

THE GLOBAL 50

PERSPECTIVES OF LEADING AUDIT COMMITTEE CHAIRS | 2005

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At a time when disclosure of an audit problem can be more damaging to a company's reputation than missing an earnings target, the audit committee has emerged as one of the most visible and important board committees. Its role in identifying and managing risk has never been more critical to the company it serves, or under as much scrutiny. Spencer Stuart's Financial Officer Practice invited the audit committee chairs of 50 global companies to participate in a discussion of the major challenges and issues being faced by audit committees and the impact of the heightened pressures and demands. The result, *The Global Fifty: Perspectives of leading audit committee chairs*, examines how changing regulatory requirements have affected the functioning and composition of the audit committee, the evolving nature of the committee's interaction with corporate management and advisers, the changing dynamics of audit committee recruitment and the heightened focus on risk management. The discussions produced a number of unique responses and, often, consensus about key audit committee issues.

What we have developed in this report is an exploration of these key issues and the best practices identified by this experienced group of audit committee chairs, including:

- > The expanded role of the audit committee chair and the responsibilities of audit committee members
- > The audit committee's heightened role in assessing business risks
- > The challenges to recruiting qualified audit committee members, including a discussion about the real and perceived increase in director liability
- > Recommended practices for running an efficient and effective audit committee
- > The compliance demands of Section 404 and the business impact of the new regulatory requirements
- > The elevated role of the internal auditor
- > The potential long-term consequences of these changes on the accounting profession

Spotlight on the audit committee

In the past several years, regulatory and legislative changes have expanded the role and influence of public company audit committees around the globe. Amid new reporting and control requirements and heightened scrutiny of boards' oversight of financial reporting, audit committees have been tasked with a demanding set of responsibilities for ensuring regulatory compliance, overseeing the external auditor and internal audit function, and signing off on quarterly financial reports. These developments have elevated the audit committee to the most important and challenging board committee.

So important is the work of the audit committee to the overall credibility and performance of the board that **BP audit committee chair Sir Ian Prosser** said he believes non-executive directors should strive to serve on the committee. "If you are going to be on the board, you should also be on the audit committee, as being a non-executive and not being on the audit committee is quite a high-risk strategy."

How has the importance of the audit committee reached this point? The immediate impetus for the growth in the audit committee's responsibilities is legislation such as the Sarbanes-Oxley Act in the United States, similar regulatory initiatives such as the Combined Code on Corporate Governance in the United Kingdom, and the rise of new stock exchange listing requirements and International Financial Reporting Standards.

These enhanced requirements rose in response to high-profile accounting and financial scandals at Enron, WorldCom, Parmalat, Shell and Ahold, among others. Since then, there has been a wave of restatements that has challenged the public's confidence in corporate accounting at many other companies. These accounting failures and cases of fraud raised the ire of critics and regulators who demanded to know why boards had not been the first to spot and correct the issues, and why boards were, in some instances, simply lax in fulfilling their fiduciary responsibilities to shareholders.

Aimed at improving the independence and effectiveness of the board and audit committee, the new regulations require that the audit committee comprise independent directors and include at least one "financial expert." Audit committees now are required to have formal charters that lay out their responsibilities. Committee members must review quarterly financial statements and earnings press releases and review the company's risk assessment and management policies. Also, the audit committee now has real authority to hire the outside auditor and help shape the scope of the audit. While many have said that the new requirements formalize practices that boards followed in the past, the consensus among regulators and investors clearly was that the sensationalized problems required new directives.

"Prior to the regulatory changes, the role of the audit committee was more of a 40,000-foot fly over. Committees relied on external auditors to validate issues; the internal auditor and management were responsible for presentations and the committee asked questions," said **Thomas Capo, audit committee chair of Sonic Automotive**. "Audit committee meetings used to be well scripted," added **J. Michael Cook, audit committee chair for Comcast**. "In this new environment, that can't be allowed. Audit committees have to improve the quality of their discussions, do their homework and get their questions considered prior to the meeting so that meeting time can focus on a discussion of issues, concerns and risks."

Audit committee members also expect more from management than in the past. "We want to know where the disagreements between management and the external auditor are. We want to know how the issues will be resolved, but also how management came to its conclusions, including an explanation of the issues and what the gray areas were," said **Dell computer audit committee chair Don Carty**. "Before, management simply presented the answer; now, directors want to know what the sensitivities were and the give-and-take that helped determine the resolution."

In general, management is receptive to the expanded role of the audit committee in such activities as reviewing and amending the scope of the audit. “Two or three years ago, a CFO would have felt we were overreaching if we had been that involved in reviewing the audit scope,” said **Edmund Carpenter, audit committee chair for Campbell Soup Company and Dana Corporation**. “For the audit committee to be deeply involved in issues is no longer a sign of distrust of management; it is seen as appropriate and necessary these days.”

The audit committee chair

As they have placed new responsibilities on the audit committee as a whole, regulators also have expanded the role of the audit committee chair. The chair must delve more deeply into company operations, while not assuming a management role. He or she must completely understand the business drivers and be comfortable with company-specific accounting policies and practices. The chair also must bring organizational and leadership skills, including the ability to orchestrate the committee’s work without dictating and the skills to effectively challenge management, outside auditors and advisers, as necessary.

