



FOLEY & LARDNER LLP

Audit Committee Effectiveness vs. Overload

FOLEY & LARDNER'S 2005 NATIONAL DIRECTORS INSTITUTE

Corporate Governance Reform:

What's Next?

AUDIT COMMITTEE EFFECTIVENESS VS. OVERLOAD

Since the enactment in July 2002 of the federal Sarbanes-Oxley Act (SOX), America's regulatory and self-regulatory institutions have been increasingly looking to the audit committees of public companies to oversee the financial reporting process. Such oversight, which requires independence from management, is designed to assure the integrity, accuracy, and transparency of the public information regarding the financial condition and performance of public companies. Because of the presence of members of management on boards of directors and the impracticability of having the entire board of directors effectively function in the financial reporting oversight capacity, the audit committee plays a very important role in the corporate governance of U.S. public companies. With the increasing importance of the role of the audit committee comes an increased need for effectiveness and efficiency.

How, then, are companies to determine the criteria to measure in assembling an effective audit committee? How can companies determine the financial literacy of prospective audit committee members? How can audit committees fulfill their duties efficiently and avoid becoming overloaded with their responsibilities?

To help answer these questions and others, the national law firm Foley & Lardner LLP hosted "Audit Committee Effectiveness vs. Overload." It was one of 11 breakout sessions that were part of the firm's fourth annual National Directors Institute (NDI) held March 10, 2005 in Chicago. The breakout session featured a panel of three experienced members of audit committees and a leading academic in the field of audit committee effectiveness. This paper is based upon the proceedings of that session.

The Importance of Financial Literacy to the Audit Committee Effectiveness

Arthur H. Bill, a partner in the Foley & Lardner LLP Washington, D.C. office and a member of the firm's Business Law Department, opened the breakout session with an introduction of his co-moderator, Ken Love, managing partner of the Chicago office of Deloitte & Touche and panelists Michelle Hooper, Dennis Chookaszian, and Jim Kackley. Mr. Love then introduced Roman L. Weil, Ph.D., CMA, CPA, V. Duane Rath Professor of Accounting at the Graduate School of Business of The University of Chicago and Director of its Directors College. Professor Weil is also Co-Director of the Chicago/Wharton/Stanford Law School Directors Consortium and Directors Accounting and Finance program.

In his introduction of Professor Weil, Mr. Love shared his view that the first priority of an audit committee should be to make sure that it is effective, and its second priority should be its efficiency. "One of the issues around being effective is: Do you have members that are qualified to fulfill the audit committee role and functions?"

According to Mr. Love, an audit committee's effectiveness is, at least in part, dependent on the financial literacy of its members.

Mr. Love continued, "Professor Weil has studied the topic of financial literacy probably more so than any other academic in the United States and, maybe, in the world."

Before describing the methods by which he measures the financial literacy of audit committee members, Professor Weil explained the importance of the financial literacy of audit committee members to shareholder value. According to Professor Weil's analysis, the stock of companies whose audit committees' "financial literacy potential" improved over the last four years outperformed the stock of companies whose audit committees did not improve in that area by an average of four percent per year in excess annual return.

"What I am talking about is not idle," said Professor Weil. "There is some payoff to this. For the companies the size we studied, we are talking about a rate of return per year for improving audit committee financial literacy potential on the order of \$500 million per year and the cost is at most \$100,000. It may be zero."

