PACIFIC SOUTHWEST
AUDIT COMMITTEE NETWORK
VantagePoint

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The changing face of the audit committee

About this document

The Pacific Southwest Audit Committee Network is a select group of audit committee chairs from leading companies based in the Pacific Southwest 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.

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.

Introduction

The Pacific Southwest Audit Committee Network held its inaugural meeting via teleconference on September 20, 2005. Discussion focused on the evolving role of the audit committee, its composition, and ideas for improving effectiveness. This document is a synthesis of the insights voiced during that call.

Members of the Pacific Southwest Audit Committee Network attending all or part of the teleconference, who collectively sit on the boards of more than 25 large-, mid-, and small-cap public companies, were:

- Tony Anderson, Pacific Southwest Area Managing Partner, Ernst & Young
- Frank Biondi, Audit Committee Chair, Amgen
- Joe Bronson, Audit Committee Chair, Jacobs Engineering Group
- Ray Dittamore, Audit Committee Chair, Invitrogen
- David Engelman, Audit Committee Chair, Fleetwood Enterprises
- George Farinsky, Audit Committee Chair, Broadcom
- Jim Lawrence, Audit Committee Chair, Avnet
- Martin Melone, Audit Committee Chair, Countrywide Financial
- Warren Pinckert, Audit Committee Chair, Pacificare Health Systems
- Bruce Stump, Pacific Southwest Senior Client Service Partner, 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.

Executive summary

Regulations and legislation that were put into effect following high-profile cases of accounting fraud in the early 2000s have increased the accountability to shareholders of management, corporate directors, and their auditors. The Sarbanes-Oxley Act, which codified the roles and responsibilities associated with financial controls and reporting, has particularly impacted the audit committee.

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

- **Section 404 remains a chief concern, with risk management also a priority** *(pages 3-4)*

  Recent anecdotal evidence has suggested that in year two, audit committees have begun to shift some of their attention away from Section 404 to other pressing audit matters. However, network members said that 404 is hardly in the rear-view mirror and that they face many challenges in the second year of implementation. Network members also expressed deep interest in better identifying, understanding, and managing enterprise risks, particularly non-financial risks. Hurricane Katrina has spurred some audit committees into reviews of their company's disaster preparedness and business continuity planning.

- **Time and available talent constrain balance in audit committee composition** *(page 4)*

  In order to fulfill the breadth and depth of their responsibilities, members value a blend of financial and operating experience from both retired and active executives. They note that their fellow board directors' increasing reluctance to serve on the audit committee is due more to the time commitment required than to concerns about liability. The availability of financial and other relevant expertise among board directors can also limit options for audit committee composition.

- **Committee effectiveness hinges on managing a burgeoning agenda** *(pages 4-6)*

  Although some members describe their audit committees as tightly managed, most continue to seek ways to improve efficiency and effectiveness. Members generally report holding between 10 and 13 audit committee meetings each year, including telephone meetings to discuss quarterly filings. Members discussed ways to improve the committee's effectiveness, including prioritizing discussion on key agenda items, increasing the number of pre-reading white papers on key topics, and delegating sections of the agenda to individual audit committee members, who then had responsibility to understand the issue, meet with the relevant members of management, and report back to the committee.

Section 404 remains a chief concern, with risk management also a priority

Within the broader and deeper set of audit committee responsibilities associated with the Sarbanes-Oxley Act, members say that Section 404 and risk management remain areas of greatest concern. Information technology (IT) will also continue to hold their attention as a subset of both the internal control environment and the corporate risk profile.

Section 404: not yet in the rear-view mirror

Attention to Section 404 compliance in year one effectively crowded other items off the audit committee's agenda, and some audit committee chairs in other networks have voiced hopes that the second year offers an opportunity for the committee to turn some attention to more strategic items, such as risk management. Members of the Pacific Southwest Audit Committee Network, however, believe that the audit committee will still need to focus considerable attention on Section 404 in year two.

