. 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 members of the network present at the meeting, who sit on the boards of nearly 20 large-, mid-, and small-cap public companies between them, were:

- Eddie Adair, Audit Committee Chair, Tech Data
- Joe Cegala, AABS Managing Partner, Ernst & Young
- Jim Copeland, Audit Committee Chair, Equifax
- Tom Hough, Area Managing Partner, Ernst & Young
- Max Lennon, former Audit Committee Chair, Duke Energy
- Paula Rosput Reynolds, Audit Committee Chair, Coca-Cola Enterprises
- Dave Rickard, Audit Committee Chair, Harris Corporation
- Jim Robbins, Audit Committee Chair, Dollar General
- Peter Wood, Audit Committee Chair, Eastman Chemical

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.

Executive summary

Responding to public outrage following several high-profile cases of accounting fraud in 2000 and 2001, the U.S. Congress enacted legislation designed both to codify the roles and responsibilities associated with financial controls and reporting and to make management and corporate directors more accountable to investors. The Sarbanes-Oxley Act has prompted management, directors, and auditors to rethink their respective roles. Audit committees have been more deeply affected by these regulatory changes than have other board committees.

In discussing these important changes, members of the Southeast Audit Committee Network addressed the evolving role and composition of the audit committee. The specific issues found to be most important to members are highlighted below, with more detailed discussion on the following pages:

- **Using time strategically** *(Pages 3-4)*
  Members are concerned that audit committees may have become so numbed by the demands of regulatory compliance that they may not be devoting sufficient attention to issues associated with broader corporate governance and enterprise risk. Although members view the activities needed to remain in compliance with legislation and regulation as a baseline, they are taking a more strategic perspective when setting their agenda and focusing on issues that represent the highest levels of risk.
- **Expectations gap associated with fraud detection and prevention** *(Page 4)*
  Although the investing public expects the audit committee to detect fraudulent activity, network members believe such expectations are unrealistic. Members believe "tone at the top" is the driver that determines whether a corporate culture discourages fraud or not.
- **Knowledge gap between audit committee chair and other board directors** *(Pages 4-5)*
  Members say audit committee chairs undertake a disproportionate amount of work relative to other audit committee members. Furthermore, audit committee members are engaged in a very different set of discussions from the rest of their board colleagues, leading to the potential for a divided board.
- **Balancing art and science** *(Pages 5-6)*
  Effective audit committees blend deep financial expertise with more general business and interpersonal instinct. Members highlighted the benefits that CEOs and other operating executives bring to an audit committee. Some audit committees have implemented a formal continuing education program in order to support members' understanding of key accounting issues.
- **Concern about legal liability** *(Page 6)*
  Members worry that audit committee chairs and members may be at greater risk of becoming targets of litigation than other board colleagues, with financial experts facing the highest level of risk. Members worry that, over time, fear of liability may deter the most qualified candidates from serving on the audit committees of public companies.
- **Value derived from committee and individual evaluations** *(Pages 6-7)*
  Members agreed that self-evaluation generally helps the audit committee to identify a focused list of items that warrant further discussion. Some members felt it was also important to evaluate the performance of individual directors and to use individual evaluations to guide nomination decisions.

Using time strategically

Members highlighted the expansive nature of the audit committee's responsibility, noting *"There are very few things that affect the company that don't affect the financial statements."* Even non-financial issues (e.g., environmental regulations, employee safety, etc.) may eventually impact the financial statements or require a disclosure in the management discussion and analysis section of the 10-K.

Noting that *"the granularity problem is real,"* one member said, *"We could meet every day and not cover all the risks in the organization."* Furthermore, audit committees are aware that they cannot use time constraints as an excuse for failing to deliver on their mandate. One member told of meeting with a lawyer who said, *"'I would love to have an audit committee member on the stand saying they don't have enough time – they'd be dead.'"*

Most audit committees develop an annual calendar with "must dos" that are driven by Sarbanes-Oxley and other federal and state regulations, their audit committee charter, stock exchange listing requirements, and compliance with other federal guidelines. Recognizing the need to develop a checklist of required activities, one member asked rhetorically whether audit committees had become so numbed by the demands of regulatory compliance that they were failing to devote sufficient attention to issues associated with broader corporate governance and enterprise risk. Clearly, given increased expectations and limited time, the need to develop a strategic audit committee agenda has never been greater.

Because every industry has a different risk profile, it is not practical to develop a one-size-fits-all risk-based agenda. Each audit committee must tailor its agenda to focus attention on the highest-risk issues. As one chair said, the key is *"to dig beyond what's in the MD&A to look for what's really going on."* This might include a deeper review of reserves, information technology, insurance, income taxes, environmental compliance, or pending litigation.