“The primary job of the audit committee chair is to serve as fiduciary, to serve as watchdog and be the ‘bad guy’ when governance issues go wrong,” said **Lowes audit committee chair Richard Lochridge**. “You must be hard-nosed, difficult and demanding as chair within meetings, but then let management run the company thereafter, being constructive and serving as counselor, aide and adviser.”

Karen Hastie Williams, audit committee chair for Gannett Company, agreed that the audit committee chair must be willing to play a visible leadership role on the board. “The audit committee cannot take anything for granted. It can make no assumptions and really must get behind the numbers. If a problem arises, the audit committee chair must be prepared to get the entire board involved.”

In turn, audit chairs have high expectations of their colleagues on the audit committee. All audit committee members must come prepared, participate and be willing to take the lead in discussions about specific topics. “Good audit committee members do not abdicate to the CFO or audit committee chair the requirement to assimilate a great deal of financial knowledge and information. Committee members no longer passively take in materials; they now take a more proactive and interactive stance,” Carpenter said.

Added **Frank Borelli, Express Scripts audit committee chair**: “I expect all audit committee members to be as conversant as they can about the financial statements, and to ask questions related to their own areas of expertise that others may not have the background to be able to ask. I expect my audit committee partners to ask a lot of questions and to not defer to the chair. Teamwork is key to a successful audit committee.”

Adapting to the new regulatory landscape

In the immediate wake of the passage of the Sarbanes-Oxley Act of 2002 and the adoption of new exchange listing requirements, many audit committees focused their initial efforts on understanding and interpreting the new requirements and establishing or refining audit committee charters to reflect the new regulations and shareholder expectations. Many audit committees also evaluated their composition, particularly in light of the Sarbanes-Oxley financial expert requirement.

“We spent two to three days early on defining the responsibilities of the audit committee and the roles of committee members. We also looked at the critical competencies of committee members, which include understanding risk management, internal controls and financial reporting, and playing a supporting role in guiding the direction of the business,” Capo said. “We spent time defining the audit committee charter and then educating the board on the charter specifics. From the charter, we have structured the annual master agenda for the committee. The sense of organization gives the board the comfort that everything is being addressed.”

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Sir Ian Prosser, BP audit committee chair

The audit committee charter should provide a realistic roadmap for the actual work of the committee during the course of a year, according to Cook. “The audit committee charter is no place to be aspirational,” he said.

A priority for U.S.-listed companies during 2004 was to ensure the adequacy and effectiveness of internal controls in order to comply with Section 404 of the Sarbanes-Oxley Act. The last and most controversial aspect of the legislation, Section 404 requires not only that companies review their financial controls, but also that the adequacy of those controls be

tested by an outside auditor who must report any material weaknesses to the board and to shareholders.

For many companies, the 404 compliance task has proven time-consuming and expensive. Some of the audit chairs we spoke to suggested that resources dedicated to the effort were excessive, even comparing it to the frenzy surrounding the Year 2000 technology-readiness initiatives, i.e., “throw whatever is required into the effort to make sure you are not caught short.” Others observed that smaller companies without the internal staff resources or excess free cash flow to fund the work were at a considerable disadvantage in trying to meet the requirement. With certification still in process, audit chairs said it is too soon to judge the overall effects completely.

“In the future, we are likely to see more retired CEOs on the audit committee, as active CEOs, particularly those who also are chairman, will not have the time to take on audit committee work.”

Richard Lochridge, Lowes audit committee chair

“The internal controls documentation has been a major challenge for companies, largely because demand for accounting resources has been extraordinary and there have been too few qualified people to handle the demands. It will be a real fight to the finish to meet these requirements and a fair number of companies will have to report material weaknesses and may be punished by the market for it,” Borelli said.

Another key responsibility for audit committees is assessing and understanding business risks and assuring that these risks are quantified, prioritized and reviewed regularly. We heard consistently that audit committee discussions are structured to review major risk issues. Many audit committee chairs said year-end planning sessions that focus on assessing risk issues and setting priorities for the upcoming year typically include key resources such as the internal and external auditors, the CFO, controller and general counsel.

“The No. 1 audit committee role is risk analysis: identifying, quantifying, determining probability and then prioritizing the mitigation of risks. The first item on our agenda always is the top 10 risks,” said **JP Morgan Chase audit chair M. Anthony Burns**.

What are the risks that keep audit committee members up at night? They run the gamut from natural catastrophes, the adequacy of reserves and financial controls, fraud, revenue

recognition decisions, senior management issues, inventory loss prevention, cash flow and pension and retiree medical costs. Maintaining the consistency of accounting policies and business practices across far-flung or acquired operations is another area of concern for many audit committee chairs. To address this issue, First Data Corp. has established a policy requiring the internal audit team to visit a new acquisition within six months of being acquired and the external audit team to visit within 12 months, said **First Data audit chair Courtney Jones**.