Professor Weil then pointed out that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) have recently added to their listing requirements that a publicly traded firm listed on either exchange must have audit committee members who are "financially literate." The problem with such requirements, according to Professor Weil, is that, while the listing rules of these exchanges require audit committee members to be financially literate, "nobody says what that is." He then described his four criteria for determining financial literacy, using the "Critical Accounting Policies & Estimates" section of Kodak's annual report as a backdrop. According to Professor Weil, all audit committee members must be able to:

- Understand the transactions that require the judgments described in the Critical Accounting Policies & Estimates of annual reports. ("I think all board members should understand how the company earns income, which I think means all board members should master this step.")
- Understand the accounting and measurement issues for the policies and estimates. ("For inventory, shall we use perpetual or periodic systems? Shall we use historical cost, lower cost, or market replacement cost?")
- Understand management's choices among policies and methods for making estimates and the reasons for them. ("We don't know why Kodak chose last-in, first-out (LIFO), but the chances are it has something to do with the tax deferral benefits of using LIFO in times of rising prices and increasing inventories. But if I am on the audit committee, I expect to be able to understand and have that discussion with management.")
- Understand the implications of management choices for potential manipulation of financial reporting. ("You are not financially literate

unless you understand, in your own head, without bringing in an outside consultant like me, the potential that this choice by management provides for income manipulation.”)

Over the past several years, Professor Weil has been scoring audit committees for their financial literacy and has laid out his four-point scoring scale for scoring the financial literacy potential of audit committee members. According to Professor Weil, the higher the average score of audit committee members, the higher the financial literacy potential of the audit committee.

4 Points: A member who, at some point in his career, has been a public accountant or a controller (“You actually had some experience dealing with accounting issues.”)

3 Points: A member who is a financial executive without accounting experience

2 Points: A member who is a business executive with no financial experience (“Think Leo Mullins of Delta Airlines. A great operating executive. Nothing in his career path suggests any familiarity with accounting.”)

1 Point: A member who is “a Greenpeace official or the president of The University of Chicago — a professor of music — who happens to know something because he has had some private tutoring.”

Professor Weil reemphasized that, with respect to the stock performance for companies that have improved the financial literacy potential of their audit committees compared to companies that have not improved, “the improvers out earned the non-improvers by an extraordinary amount.”

Audit Committee Overload

At the conclusion of Professor Weil’s remarks, Mr. Bill displayed a list of audit committee responsibilities. The list included:

- Overseeing the company’s accounting and financial reporting and monitoring and evaluating its independent and internal audit processes
- Reviewing the quarterly and year-end financial statements and related Form 10-Q or 10-K MD&A and press releases, understanding the critical accounting policies used by the company, as well as meeting separately with the company’s management, auditor, and internal auditor to discuss such matters
- Hiring and monitoring the performance and independence of the outside auditor in connection with both its audit and non-audit services
- Implementing a whistle blower process for complaints regarding financial reporting and internal accounting and auditing matters

- Overseeing the performance of the company's internal audit process and the establishment and maintenance of effective internal control over financial reporting
- Self-assessing the effectiveness of the audit committee
- Sometimes being called on to conduct internal investigations as a result of allegations of possible accounting irregularities, whistle blower complaints or up-the-ladder reporting of possible material violations by counsel
- Assisting in board oversight of the company's compliance with legal and regulatory requirements
- For a NASDAQ-listed company, reviewing related party transactions for potential conflicts of interest

Best Practices for Ensuring Audit Committee Efficiency and Effectiveness

Rather than expound on each responsibility listed, Mr. Bill and Mr. Love decided to ask Ms. Hooper, Mr. Chookaszian, and Mr. Kackley to each discuss their particular committees' best practices and how they are dealing with the handling of the overload that is involved in audit committee responsibilities.

The Committee Charter and Pre-Meeting Mailings

Michelle Hooper, managing partner of The Directors' Council and chair of the audit committees of both Target Corp. and PPG Industries, spoke first. "For the audit committees I sit on and I chair, it really starts with our charter, and we have spent quite a bit of time in our committees not only looking at what the responsibilities and accountabilities are on our charter, but using the charter then to lay out our annual agenda and to have that agenda be pretty detailed in terms of those things that we are required to do," Ms. Hooper said.

