



## Adapting audit committee oversight to a rapidly changing environment

### Introduction

On March 23, 2009, Canadian Audit Committee Network (CACN) members gathered in Toronto to discuss how audit committee and board oversight is adapting to rapidly changing market and economic circumstances. Members anticipate ongoing challenges and don't expect a return to pre-financial crisis market and economic conditions any time soon. Their audit committees are focusing on near-term financial health, but also engaging management and the full board in more forward-looking strategic discussions.

This document reflects a synthesis of the key issues that emerged from the meeting. Between them, the members of the network who participated in the meeting sit on the boards of over 35 large-, mid-, and small-cap public companies. Those members participating in the meeting were:

- Bill Anderson, Audit Committee Chair, TransAlta
- Mike Boychuk, Audit Committee Chair, Yellow Pages Income Fund
- Bev Briscoe, Audit Committee Chair, Goldcorp
- John Caldwell, Audit Committee Chair, IAMGOLD
- Don Fullerton, Audit Committee Chair, Husky Energy
- Krys Hoeg, Audit Committee Chair, Sun Life Financial
- Ted Reevey, Audit Committee Chair, Aliant
- Pierre Robitaille, Audit Committee Chair, Gildan Activewear
- Vic Young, Audit Committee Chair, Royal Bank of Canada

Attending the meeting from Ernst & Young Canada were:

- Colleen McMorrow, Senior Client Service Partner and Greater Toronto Area Leader, Technology, Communications, and Entertainment Industry Practice
- Rob Scullion, Managing Partner for Assurance and Advisory Business Services

*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. Quotes in italics are drawn directly from comments made by Canadian Audit Committee Network members during the meeting.



## Executive summary

- **Audit committee focus is increasingly strategic and forward looking** (Page 2)

Network members expect current economic and market challenges to continue for some time. As a result, the audit committee, which today often doubles as the finance committee, is increasingly focused on issues of strategic importance, such as liquidity and solvency, access to capital, and capital structure. These strategic issues require the attention of the full board, and members report increasing engagement and interaction between the full board and the audit committee.

- **Audit committee meetings are changing in response to shifting areas of focus** (Page 4)

The time required to oversee forward-looking, strategic, and financial issues requires audit committees to reprioritize their agendas. They are increasing the efficiency of audit committee meetings by reducing time spent on presentations and compliance and adopting consent agendas to cover routine issues. They are also looking for more and deeper insight from management and the external auditor to help inform strategic discussions.

- **The new risk management battle cry is “back to fundamentals”** (Page 6)

Many people have suggested that the financial crisis represents a massive failure of risk management, following a period in which management and boards focused on developing better risk management frameworks and processes. Members are considering how they might work with management to ensure risk is better managed in the future, not through frameworks or complex financial vehicles, but by asking for more scenario planning, better forecasting, and balancing a more conservative posture with the need to seize strategic opportunities in order to compete.

- **Boards are reconsidering the best approach to governance** (Page 8)

In a conversation prior to the meeting, a network member asserted, “We’ve just witnessed the biggest failure of governance during the biggest focus on governance in history.” In addition to revisiting risk management, boards are considering how they might improve board governance more broadly. They are considering a number of factors, including the right size and profile of boards, the appropriate committee structure, and information flows from management.

## Audit committee focus is increasingly strategic and forward looking

CACN members report a significant shift in audit committee focus: the audit committee now considers the impact of financial issues on strategy more broadly instead of concentrating on compliance and financial reporting. One member said, “*The audit committee is changing. It is more forward looking, dealing with treasury, hedging, cash management. We’re spending half our time on forward-looking, strategic issues.*”

## Economic recession will have lingering effects

Members expressed concerns that political responses to recession and the financial crisis seem aimed at getting back to the “normal” conditions that led to the financial crisis. A network member observed,



*“[Some leading bankers and politicians] see recovery as getting back to where it was, and soon ... It’s very worrisome.”* Another member said, *“It wasn’t good times, it was just a buildup to disaster. We will bounce back to a much lower level of economic activity. That is a more sustainable level of activity.”*

Members generally agree with David Dodge, the former governor of the Bank of Canada, who said in March, “I think anybody would be dreaming in Technicolor to think that you’re going to get through this by the third quarter of this year.”<sup>1</sup> Members also say financial reporting issues, such as asset impairments, will continue to be “*big issue[s]*” through most of 2009.