“There are a lot of gray areas. We spend a lot of time understanding how outside auditors interpret findings and where those fall in the spectrum of other companies within our peer group,” Carty said. “Boards must spend time to understand competitors’ accounting treatment and be comfortable that their own company’s policies are consistent with others in the industry.”

Ultimately, the audit committee has to be confident in the integrity of management and the organization as a whole because of what **MMo2 audit chair Stephen Hodge** calls the “Rumsfeld conundrum.” “You don’t know what you might not know,” Hodge said. **Hilmar Kopper, Unilever’s audit committee chair**, agreed that there always will be an element of uncertainty in determining a company’s risks. “Trying to get to the heart of risk exposure in a big company is like taking a big pole and poking about in the fog,” he said. Added **Alison Carnwath, audit chair of the Man Group**, “What keeps me awake at night is the question, ‘Have we missed something?’”

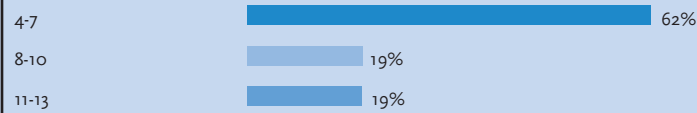
Changing audit committee relationships

The new regulatory, governance and risk management environment has had a dramatic effect on the relationships between the audit committee and other players, including senior management, the internal audit function and the external auditor.

Many audit committees today exert much more influence over the external auditor and have much more substantive interactions with their audit firms than in the past. In part, the changes in the relationship between the audit committee and external auditor stem from the committee’s more central role in hiring the auditing firm and establishing the scope of the audit. While the audit committee’s precise role varies from company to company, it is clear that audit committees today have more responsibility for the auditor relationship, in some cases, approving the CFO’s choice of auditor, signing off on the scope of the audit and agreeing to the auditor’s fee negotiated by management. At other companies, the audit committee chair signs off on an engagement letter, interviews partners and

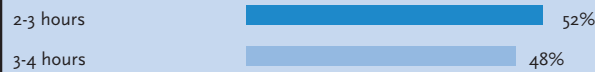
How many times do you expect the audit committee will meet this year in person and by phone?

Number of meetings



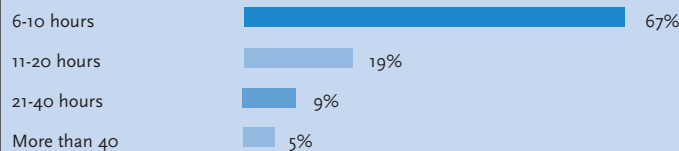
What is the average audit committee meeting length?

Meeting length



How many hours per month do you spend in total on audit committee duties, including meeting time and preparation?

Time spent on committee duties



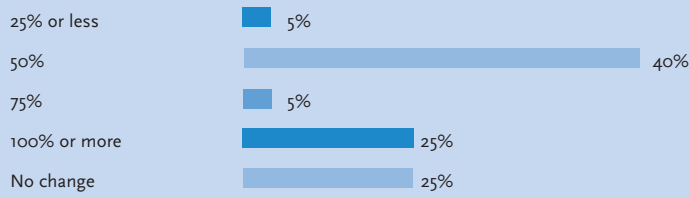
preapproves the audit scope. Audit committees also are paying closer attention to who is on the audit team, the rotation of team members and who is the lead partner.

“We are much more concerned about whether the external auditor is doing a good job and whether they have an appropriate relationship with management — ensuring that it is not too cozy or, conversely, focused on scoring points,” said **Rudy Markham, audit chair for London-based bank Standard Chartered.**

Contributing to this new alliance is the auditors’ own motivation for distancing themselves from management. Audit professionals are expected to question and challenge corporate accounting more than they have in recent times and, in the U.S., now have a new federal agency — the Public Company Accounting Oversight Board — looking over their shoulders.

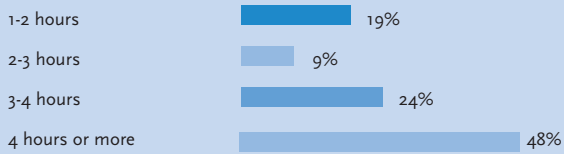
“Auditors understand their allegiance is with the audit committee and are more open to dialogue and providing greater transparency. And audit committee chairs should not hesitate to replace an audit partner who they do not feel is competent, consistent and professional,” Burns said. **Barbara H. Franklin, audit committee chair for Aetna,** described how a recent change in the audit team serving Aetna underscored the audit committee’s new prominence. “When our lead partner had to rotate off, we asked the firm to give us a couple of candidate choices. They gave us two strong partners with very different styles. We felt one of the candidates was more suitable because of his communication style. This process made it very clear that the audit partner reports to us, the audit committee.”

How much more time are you spending on audit committee duties relative to what you were spending two to three years ago?



How much preparation time, on average, do you spend in advance of each audit committee meeting?

Meeting preparation time



As a result, the relationship between the audit committee and the external auditor has become more formal and structured. External auditors provide more timely communication, are more responsive to the concerns of audit committee members and are more open to questions from the committee than in the past, audit committee chairs said. Increasingly, audit committees also are scheduling an annual meeting with the auditor separate from regular audit committee meetings for a wide-ranging discussion about finance and management issues, said **3i Company audit chair Oliver Stocken**.