She also noted that, as chairperson of two audit committees, she pays particular attention to materials mailed to committee members prior to meetings. To avoid overload and increase efficiency, Ms. Hooper strives to send mailings that are very focused. This avoids what she calls a "data dump." In her view, these shorter, focused mailings increase the likelihood that all committee members will read all of the materials mailed prior to meetings. This allows Ms. Hooper to do presentation overviews, highlighting those things that she determines are important to the discussion topic and spending the rest of the audit committee meeting time in interactive discussion between the committee members and the outside auditors and management.

Interviewing, Delegation of Duties, and the Use of Technology

Jim Kackley, a former practicing certified public accountant (CPA) and a current member of the audit committees of both Herman Miller, Inc. and Pepsi Americas, Inc., spoke next. Mr. Kackley said he recently realized that, in order to be an

effective and efficient audit committee member, he was going to have to look to other people.

“It became apparent that I would wisely spend my time by interviewing extensively the financial people within the company, the internal audit group, and the outside audit team, so I made it a point to do that before I joined the board,” Mr. Kackley said. This allowed him to be confident of both the capability and the integrity of the audit teams and to see if there was any indication that the senior management was applying undue influence to “make the numbers.”

Mr. Kackley then explained the importance of appropriate delegation of duties among audit committee members. He used as an example his experience on the audit committee at Herman Miller, Inc. There, an audit committee member who is a securities lawyer by trade is delegated all duties involving U.S. Securities and Exchange Commission (SEC) and NASDAQ or NYSE communications, while Mr. Kackley is responsible for the interface with the outside CPA firm. This includes responsibility for the evaluation for negotiating all fees, for visiting at the various key locations outside the country to meet with the CPA firm representatives, and ensuring that high quality audit teams are in place.

The third technique for improving efficiency and avoiding overload mentioned by Mr. Kackley was the use of technology, specifically a secure directors’ Web site. Such a Web site allows Mr. Kackley to download both internal analyses of earnings as well as the comments provided by outside CPAs.

“Since I happen to live on a farm in rural Wisconsin and we don’t have FedEx yet, why, this is a marvelous way to get access to information,” Mr. Kackley said.

The Annual Audit Plan, Being Proactive, and Integrated Risk Management

Dennis Chookaszian, retired Chairman and CEO of CNA Financial Corporation and member of the audit committees of various public companies, then shared his thoughts on improving audit committee effectiveness and efficiency, while avoiding overload. Mr. Chookaszian first explained the importance of an annual audit plan.

“I think one of the most important things that an audit committee needs to do is, at the beginning of the year, to set out an agenda and determine what is going to take place at which meeting,” Mr. Chookaszian said. “You have to determine what are the important things you have to do and you have to slot them into meeting time frames.”

According to Mr. Chookaszian, failure to set a clear agenda can result in an inordinate number of audit committee meetings throughout the year. “One of the companies whose audit committee I am on, the year before I joined — I am now chairing that committee — the audit committee met 24 times, and I couldn’t believe that,” Mr. Chookaszian explained.

Mr. Chookaszian's second point was the importance of audit committee members being proactive. He said that, prior to the enactment of SOX, audit committees were able to fulfill their responsibilities by simply listening to two presentations, one by the chief financial officer (CFO) and one by the internal auditor.

"Today, I don't think you can properly exercise your responsibilities as an audit committee member without being extremely proactive," Mr. Chookaszian said. He then gave examples of some of the things he does to be proactive, such as traveling to foreign locations to have technical discussions with the internal and external auditors and, if he is unhappy with the quality of the external auditors, asking for them to be replaced.

Mr. Chookaszian then expanded on his third point, integrated risk management. He said that, as SOX 404 requirements are implemented and enforced more extensively in the future, companies will need to have an integrated risk management process that ties into the audit process.

"Most of the auditors I have spoken to in the firms I am involved in are recognizing that they are going to have to make some changes in their audit plans or audit programs to focus on some of these risk management issues," Mr. Chookaszian said. "As a company, if you build that into the whole planning process, you can do some pretty effective things with it."

For More Information

To learn more about “Audit Committee Effectiveness vs. Overload,” feel free to contact the session speakers.

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