Techniques to improve efficiency and effectiveness of audit committee meetings

- **Delegation:** Members described two approaches: (i) reviewing activities to determine if they can be handed off to another board committee and (ii) assigning primary responsibility to an individual or sub-committee.
- **Offline review:** Audit committee members are increasingly asked to review material outside committee meetings. While this practice can free up meeting time, members cautioned that it is important to set an appropriate threshold for relevance.
- **Consent agendas:** Committees may cover standard, non-controversial, and/or self-explanatory items without formal discussion. In such cases, some pre-meeting reading is distributed to committee members on the understanding that it will only be discussed upon request.
- **Question-and-answer sessions:** Audit committees review presentations prior to the meeting and engage in focused question-and-answer sessions with management. One member said this practice has reduced the time devoted to the internal audit report from 45 minutes to 15 minutes.

While these practices may enable audit committees to work more efficiently, there are potential drawbacks. Reflecting on the increased use of pre-meeting reading and consent agendas, one member observed, *"Some things we send out and don't review, so in effect we don't look at them as a committee; we look at them as a series of individuals."*

Expectations gap associated with fraud detection and prevention

Management and accountants have spoken for many years about an "expectations gap" between what auditors actually do and what the public expects them to do.[1] However, members of the Southeast Audit Committee Network describe a new expectation gap – one that affects the audit committee itself.

Given that Sarbanes-Oxley was enacted in response to corporate fraud, members believe the investing public now expects audit committees to detect fraud in those rare cases when it does occur. One member said, *"As hard as it is to find collusive [management] fraud, the public expects it."* Other members described the challenge of identifying not only fraud, but even the misapplication of complex accounting standards; they agreed there was *"no chance of this happening on any regular basis."*

While the audit committee plays an important role overseeing the integrity of a company's financial statements, management is responsible for developing the systems that collect information on (and report on) the financial condition of the company. In words and actions, a company's leaders set the tone that ripples throughout the organization, and the audit committee must consider "tone at the top" when evaluating the likelihood of fraud. As one member said, *"We're living in a world in which the prism through which we look at corporate leadership keeps changing."*

Of course, no executive would overtly promote unethical behavior. Members noted that management will always *"say the right things"* and agreed that the important issue was the way in which subordinates interpreted the messages. Clearly, a healthy corporate culture must be based in integrity. One member said, *"This is a visceral point for all of us. If there is a lack of integrity, [people] can get into mischief."* In some cases it is not a lack of integrity but rather an aggressive or unforgiving culture – one in which management is afraid to give the CEO bad or difficult news – that leads to negative behavior.

Knowledge gap between audit committee chair and other board directors

Members observed that prior to Sarbanes-Oxley, audit committees had often been an effective training ground for new directors. However, they agreed that if you put a new director on the audit committee now, *"you do that person a disservice,"* since the demands placed on the committee allow little time for new directors to get up to speed on the issues.

Members also said that the number and length of audit committee meetings make it difficult for directors to serve on other committees. Consequently, at many companies roughly half the independent directors serve on the audit committee, while the other half serve on the compensation, nominating and governance

[1] For more background on the expectations gap, see Audit Committee Leadership Network, "The future of the accounting profession," *ViewPoints,* April 22, 2005, 6. Full PDf available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Apr05_View9.pdf

committees. With the financial experts engaged in one set of discussions and the rest of the directors engaged in completely different discussions, one director warned of the risk that *"you [will] have a divided board."*

The audit committee is generally more engaged with the company's financial results and controls than the rest of the board, and the audit committee chair even more so than other audit committee members. Underscoring the disproportionate workload borne by the chair, one network member mentioned having over 70 discussions last year, meeting in person with the CEO, the CFO, the controller, and the head of internal audit prior to each audit committee meeting. Members generally agreed that *"committee members are not nearly as informed as the chair … [it's] not even close."*

While an engaged and active audit committee chair is important, members recognized some risk inherent in a model in which the chair has substantially more insight than other committee members, all of whom have more knowledge than the rest of the board. Sitting at the top of the pyramid, the audit committee chair has an almost overwhelming amount of responsibility considering the liability issues involved (see below).

Balancing art and science

One member described the work of the audit committee as a blend of art and science. This member said, *"Pre-Enron, we didn't do a great job with either one. Post-Enron, we're doing a good job with science, which includes financial controls. The harder issue is with the art."*

Science: the value of financial expertise

Members agreed it was important for audit committee members to be financially literate. All members, they said, should be able to read a balance sheet, an income statement, and a statement of cash flows. Several members highlighted the audit committee's role in overseeing complex accounting practices; they worried that an audit committee member without a solid foundation in finance and accounting would lack a basic understanding of commonplace assumptions and alternative accounting treatments.