Hanson audit committee chair Sheila Noakes said she now routinely meets with the external auditors before committee meetings and speaks by phone with them between meetings. “The relationship is rather more structured than it was before and discussions are wider ranging,” she said. Kopper agreed, “How has the relationship between the audit committee and the outside auditor changed during the past two years? We are seeing much more regular communication between the audit committee and the external auditor. We also expect better advice about the challenges we face.”

One result of the closer relationship between the audit committee and the audit partner is an increase in tension between management and the outside auditor and a greater willingness of the audit partner to say “no” to management, which several audit committee chairs said they viewed as a healthy development.

New demands, new priorities: Regulations' effect on the audit committee

Growing time commitment

There is no question that the responsibilities specified by Sarbanes-Oxley, the Operating and Financial Review in the U.K. and new International Financial Reporting Standards have increased the time commitment for audit committee members dramatically.

Everyone we interviewed agreed that committees are meeting more often, for longer periods and that committee work typically requires much more preparation and communication in between meetings. "To say that audit committees are spending dramatically more time is too mildly put," Burns said.

Burns estimates that he has seen a tenfold increase in the amount of time required for committee work during the past 10 years, including preparing the agenda, in-person and telephonic committee meetings, reviewing audit findings, conducting confirmatory due diligence, reviewing quarterly financial statements, participating in performance appraisals of internal auditors and ongoing conversations with the internal auditor and management, other committee members and the external auditor. One-third of the audit chairs included in our survey said they spend 130 hours or more a year on committee work, not surprising when you consider that nearly half said they spend at least four hours to prepare for each audit committee meeting and 40 percent said the audit committee meets at least 11 times a year.

"More time is spent on everything," said **Schering-Plough audit committee chair Arthur Weinbach**. "Meeting times have been extended. Preparation time has doubled. There is more to cover, more information to consider and act upon, and more thorough vetting throughout. The interaction between meetings with the CFO and the internal and external auditors also is now much more ongoing." Capo concurred, "It's an extraordinarily big time commitment."

Beyond the time, audit committee work also requires a greater level of intensity than in the past, audit chairs said. "The intellectual energy and level of vigilance have gone up," Franklin said. "The first year of Sarbanes-Oxley compliance required an even greater time commitment; we're now at a level that will stay fairly steady for a while."

Audit costs on the rise

Total audit costs have risen both for general audits and work related to Section 404 and other regulatory compliance. Our survey of audit committee chairs indicated that audit costs have increased by as much as four or five times compared to a few years ago. More typically, audit committee chairs reported increases of between 40 percent and 50 percent.

“The costs of compliance are grossly understated. While it may cost a large company in the single digit millions for external consultants, the cost of internal compliance is much, much higher. It is almost like deferred maintenance for some companies. Further, the bar is being raised for all companies on the standards of internal control documentation and testing. The challenge is not only to identify best practices, overlaps and redundancies, but also to get a reasonable payback on these investments for shareholders,” said **Microsoft audit committee chair Charles Noski**.

Many audit committee chairs expect audit fees to decrease over time as internal controls are reviewed and put in place. “It is hoped that audit fees will come down as internal audit gets stronger and better and that Sarbanes-Oxley costs will be one-off to a certain extent and will reduce in the future. The 2003 to 2004 timeframe seems to have been the bulge year when the costs were frighteningly high,” Kopper said.

Is it worth it?

Heated debate continues within the business community and government circles about how valuable the new regulations and listing requirements will be in promoting more accurate financial reporting and preventing fraud. Indeed, audit committee chairs expressed concerns about the cost of complying with the new requirements, their effectiveness and the ability of smaller companies to comply. Nevertheless, a consensus emerged among audit committee chairs we interviewed that the renewed rigor within the audit committee has produced real benefits to companies in the form of improved controls, more active reviews of audit and accounting issues, and vigorous debates about risks and accounting procedures. Combined with the heightened investor scrutiny of boards, these developments help to promote strong financial reporting that can restore the confidence of investors and reduce the likelihood of fresh scandals — even if specific legislation cannot.

“Legal liability has changed very little, if at all, but the emotional perception of liability has changed a lot. There is a lot of public hostility to directors and this is increasing.”

Graham Pimlott, audit committee chair for U.K.-based retailer Tesco

“While regulatory scrutiny and reforms may not always seem like a positive development, especially the attestation and 404 requirements, anything that can be done to improve the reputational risk of corporate America and CEOs, in particular, is critical,” Burns said.

Jones sees similarities to the “Y2K crisis,” when companies spent millions of dollars to upgrade computer systems to avoid IT systems failures at the start of the new year. “During the Y2K crisis, companies realized that their documentation of information technology was severely lacking, so the Y2K review forced them to go back, clean up and create much more documentation. Ultimately, it was a very valuable effort for companies’ technology infrastructures. The internal controls review may yield a similar benefit in improving the accuracy of financial information,” he said.