If companies in the first year of Section 404 were mainly focused on meeting deadlines, one member sees compliance in the second year as focusing on *"the sustainability of processes, moving to internal management accountability, and getting operational control over transactions so they can be verified."* Another member said that while the company has a better grasp of Section 404, much remains to be done: *"We're spending time and money on installing software we believe will help us manage the process better ... We're not … streamlined yet; we may spend a bit less money in year two, but [it's] still a lot."*

Several audit committee chairs in other networks mentioned that they expected to move some internal audit resources away from Section 404 in the second year of implementation and redirect them to pre-404 auditing tasks. However, a Pacific Southwest ACN member noted, *"Companies are still busy with Section 404 because most weren't ready for the second year, [which] is still highly, if not entirely, manual [work]."*

Managing risk

Many audit committees are responsible not only for overseeing the process of risk management in their companies, but also for discussing particular risk items identified by that process. In some cases, audit committees are looking beyond financial risk to operational and reputation risk. Network members are seeking more effective and prescient frameworks to help identify and manage current and emerging risks, particularly non-financial risks.

Several echoed one member's concern that *"we're only doing minimal compliance [on risk management]. I don't even know what the whole realm is."* One member said he expects to spend more time looking at IT risk: *"[IT accounts for] a great deal of our [Section] 404 deficiencies, so we'll be jumping into that; and I can see once we're done with IT, we'll be going into operating divisions."*

The question of which board entity ultimately owns risk management is not neatly answered. *"At some level, it's the collective board's responsibility,"* observed one member, while another member said, *"It's more the systemic risks – the enterprise risks – we're trying to get a handle on: how to measure them, how to handle them. Realistically, [risk] defaults to the audit committee because no other committee has the* *structure to handle it."* Other solutions include dividing risk topics across board committees and, in the case of financial services companies, forming an additional "risk committee." A number of members said the aftermath of Hurricane Katrina had left their audit committees asking questions about their companies' disaster preparedness and business continuity planning.

Time and available talent constrain balance in audit committee composition

With non-financial risk oversight increasing in importance, audit committee chairs find that financial expertise alone is insufficient to assess business risks; audit committees need members with a combination of financial expertise and operational experience. One member commented, *"Business experts on the committee ask lots of questions that impact how and why business is done, which is good for the financial experts because we wouldn't know the risks in the business otherwise."* Another member said, *"You want a good inquiring mind. The whole audit committee should not be financial experts. Like a full board, the audit committee needs a broad experience base. Of course, it's important that at least one [member] should understand controls and have a reasonable grasp of accounting."*

Members also believe a combination of retired and current executives is desirable, although it is increasingly difficult to find current executives to serve on the audit committee. Their reluctance has less to do with concerns about personal liability than with the time commitment required. One audit chair revealed, *"I have to beg sometimes."* Another member said, *"Even retired CPAs just don't want to do it. [Current] CEOs on some boards won't take it. I'd be surprised if an active executive with other commitments can make meetings and be prepared – it's a challenge."* Serving on several boards himself, the member observed wryly, *"Maybe I'm not retired anymore!"*

One audit committee chair reported joining with the board chair and the chair of the governance and nominating committee to restructure the audit committee's composition to *"get people who would focus and come prepared,"* while another member said that to achieve the desired skill set, "*Our incoming CEO made it a condition of new directors he recruited to the full board that they serve on the audit committee, so we could get more financial experts."*

Committee effectiveness hinges on managing a burgeoning agenda

As the number of meetings and hours committed to managing the audit committee agenda grows, members are ever more intent on having meetings *"move along at a reasonable clip."* Managing the agenda well can improve overall committee effectiveness. Members discussed who helps set the agenda, how it is developed, techniques to streamline meetings yet cover what is important; and evaluating the committee's performance.

Members report that they stay ahead of the curve through regular meetings with financial and operating executives, such as a quarterly face-to-face meeting with the CFO. One member described *"substantial reading, conferences, quarterly meetings with all the key financial management, plus we [audit committee members and other directors] visit HQ and get out into the field."* Others visit R&D, manufacturing and distribution sites. Several members require operating people to attend audit committee meetings, so *"the committee not only gets the financial aspects of results, but has the opportunity to ask questions and better understand issues and controls for operations."*

Managing the audit committee agenda

The number of meetings that members hold for audit committee business ranged from under 10 to 13, including quarterly telephone calls to review the 10-Qs. The actual hours involved per meeting might be as low as one hour for a telephone meeting, or up to eight hours for face-to-face sessions – one member's meetings, which he acknowledged "*run on the high side,*" occasionally spill into a second day. Another member remarked, *"Committee members challenge me to be a better manager of the clock, so we discuss substantive issues of value to the process."* Time spent on audit committee matters is dependent on the business model, members noted, so audit committees of companies in complex or regulated industries tend to have longer meetings and, if the companies are in regulated industries, have less choice in the items on their agendas. However, one member cautioned that even in relatively simple industries, *"you can't discount the complexity of the business and business processes … Every company has different risk factors."*

