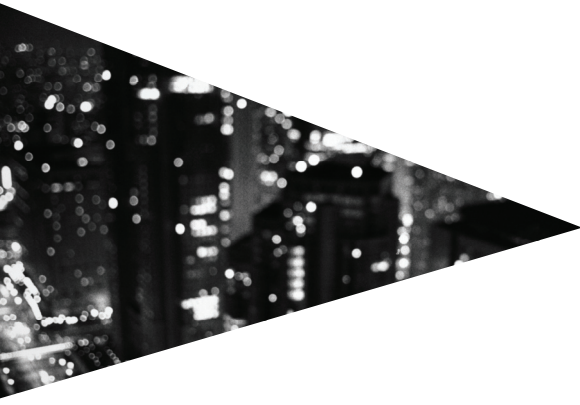


The focus of audit committees during the financial crisis



Executive summary

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Ernst & Young convenes seven audit committee networks in North America and Europe. These networks are orchestrated by Tapestry Networks. Together, these networks comprise over 100 audit committee chairs and members. They sit on over 300 large and medium sized company boards, with a total market capitalization in excess of \$1.2 trillion. *For a complete list of networks, please see the appendix on page 3.*

Not surprisingly, the financial crisis has dominated discussions at network meetings in recent months. The depth and breadth of the financial crisis has shocked audit committees. Committee agendas have been changing dynamically. Leading companies' audit committees are focused on:

- ▶ Scrutinizing financing on an ongoing basis
- ▶ Broadening analysis of near-term risks and key relationships
- ▶ Analyzing year-end issues
- ▶ Revisiting financial plans and budgets
- ▶ Re-evaluating financial communications
- ▶ Ensuring controls remain robust
- ▶ Considering implications for enterprise risk management

The financial crisis calls for additional audit committee scrutiny

According to audit chairs in the networks, audit committees need to:

Scrutinize financing on an ongoing basis

- ▶ Conduct in-depth analyses of the company's liquidity, debt and credit-line maturities, use of capital, access to credit, ability to refinance; analyze condition of key financiers; more companies are drawing down commitments even if they are not needed
- ▶ Review investment portfolio, investment policy and treasury function
- ▶ Review company defined-benefit pension funds, with focus on asset values and discount rates; identify any potential year-end funding deficits
- ▶ Request additional detail from management about exposures to financial instruments

Broaden analyses of near-term risks and key relationships

- ▶ Evaluate concentration and counterparty risks: analyze financial condition of, and state of relationships with, key customers, suppliers, joint-venture partners and insurers (including directors-and-officers liability insurance carrier)
- ▶ Pressure-test the balance sheet, with a line item review of assets and liabilities

Analyze year-end issues

- ▶ Discuss year-end opinions with financial management and the external auditor; explicitly discuss potential for impairment of goodwill and tangibles
- ▶ Review litigation reserves
- ▶ Determine valuation of financial assets and liabilities and monitor developments in application of fair value accounting

Revisit financial plans and budgets

- ▶ Perform scenario-testing on company's financial projections
- ▶ Re-consider significant investments and expenses in 2009; key word is prudence
- ▶ Ensure management is patient in seeking out opportunities created by financial crisis, e.g., potential acquisitions

Re-evaluate financial communications

- ▶ Identify increased disclosure requirements that may develop as the company determines how various financial instruments expose it to risk
- ▶ Consider more expansive communications in the Management Discussion and Analysis (MD&A), for example, on pensions and the investment portfolio

- ▶ Focus more attention on vetting press releases and other key financial disclosures
- ▶ Consider withdrawing annual earnings guidance in light of the economic uncertainty

Ensure controls remain robust

- ▶ Be vigilant of financial controls because management and employees could feel increased pressure in the current environment to hit targets or to manipulate losses/expenses
- ▶ Ensure internal audit is focusing more attention on those areas where management or employees may experience the most severe performance pressures
- ▶ Encourage the external auditor to voice any concerns about the company's culture and performance environment
- ▶ Ensure messaging to employees reinforces need to operate ethically, and to report and escalate any concerns that they may have on inappropriate behaviors
- ▶ Discuss potential Sarbanes-Oxley certification problems: talk to the CEO and CFO about 302 certifications, and with financial management and the external auditor about 404 certifications

Consider implications for enterprise risk management

- ▶ Push management to identify the "unknown risks" and second-order effects of the current financial crisis; management should "think the unthinkable" and revisit their fundamental assumptions, and discuss their views with the board and audit committee
- ▶ Add "changes to the risk profile" to every audit committee and board agenda; this should include assessing and enhancing risk-management practices
- ▶ Have experts, both inside and outside of the company, look at the company's risk profile and process; include outside advisors, and the internal and external auditors
- ▶ Evaluate implications for the investment process; for financial institutions, consider enhancement to their internal "rating" systems; don't just rely on external credit ratings
- ▶ Consider need to change governance of risk, in particular the delineation of roles between the full board, audit committee and other committees (e.g., finance committee), the need for (additional) cross-committee membership, and any skills gaps among the board and committee membership; key theme: don't overload the audit committee such that it strays from its core responsibilities

Appendix: Audit committee networks

There are seven audit committee networks convened by Ernst & Young and orchestrated by Tapestry Networks.

The networks are:

- ▶ Audit Committee Leadership Network in North America
- ▶ Canadian Audit Committee Network
- ▶ European Audit Committee Leadership Network
- ▶ Midwest Audit Committee Network
- ▶ North Central Audit Committee Network
- ▶ Pacific Southwest Audit Committee Network
- ▶ Southeast Audit Committee Network

About this document

InSights is produced by Tapestry Networks to provide assessments of key issues of interest to audit committee members in North America and Europe. Initially, *InSights* will be distributed to members of the audit committee networks convened by Ernst & Young, the members of which will, in turn, share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

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EYG No. CJ0093

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