Still, even audit committee chairs who largely support the new requirements note the limitations of any regulatory framework in the face of an individual determined to defraud. “The new regime is certainly more clear cut and transparent and potentially more effective, but nothing is foolproof if you have a crook at the wheel,” Kopper said.

It is this concern — that companies are spending significant time and financial resources to comply with new regulations for little real benefit — that has made other audit committee chairs critical of Sarbanes-Oxley and similar initiatives. Several audit committee chairs characterized the regulations as an overreaction to the scandals, saying they are introducing bureaucratic headaches and tamping innovation. Complying with Section 404, in particular, is proving to be a burden for decentralized companies, which must show that operations in far-flung locales have adequate internal controls in place, and for smaller companies without the resources or clout with the major accounting firms.

“No amount of corporate governance codes or regulation can guarantee that nothing will go wrong — now or in the future,” said **Sainsbury audit chair Jamie Dundas**. “In practice, what seems to matter are the expectations of the Department of Trade and Industry, the press and some investors. We are kidding ourselves if we think that non-executives can always prevent some of the things that might happen in the future.”

For companies already adhering to audit committee and accounting best practices, the new requirements will add little value, audit committee chairs said. “We already were doing what I perceive to be the intent of Sarbanes-Oxley. For example, we always had sought financial experts for the audit committee and tried to avoid excessive consulting by the external auditors. These regulatory changes haven’t added value to the firms I work with. Section 404 has added enormously to the time commitment, as much as 50 percent to the audit committee workload; I’m not sure it will be worth the time and effort,” said **Allstate audit committee chair James Andress**. Lochridge agreed: “There is no evidence that the 404 compliance uncovers weaknesses better than a good internal audit team would, and external auditors are immersed by 404 in a process that distracts them from applying more sophisticated judgment. If a company is well run, Sarbanes-Oxley should be a costly nuisance.”

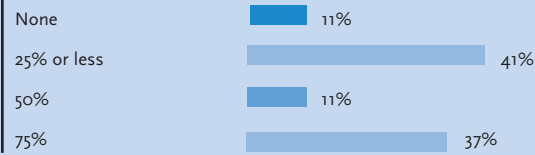
Others have raised questions about unknowns such as the consequences for reporting material control deficiencies, the penalties for non-compliance and the long-term sustainability of the reforms. “The question is what kind of legs will this have,” Noski said. “Will Sarbanes-Oxley end up like the Foreign Corruption Practice Act of 1977? Accountants, consultants and attorneys made a lot of money helping clients to implement that legislation, but it became largely a non-issue five or 10 years later.”

The changing profile of the audit committee

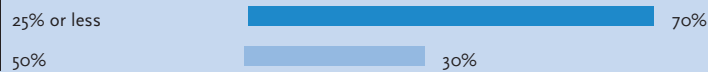
In the immediate aftermath of the passage of Sarbanes-Oxley, many boards rushed to add financial experts to their ranks. Indeed, Spencer Stuart’s Board Services Practice has seen significant new demand for directors meeting the Sarbanes-Oxley financial expert definition in the past two years. Beyond meeting the financial expert requirement, directors have become more conscious of maintaining an audit committee with a complementary mix of skills and experience. The most effective audit committees include directors with general management, financial, regulatory and legal expertise and hands-on business experience, audit committee chairs said.

“The most important characteristics audit committee members need to have are energy, diversity of opinions and broad-based business experience. Ideally, the audit committee would include an active or recently retired CEO and CFO,” Noski said. “The CFO is critical because that person has been there and understands the complexity and push-and-pull between management, Wall Street and the board. All members must have a thorough,

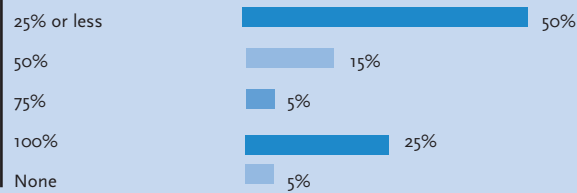
What percentage of the audit committee seats have turned over during the past three years?



What percentage of the audit committee seats do you anticipate will turn over during the next two years?



What percentage of audit committee members are considered financial experts?



in-depth understanding of controls and accounting policies. They must understand the underlying business, risks and myriad judgment calls that are made in applying financial and accounting standards.” Added Markham, “In my view, proven business acumen, as well as diversity in style and geographic experience, will lead the audit committee to ask the right questions and get the right answers. We are looking for business professionals who can play in the team.”

Audit committee chairs said boards should look beyond CPAs, CFOs and other financial experts for the audit committee. “There needs to be diversity of experiences and knowledge. Individuals with political experience can provide valuable insights about regulatory and governance issues, while lawyers bring the lens of the law — which can be helpful given the increasing interface between the governance and audit committees,” Carty said. Added Weinbach: “Good business knowledge is irreplaceable, but other qualities also are important, such as the ability to listen and interact without driving people crazy, the ability to be focused and the willingness to make the time commitment. And integrity and ethics override everything else.”