Aside from seeking ways to streamline and be more efficient, members struggle over making meetings effective: Are they spending too much time, or not enough? Are they covering the right topics? One member described*, "We have a grid we cycle subjects through, of 'need to' [or] 'want to' [discuss],"* the problem being that *"because of Section 404, we never get to the 'want to'."*

Members have a variety of techniques for managing the content they must cover, including using e-mail for more frequent touch points with management. One member gets input from the CEO, the chief audit executive, and the chief compliance officer. Another maintains a *"one-year's worth of topical rolling agenda items; people are well briefed in advance,"* and a third described setting the agenda up front using input from the entire audit committee and management. Members agreed that it was wise to hash out the priority of items on the agenda with individual members prior to the actual meeting. One member said, *"I take care of 'hot button' issues in advance so we won't go down a rabbit hole [in the meeting]."*

Techniques to improve the effectiveness of audit committee meetings

- **Set agendas in advance and prioritize later.** Maintain a one-year set of rolling agenda items and speak with members prior to each meeting to prioritize the time spent on each item.
- **Delegate.** Where possible, audit committee chairs should assign activities to another board committee or to another member within the audit committee.
- **Use consent agendas.** Committees may cover standard, non-controversial, and/or self-explanatory items without formal discussion. Distribute pre-meeting reading to committee members on the understanding that it will only be discussed upon request. However, *"don't assume that just because no one has questions, they've read and understood the material."*

Several members make judicious use of white papers to provide essential information to members prior to meetings. For example, *"the company prepares white papers on accounting issues that occurred in the quarter. They're reviewed by operating folks and discussed in committee. [There's] no presentation, just questions and discussion."* Another member said, *"We use white papers to get risks out on the table early, and we'll cycle in certain subject to have ample time, such as risk assessment and IT."*

Members of other audit committee networks have cited a tendency for audit committee chairs to "become" the committee, bearing the lion's share of the workload. Members in the Pacific Southwest network agreed that *"all chairs need to guard against that happening,"* but seemed less concerned about the phenomenon.

While members naturally shoulder a greater proportion of the work and the responsibility for seeing that the agenda is accomplished, some have found ways to leverage the rest of the committee. For example, while keeping everyone informed is primarily the chair's role, one member said, *"I delegate portions of the agenda to a member of the committee who then must be the one to interact with management. This engages them more; they have more interest and ownership in their piece."* However, while other members thought this a useful idea, it did prompt one member to wonder, *"Do I have any players who'll step up?"*

Overseeing internal audit

As internal audit increasingly reports to the audit committee, members voice a common concern about crossing the "bright line" into operational issues. They see their role as overseeing the work of internal audit, not making decisions that belong in management's domain. *"Our [internal audit] staff is aggressive in setting the audit agenda,"* said one member. *"The audit committee's main obligation is to ensure they have personnel and resources – we provide the umbrella."* Members agreed the topic warrants deeper discussion.

Evaluating audit committee performance

Most members had seen practical improvements in boards that use evaluations but not all had participated in an audit committee evaluation. Several members said that they expect to benefit from the process. One member who has participated in comprehensive evaluations for several years said, *"It's worth doing; we'll continue. It's not perfunctory, it's very candid."* The company's general counsel takes the audit chair through the findings and distributes the results on an aggregated basis to other audit committee members. One member found evaluations valuable because *"we talk to each other, get a member to do more document review, get one to participate more – it made us a more cohesive committee."*

Conclusion

Compared with members of similar networks of audit committee chairs serving companies in other regions of the United States, [1] participants in the first meeting of the Pacific Southwest Audit Committee Network expressed greater interest in understanding enterprise risk more fully. Members of all networks largely agree that: (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 is likely to improve audit committee performance.

[1] *VantagePoint* on "The changing face of the audit committee" from the Southeast, Mid-Atlantic, and North Central Audit Committee Networks are available at http://www.tapestrynetworks.com/net_audit.html