This outlook is impacting the way members are approaching audit committee and board oversight: now they are generally taking a more assertive, forward-looking approach, including digging deeper into assumptions and risk management processes. According to one member, *“It will be a different world, not the world we were comfortable with, when companies performed so well.”* Several noted that disclosure has changed. Many companies’ new management discussion and analysis (MD&A) disclosures addressed performance in the context of the economic environment, rather than offering purely factual disclosures that merely compare results in one period with another. At least one member approved of the change, remarking, *“I hope that sticks.”*

### **The audit committee often acts as the de facto finance committee**

Because many companies lack a board finance committee, the audit committee is often the logical forum for a “*deep dive*” into oversight of the capital structure, liquidity and solvency, operating cash flow, and issues related to pension funding. A member said, *“Stress testing [of financial projections] is acute.”* Another member said that in the current environment, *“The audit committee is looking at liquidity, the overall financial position of the company. The audit committee talks to management about where they see this going. Normally, it’s a full board issue, but the audit committee has to deal with it in a more detailed, forward-looking way to advise the board.”*

Members note that access to capital is still limited, and one said, *“It’s a new world in terms of bank credit facilities, terms, and cost.”* Another member challenged, *“Today, try to raise money if you’re a below-investment-grade company.”* Several agreed that liquidity is of central importance to strategic discussions at the full board level. One stated bluntly, *“Strategy is being driven by the available capital resources,”* and members noted that those capital resources are scarce right now.

### **The full board is increasingly engaged in audit committee activities and vice versa**

Financial discussions *“add a lot to audit committee meetings,”* but also require the attention of the full board. Network members report that more board colleagues are attending audit committee meetings because the audit committee is where financial issues are discussed in greater depth. One said, *“Many board members are showing up at audit committee meetings. They feel they need to get information [firsthand] to do their job properly.”* Another member observed that other board directors’ participation in audit committee meetings *“impacts the board dynamic. We’re discussing strategy at every board meeting, and now all*

<sup>1</sup> Ajay Kamalakaran, “David Dodge says Canada facing long recession: report,” *Reuters*, March 18, 2009. Available at <http://ca.reuters.com/article/businessNews/idCATRE52H25I20090318>.



*directors have a better understanding of the backdrop of the company's financial position. Everyone is on the same page."*

Some board members who are not on the audit committee, however, are uncomfortable with the degree to which financial discussions have shifted from the full board to the audit committee. One member described a *"healthy tension"* between the full board and the audit committee in some cases. Another member said the audit committee takes leadership on some of these issues, but others are handled by the full board. This member noted, *"I am uncomfortable with the audit committee driving big, strategic liquidity decisions."*

### **Audit committee meetings are changing in response to shifting areas of focus**

As audit committees have taken on a central role in oversight of strategic financial issues, audit committee chairs are identifying ways to ensure their time is appropriately focused and the full board stays well informed. One member warned that *"if things don't improve,"* the audit committee will have to have *"more frequent or longer meetings."*

### **Ensuring the audit committee agenda is focused**

As one member noted, *"We still only have a finite amount of time. The audit committee relies on the audit committee chair to ensure the agenda is targeted. That requires the audit committee chair to spend a lot more time with management, preparing."*

Another network member shared a simple practice that many others plan to emulate: asking all audit committee members to help shape the agenda before each meeting. This member said, *"The [outline of the] agenda is set a year in advance ... It must be outdated [by the date of the meeting] because the environment is changing so rapidly. I send it to members to remind them and say, 'What is not on the agenda that you would like to see?' It ends up [that they identify] the most important topics."* This practice signals to management that they do not own the agenda and motivates audit committee members to get engaged earlier. While this process requires additional time and coordination from the audit chair, one member said the agenda gets changed significantly as a result, focusing audit committee meetings on critical, timely issues.