Interestingly, while the majority of audit chairs we spoke to strongly favored having a diversity of experience on the committee, at least one senior accounting firm executive has suggested that corporate audit committees should consist entirely of financial experts to enhance their ability to effectively oversee management. In our survey of audit chairs, just 25 percent said every member of the committee was considered a financial expert, while half said 25 percent of the audit committee membership was qualified as a financial expert.

From where are corporate boards drawing financial experts? Today, active and retired CEOs, CFOs and banking and finance professionals make up the greatest share of audit committee financial experts. A Spencer Stuart analysis of the 2004 proxies of S&P 500 companies found that 52 percent of the 832 “financial experts” are active or retired chairs, CEOs or presidents; 9 percent are active or retired CFOs; and 8 percent are active or retired accounting professionals.

If the view that audit committees only should include financial experts were widely accepted, the current audit committee member profile almost certainly would change. CEOs long have been favored for audit committee membership because of their broad business and financial experience and high-level perspective, but there is growing evidence that time demands on CEOs — and on audit committee members — will result in fewer CEOs serving on the committee. “In the future, we are likely to see more retired CEOs on the audit committee, as active CEOs, particularly those who also are chairman, will not have the time to take on audit committee work,” Lochridge said. Active CFOs have similar demands on their time that may restrict their ability to take on outside board work. In addition, boards are restricting their sitting CEOs, CFOs and other top executives from accepting more than one outside board assignment.

To expand the pool of potential audit committee members, many boards will have to consider recruiting more retired corporate executives and accounting professionals. Over time, corporate treasurers, chief accounting officers and other senior financial executives, who have not been board candidates traditionally, may find themselves in demand.

As they seek the right mix of experience, audit committees also should resist growing too large, audit committee chairs said. Three to four members is the ideal size — enough to maintain the audit committee’s independence and include a strong mix of experienced directors without being unwieldy. In fact, the 2004 *Spencer Stuart Board Index* found that the average number of directors on the audit committees of S&P 500 companies is just over four.

Challenges to recruiting for the audit committee

Much has been made in the press about the demand for directors and the difficulty recruiting experienced board members. Recruiting new directors has been an ongoing need for most boards during the past few years, and will continue to be for the foreseeable future. More than 45 percent of the audit chairs we interviewed said at least half of their audit committee has turned over during the past three years; 30 percent said they expect that half of the audit committee membership will turn over during the next two years.

Developments such as the WorldCom and Enron settlement agreements — in which directors agreed to pay a portion of litigation settlements out of their own pockets — underscore the professional and personal stakes directors have in ensuring that the board exhibits strong and independent oversight of management. It is too soon to tell how much these settlement agreements will affect director recruitment. We do know that prospective board members already are concerned about liability — to say nothing about the growing time demands on directors. So far, however, the audit committee chairs we spoke to said that the heightened concern about liability risks has not posed a significant deterrent for recruiting directors to large, well-run companies.

“The audit committee cannot take anything for granted. It can make no assumptions and really must get behind the numbers. If a problem arises, the audit committee chair must be prepared to get the entire board involved.”

Karen Hastie Williams, Gannett Company audit committee chair

“Directors are walking a fine line between ‘reasonable care’ and ‘unreasonable worry.’ Responsible board members, audit committee members or chairmen should be concerned, but they need to find the right balance between oversight and overmanaging the details,” said **Delphi audit chair Robert H. Brust**. He brought in legal counsel to advise Delphi board members about liability risk to ease some of their fears. “The key is maintaining reasonable diligence of review — including appropriate fraud detection — a sound audit process and a close relationship with auditors.”

However, board candidates are not ignoring the potential liability risks. Many want to review a company’s director and officer liability coverage before agreeing to accept a new board assignment, and others are passing on directorships for troubled companies. Organizations have responded to these concerns by increasing D&O coverage, not just during directors’ terms but also for several years after they leave the board.

“Legal liability has changed very little, if at all, but the emotional perception of liability has changed a lot. There is a lot of public hostility to directors and this is increasing,” said **Graham Pimlott, audit committee chair for U.K.-based retailer Tesco**. “The public, and indeed the law, does not distinguish between executive directors and non-executive directors and therefore non-executive directors are on the receiving end much more frequently than they used to be. This has impacted U.S. companies and U.K. companies that are listed in the U.S. more so than purely U.K. companies, where I really perceive no shortage of board candidates.”

Other audit committee chairs said fears about liability are overblown. “The truth of the matter is if you do your job right, you don’t lose in these lawsuits. Do your job properly and you’ll be fine,” Lochridge said. Added Carty: “Some people may not want to serve, yet being able to serve on the boards of great companies and bring something unique is an honor. Most directors feel that they want to and are doing right, so they are not as concerned about legal liability, but there is concern about the dramatic increase in what one is being held accountable for.”

Best practices are emerging

What practices and policies have made the audit committee chairs we talked to more effective? The combination of efficiency, regular communication and training, and a strong internal audit function can help the audit committee work smoothly.

Efficiency is king

With so much on their plates these days, audit committees must be diligent about running meetings efficiently and focusing on top priorities, audit committee chairs said. Audit committee meetings should be scheduled for two hours, and not drift toward three or more, and everyone should come prepared. Despite their prescription for two-hour meetings, nearly half of the audit chairs we surveyed said their meetings routinely ran between three and four hours.