Art: the value of instinct

One member said that in the course of his career, he has found that *"the most effective [audit] committee members weren't the financial experts."* This member described one person in particular who was unusually effective at reading body language, acting *"like a bulldog once something surfaced,"* and instinctively pursuing an issue until the problem was solved. Another member agreed that financial expertise could be a double-edged sword, as members who focus on technicalities *"don't have [the] right [skills to] sniff for fraud.*" Members acknowledged the value of non-traditional audit committee members, *"people who are not just [caught up] in the minutiae of debits and credits."*

One member said that while they may lack deep financial expertise, operating executives bring a unique perspective to audit committees. Stating that the best audit committee members are those who can combine science and art, one member said, *"You find me a CEO, that's just fine."*

Importance of continuing education

Given the complex issues that audit committees much confront and the varying levels of expertise that committee members bring to their role, several network members spoke of their commitment to continuing education. Some audit committees make a point of including an educational component in every meeting. During this part of the meeting, management typically walks the committee through a detailed topic area, helping members understand how the underlying activity flows to the financial statements.

One member said it is *"incumbent on the audit committee chair to make sure the committee is educated enough and has broad enough understanding, so [their] comments come off some baseline."* Education at some committees bubbles up from members themselves, with each member submitting a list of three or four topics they would like to cover during the year.

Concern about legal liability

Corporate directors have been subject to increased scrutiny in recent years. In some cases, directors have been held personally liable not for their own actions but for failing to identify or prevent the mistakes of others. Given the audit committee's responsibilities associated with financial reporting and compliance, many observers believe audit committee members may face a greater risk of personal liability than other members of the board. In fact, several members reported hearing of lawyers advising prospective directors against serving on the audit committee of any U.S. public company.

If audit committee members face increased personal liability, those who are identified as financial experts may be at the greatest risk. One member, commenting on recent cases coming out of the Delaware Chancery Court that appear to indicate that financial experts could be held to a higher standard than other audit committee members, described the situation as *"kind of terrifying."* Because of this perception of increased risk, members said some directors have refused to be identified as financial experts even when their experience would suggest otherwise.

Some members suggested an audit committee member faces the greatest risk when he or she is the only financial expert on the audit committee. Members also worried about the possibility of a *"sea change in the law"* that would forbid directors from relying on the judgment of outside experts if their own expertise was equivalent to that of the independent experts.

Observing that directors with both financial means and specialized expertise may be targets for litigious investors, some members worry about the ability to attract qualified audit committee members, with one member joking, *"We're only going to have dumb and poor directors over time."*

Value derived from committee and individual evaluations

In their quest for improved performance, most audit committees complete an annual self-evaluation survey. This survey typically measures the effectiveness of the whole committee, though a few members said their committees also take the opportunity to evaluate the contributions of individual members. Some members felt individual evaluations should be completed before directors are due to stand for re-election and asserted that information collected through the evaluation process should be available to the nominating committee as a way of managing individual performance.

Members agreed on the value of the audit committee self-evaluation process and spoke of benefits derived from both quantitative and qualitative self-evaluation tools. One member said the actual survey scores and narrative responses are less important than the committee's ability to generate a focused list of issues for subsequent discussion. Most companies said they perform the self-evaluation internally, although a few have engaged independent consultants to conduct the surveys in a confidential and objective manner. Members agreed that it was important for any outside consultant to be sensitive to board and committee dynamics. With this in mind, one member said the company had hired a former board member to manage the process.

Conclusion

Compared with similar networks of audit committee chairs from companies located in the Mid-Atlantic and North Central areas[2], members of the Southeast Audit Committee Network expressed a deeper appreciation of the expanding role of the audit committee in fraud prevention and detection and greater concern over personal liability. However, members of all three networks agree on several key points: (i) overloaded audit committees rely on the chair to set the strategic direction and to coordinate with management and auditors, (ii) audit committees benefit from a blend of financial and operating expertise, and (iii) a thoughtful program of committee self-evaluation nearly always results in improved performance.

Since the passage of Sarbanes-Oxley it has become increasingly difficult and, some would say, increasingly risky to serve on a public company audit committee. However, the audit committee has never been more important, and the commitment of the audit committee chair is a key driver of effective corporate governance.

[2] See Mid-Atlantic Audit Committee Network, "The changing face of the audit committee," *VantagePoint,* January 4, 2005, and North Central Audit Committee Network, "The changing face of the audit committee," *VantagePoint,* November 12, 2004.