Members see opportunities to optimize in camera sessions with management and the external auditor to bring the most salient issues to the fore prior to audit committee meetings. One network member said, *"I am being more proactive with the CFO beforehand in setting expectations, instead of letting the CFO lead the discussion."*

### **Increasing the efficiency of audit committee meetings**

One audit chair observed, *"There's been a big change. Pre-audit meetings are longer, audit committee meetings are longer, and the number of meetings is up."* Because audit committee agendas are filling up with additional items, keeping the number and length of meetings under control requires not only reprioritizing agendas, but other new approaches as well. As one member said, *"We really want to spend time on key issues."*

One way to do that is to relegate routine, *"check-the-box"* items to consent agendas or question-only discussions. A network member quipped, *"We can all read,"* noting committees can save substantial time by



assuming members have read the material in their meeting books. Several members agreed that these changes are making committee meetings not only more efficient, but also more interesting because committee members are able to focus on core oversight responsibilities and issues of critical importance during a challenging period.

Some audit committees have also moved ad hoc educational sessions outside of audit committee meetings. Several members said this was a useful practice, not only to preserve time during audit committee meetings, but also to involve other board directors in educational sessions.

Members are also working to better coordinate their agendas with those of the full board. According to one network member, *“Some items [on the audit committee agenda] become hot topics for the board, so the full board is invited to the audit committee meeting. We try to line up those audit committee meetings next to a full board meeting. That way, we don’t need to cover it again with the full board.”* Another member said he takes the same approach with the board that he expects executives to take with the audit committee: he assumes that board members have read the summary committee materials and focuses his report on the two or three issues the board needs to understand.

#### **Ways to focus the audit committee agenda and increase meeting efficiency**

- **Involve audit committee members in developing the agenda**
- **Limit in-meeting management presentations; focus primarily on questions**
- **Designate routine items as consent agenda items**
- **Move educational sessions outside audit committee meetings**
- **Invite the full board to audit committee meetings to avoid repetition in the full board meeting**

#### **Looking for additional information from financial management**

Members generally report spending more time with management asking for information, especially from the CFO. One member said that although current conversations with CFOs are not materially different from those in the past, today’s market volatility means that *“we’re getting into it weekly, sometimes almost daily ... It starts with the CFO interfacing with the market and bankers.”* Another member realized that *“the CFO is a lot better than I’ve ever known,”* something that has become evident *“as the audit committee is spending more time than ever with [the CFO].”* In addition to having more frequent conversations with the CFO, some members are asking the CFO to explain assumptions and accounting judgments in greater depth.

Some members said they close each meeting with the CFO by asking, *“What else do we need to know about?”* But members acknowledged that the CFO inevitably answers, *“Nothing.”* One network member suggested an alternative tactic: *“Frame [the question] by expressing your worries about plausible negative*



*scenarios: “I think this is going to happen, so give me some comfort that I shouldn’t be so worried about it. And, if it can happen, how would we react?”*

### **Asking the external auditor for broader perspectives**

Members are looking for different kinds of information from the external auditor. One member said, “*We want to talk to the external auditor about issues they’re having in closing the [financial] statement, or over the course of the year, so I can identify issues that will be most important for the audit committee to review.*” Several members said that in the current environment, they also expect the external auditor to highlight future areas of concern. One member commented, “*Meetings [with the auditor] tend to focus on the past. There needs to be more focus on red flags now.*” Another stated, “*The dynamics at the audit committee have changed. The auditor needs to be sure they are providing value to forward-looking discussions, cash flow forecasting, etc. Not just the audit mentality of the past, but bring new depth. They have the organizational capabilities [to do this].*”

Several members said they turn to the auditor for perspectives gleaned from experience across clients and industries, perspectives members can use to benchmark their own companies’ performance and situation. Some network members are also looking for an assessment of the audit committee and the chair and for new approaches or practices they could adopt to improve the audit committee’s effectiveness. Members welcome the auditor’s perspective on the resourcing and capabilities of the finance organization. Some members thought the auditor’s perspective on the competence of the CFO and his or her staff can be valuable, although one questioned whether the auditor spends enough time with the CFO or sees the full breadth of the CFO’s activities to offer a fully informed perspective on the CFO’s performance.