“There is a tendency for audit committee meetings today to get too long, too unproductive and too big. Sometimes, they can involve up to 25 people, including external audit, internal audit, internal finance and senior management. Because no one should be offended, everyone is invited and everyone shows up. Too many boilerplate issues get regurgitated,” Weinbach said. “The audit committee chair must continually review whether the

committee is spending its time appropriately. It's better now to cover the bases beforehand with all the right people and then relay results during meetings.”

Materials should be distributed well in advance so directors have at least a weekend prior to meetings to review, reserving meeting time for unscripted discussion about top issues and robust Q&A. This establishes an obligation for committee members to read and review materials and be prepared for a thorough discussion of issues. “Gone are the days of ‘Death by PowerPoint.’ Critical issues have been vetted by the time of the meeting. Presentations are limited to five- to 10-minute summaries, followed by 45- to 50-minute discussions. Nothing is scripted,” Cook said. Added Noski: “An interactive exchange between the audit committee and management not only is more efficient, but also provides a better understanding of issues and lets the board see the calibre of people in how they interact.”

Provide regular, robust communication with the full board

Now under more scrutiny, boards need to feel confident in the work of the audit committee. The audit committee earns this trust through regular, complete communication with the full board about committee meeting discussions and critical audit issues. “Reports back to the board from the audit committee are increasingly detailed and really expose the issues that are concerning the audit committee, rather than just reporting back in a fairly anodyne sort of way,” Prosser said.

Another method to enhance communication between the audit committee and the full board is to invite other directors to attend audit committee meetings. In this way, said Williams, less time has to be spent on audit committee topics during full board meetings. It also underscores the shared responsibility of the audit committee’s tasks. Other boards simply allow any director to attend any audit committee meeting or invite directors to specific meetings. “The rule at Anglo is that all board members can attend the audit committee if they wish to do so. The chairman, chief executive and the CFO always attend and so there is complete flow of information,” **Anglo American audit committee chair David Challen** said.

Maintain a strong internal audit function

Benefits such as lower costs and access to skilled talent are spurring many companies to consider outsourcing the internal audit function. While acknowledging these potential benefits, the majority of audit committee chairs we interviewed believe that an internal audit function has intimate knowledge of the company and provides more control and

BEST PRACTICES FOR AUDIT COMMITTEE CHAIRS

- > Appreciate your responsibilities, not just to shareholders or the board, but to fellow committee members. Recruit value-added members to the committee who will be accretive immediately and hold each other accountable for continually raising the bar.
- > Even as you juggle the myriad new regulatory requirements, do not lose sight of the big picture. Keep an open mind. Be flexible.
- > Establish stretch, but realistic goals for the audit committee within the committee's charter and create a framework to achieve them. Each year, create an agenda to explore specific areas and maintain the discipline to address these areas throughout the year.
- > Maintain an ongoing dialogue with all committee members, internal audit and external auditors between meetings. Use one-on-one sessions to clarify critical issues and establish agendas for upcoming committee meetings. Create an atmosphere in which committee members feel free to come to you to raise questions.
- > Foster a rapport among committee members and strong working relationships with management and outside auditors. Teamwork is critical. No grandstanding. Respect the unique perspective that each audit committee member brings, or find a replacement.
- > Schedule and maintain tight agendas. Presentations should be provided electronically to committee members at least 72 hours prior to meetings to allow a thorough review. Focus meeting time on robust discussions of critical issues, comparable benchmarks and follow-up items, rather than a review of background materials.
- > Stay current on new regulations, pronouncements and interpretations. Bring in experts on key issues, inviting the full board, as appropriate.
- > Pursue the role with uncompromising passion and rigor.

better responsiveness than when it is outsourced. "There is a major resource crunch at the moment, largely due to 404 compliance work, but I'm not an advocate of outsourcing the internal audit function. I think you need it inside as a check and balance," Franklin said. In addition, many people regard the internal audit function as a valuable developmental role for future finance executives and a potentially important source of whistleblowing activity. While whistleblowers today more often than not are airing minor personnel grievances, the procedures and policies in place to encourage and protect whistleblowers is another ace in an audit committee's deck of cards. "The best defense is a great internal audit function. Whistleblowers were the reason WorldCom and Enron were discovered," Lochridge said.

Several audit committee chairs who initially resisted the idea of outsourcing the internal audit function have come around to the idea, citing the demands on the audit team and the difficulty of fully staffing the department, particularly in remote operations. “I was very against outsourcing initially but I have seen it done successfully at Xerox. We have outsourced the whole function on an independent basis and I believe it adds another layer of independence and credibility, as well as control. We have a global service with high standards that is distinct from management,” Kopper said.

The key to outsourcing the function successfully, said **Xerox audit committee chair John E. Pepper**, is ensuring the quality and continuity of the audit team. Added Stocken: “There should always be a head of internal audit within the company who manages the process and the outsourced team, but there is no reason why the team should not be outsourced. You should outsource to somewhere other than the external auditors.”