### **Engaging management outside the finance organization**

One member always meets not only with the CFO and treasurer, but with the head of sales prior to a meeting. This allows him to “*pick up amazing insights to bring back to the committee, with a good sense of the organization.*” This member said that when meeting with executives outside of finance and audit, he sends a quick note to the other audit committee members outlining key takeaways.

Most members say the CEO attends all audit committee meetings. Yet members are quick to point out that, in most cases, the CEO is invited only to attend, observe, and participate in discussion as necessary. In their view, the CEO should not present in place of other executives, as network members would view that as a signal that something is wrong, or that the CEO is uncomfortable letting the management team step up. They also note that the CEO is not there “*to get other management out of trouble [during difficult discussions].*” One member emphasized, “*It’s really important for the CEO to hear audit committee concerns, questions, and our interactions with management.*”

### **The new risk management battle cry is “back to fundamentals”**

The financial crisis and recession have reinvigorated audit committee and board discussions of risk management. In the words of one member, boards are trying to determine “*what we lost in this void and how to ensure we keep it from happening again.*” A member suggested that companies had gradually adopted riskier practices over time: “*We went through an unlearning process in the last couple of decades.*”



*We had a good understanding of the risks in our businesses, [and] then we unlearned how to run businesses without stretching out. Competition has intensified, stretching risk parameters gradually ... We've got to get back to fundamentals." Another said, "I've watched strategic planning sessions [in the past], and the word 'risk' hasn't even been involved. You could do no wrong ... Today, risk is driving strategic plans."*

Members said they are going over risk basics with management rather than discussing frameworks and complex risk identification and mitigation processes. They are asking probing questions of management about third-party risk, considering the status of strategic partners, customers, and suppliers.

### **Challenging forecasting and scenario planning**

Looking ahead, members expressed concerns about the validity of forecasting. One member asserted, *"Bluntly, I haven't seen many forecasts that have stood up recently. We keep re-budgeting and forecasting. So what is the audit committee's role? Sometimes, we're presented with a best case, a worst case, and a really ugly case, and what's happened has been worse than the really ugly case."* Another said, *"I like to ask the question, 'Under what scenario would this not be approved by the board?'... I have seen proposals turned down on that test."* A member added, *"The board is not going to do the forecasting, but we need to ask pointed questions about assumptions going into the forecasting [that] we might not have asked before."* Members said that if management brought only a rosy scenario in which economists predicted recovery next year, they would *"send them back. [We] wouldn't accept it."* Several members noted that management is naturally inclined to be optimistic, requiring the board to push back. As one member said, *"It's not about the nightmare scenario, it's about [considering] likely, or [at least] not-unlikely scenarios. This can happen."* One member asserted that the *"board's biggest failure is focusing on one risk [instead of on] the confluence of multiple risks."*

Despite consistently having to revisit forecasts, few members reported reflecting on why plans needed to be revised so regularly or on whether any of the revisions were avoidable – both questions that audit chairs might raise with their boards to be sure that they are not overlooking any potentially systemic mistakes in forecasts and planning.

### **Balancing conservatism and strategic growth**

Several members suggested boards will need to ensure companies limit risk and operate with a more conservative capital structure *"in a world where you want to be less reliant on debt."* This member noted that *"today, companies are being rewarded for liquidity,"* but then asked, *"How long [will it be] before shareholders want them to lever back up again and buy back stock? Will companies be disciplined enough? Will they do what's right for the business versus what the equity markets want?"* The same member said, *"The first principle is, safety, liquidity, then yield. That got reversed. The days of trying to squeeze that extra juice are over."*

Despite generally advocating a more conservative approach, one member noted, *"There are opportunities in these times. You can't ignore them."* Another member agreed: *"There is a risk of not being competitive, even if the market is going somewhere you're not comfortable with."* The difference now, according to one member, is that companies should *"at least understand the risk and price it. You can't stop taking the*



*risk, but we were allowing managements to put returns forward that were not commensurate with the risk.”* But another member said it all comes back to financing and capital structures: *“Should you take the risk, how will you finance it? Boards have to step in and ensure the company structures [financing] a different way, by accessing equity markets instead of borrowing [capital]. Boards will push for a more conservative capital structure ... Right now, it’s all about capital structure.”* Ultimately, companies may have to answer the question posed by one member: *“Can you differentiate yourself in a less risky way?”*