Whether or not the audit committee chairs favored outsourcing, the majority said it is important to have the right person in the chief internal auditor role, today a much more important and visible position than in the past. “The key is good leadership in the internal auditor role. The senior internal auditor must be engaged and must spend time prioritizing key areas of risk exposure and meet monthly with the audit committee chair. He or she must hold people accountable for changes in the plan,” Carty said.

Typically, the internal auditor reports both to the audit committee chair and to the CFO or CEO. “At BP, the chief internal auditor reports directly to the CEO, which has the advantage of demonstrating to the whole company that he carries real weight and influence with the top management. He also has a dotted-line relationship to the chairman of the audit committee,” Prosser said.

If the internal auditor does not report directly to the audit chair, he or she should at least have ready access to the committee, Stocken said. “The chief internal auditor reports to the CFO but obviously has as much access as he needs to the chairman of the audit committee. He comes to the audit committee and is a senior person who is very definitely able to hold his own with the committee and the board.”

Provide board training

Finally, several audit committee chairs said audit committees benefit from having access to regular training and educational opportunities on important audit and financial topics, such as the new international accounting standards. “We typically schedule educational

programs for the board in conjunction with dinner the evening before the board meeting. These are sold-out events, covering topics such as Section 404 compliance, pension and post-retirement medical benefit issues, LIFO accounting and risk management concerns,” Brust said. Directors on the audit committee also should take advantage of outside training opportunities, including peer-group gatherings and accounting firm sessions, Stocken said.

Implications for the accounting profession

Several forces have converged to change the auditing profession. Under more scrutiny from regulators and the investing public in the wake of accounting scandals that tarnished their reputation, accounting firms are eager to earn back credibility. New regulations have limited firms’ ability to do consulting work for audit clients, but created other opportunities, at least in the short term, with Section 404 compliance services. What are the long-term implications for the accounting profession given these developments?

“The big issues for the accounting industry are whether regulatory work will keep the ‘Big 4’ firms busy enough and whether the audit business remains attractive for the long term. Historically, audit fees have been too low and audit firms have relied unduly on fees generated from tax and other consulting services,” Lochridge said. “The long-term issue for audit firms is, with the loss of cross-selling opportunities, how will they manage workloads and fee levels to maintain a viable business model? What will happen to them after the fees from regulatory compliance work diminish and will fee structures have to change? Their business model needs to be re-examined.”

Cook sees the situation differently: “The system is sound. The audit firm model has returned to where it was several years ago when accounting revenues drove the business model with some ancillary tax, controls and internal audit outsourcing revenues.”

Audit committee chairs also expressed concern that, as consulting services become less important to accounting firms, the career path for accountants will narrow. “It may become increasingly challenging to recruit the best and brightest out of schools because of the narrower scope of opportunities that audit firms will be able to provide,” Noski said. “In the past, there have been opportunities beyond audit, such as consulting and tax work. In addition, audit firms provided individuals with good access to clients that might hire individuals who have worked on their account. Many of those opportunities are gone. Today, with the liability threat, the spinning off of consulting and the limitations on tax

work for audit clients, it may be difficult to convince a young professional that he or she should be attracted to the profession.”

Conclusion

The role, responsibilities and the composition of audit committees are vastly different than just a few years ago. Our conversations with experienced audit committee chairs about these changes, the challenges facing the committee and heightened pressures and demands on audit committee members produced the following observations:

- > The pendulum has swung toward greater board vigilance and increased scrutiny from investors and regulators. While audit committee chairs largely support the regulatory changes and exchange listing requirements as essential to rebuilding investor confidence, they call for a sensible balance between the demands of investors for greater transparency and the temptation to place excessive and sometimes wasteful requirements on companies.
- > New regulatory requirements and market expectations have raised the profile of the audit committee and broadened its responsibilities, dramatically increasing the time required for audit committee service.
- > The composition of the audit committee will continue to evolve as boards likely will find it difficult to recruit enough new directors meeting the financial expert definition from the traditional sources. Time constraints and liability concerns have begun to cause CEOs and CFOs to turn down directorships.
- > Boards may conclude that their current criteria for recruiting financial experts are too narrowly defined and may need to be expanded to include corporate treasurers, controllers and accountants if the ongoing demand for financial experts is to be met.
- > Board candidates still regard board service as prestigious, but, nevertheless, are more cautious about accepting new directorships. Candidates are conducting careful due diligence aimed at assessing the integrity of the organization before joining a new board. Smaller companies and those that have not demonstrated the adequacy of their accounting and reporting systems will be at a disadvantage when trying to attract qualified directors.

> Accountable in ways they have not been before, even long-time audit committee members should not hesitate to demand training on company processes and risks as well as key regulatory developments.

What is next for the audit committee? Corporate executives, boards, institutional investors and regulators will continue to debate the effectiveness and appropriateness of the regulations that have raised the profile and increased the authority of the audit committee. It is in the best interest of all these parties to push this debate toward a consensus about the rules and practices that can promote transparent financial reporting and restore the confidence in public companies and their boards, without unduly restraining companies' ability to be creative and take calculated risks.

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