### Boards are reconsidering the best approach to governance

Current challenges have pushed boards to reconsider not only their approach to risk oversight, but also to board governance more broadly. Members considered the following:

- **Committees of the whole may be an attractive alternative.** Some members have seen smaller boards effectively involve all board members in all committee activities, which ensures all board members are equally well informed in each committee area and saves time at board meetings by removing the need for committee presentations and reports. Members noted that this approach does require a greater time commitment from each director. In cases where committees of the whole may not be feasible, members said a simple way to engage all directors on committee issues is to distribute full committee materials to all directors.
- **Boards should be big enough, but no bigger.** Smaller boards tend to encourage all members to engage fully in board activities and increase efficiency, but members cautioned that boards also need to have a broad enough range of experiences and perspectives to be effective in oversight of a broad range of issues.
- **Effective oversight is less a function of industry expertise than of individual commitment.** Members noted that the way to improve bank oversight being prescribed by some is to add former bank executives to bank boards. Yet members said a broad range of experience and expertise in different business areas (human resources, technology, finance, etc.) is often more important than industry expertise. Additionally, companies benefit most when directors are willing to commit adequate time and step forward to challenge management in a constructive manner.
- **Boards must challenge management to simplify the business.** A network member said that in his experience, one of the best directors had little business or finance experience, but was willing to keep pushing management to simplify their explanations until they were understood. This member said, *“[The director] was quite prepared to look stupid, but wasn’t prepared to make a stupid decision.”* Often, members agreed, complexity is just a way to cover up a potential problem. For audit committees, simply accepting that financial reporting conforms to generally accepted accounting principles doesn’t mean their job is done. Audit committee members should ask management to simplify and explain everything in their financials until they are satisfied they understand how the company makes money and where risks might lie. That includes looking closely not just at underperforming areas of the business, but areas that may be performing unexpectedly well.



- **New directors can benefit from serving on the audit committee.** One network member described a board that assigned all new directors to the audit committee because of the opportunities to learn about company operations, risk management, and finance in greater depth.
- **Governance changes are not short-term responses to crisis.** Members generally said that while the financial crisis has prompted new thinking about corporate governance, these ideas may well constitute better practice long after the crisis abates. In a memorandum entitled *Some Thoughts for Directors in 2009*, Martin Lipton and other partners from the law firm Wachtel, Lipton, Rosen & Katz summarize the challenge boards must address: “In short, the task for boards is not simply to go into crisis mode in order to deal with current issues, but rather to take a more holistic, long-term approach to reassessing their proper role and functioning.”<sup>2</sup>

## Conclusion

Boards are being challenged by ongoing economic and market challenges to reprioritize their agendas and areas of focus. The level of risk in the current environment requires the attention of the full board, but CACN members say the audit committee will still lead deep dives into key financial risks related to liquidity and capital structures. This, in turn, is leading to increasing engagement with the full board, management, and the external auditor in more strategic, forward-looking discussions.

The financial crisis and recession raise questions as to how boards might improve governance and better facilitate risk management oversight. Regardless of how boards answer these questions, it is clear that directors will have to spend more time, gather more information, and be willing to challenge management in order to fulfill their oversight responsibilities.

## About this document

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. 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 committee 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 *VantagePoint* 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.

*The views expressed in this document represent those of the Canadian Audit Committee Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.*

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<sup>2</sup> Martin Lipton, Steven A. Rosenblum, and Karessa L. Cain, *Some Thoughts for Directors in 2009* (New York: Wachtel, Lipton, Rosen & Katz, 2009), 1. Available at <http://www.wlrk.com/docs/ThoughtsforDirectors2009.pdf>.



## **Appendix: Questions for audit committees to consider**

- ?** What do you predict will be the biggest ongoing valuation or reporting issues during the course of 2009?
- ?** How has your company modified its liquidity and cash management analysis? How much discussion has taken place at either the audit committee or full board level on liquidity concerns at key suppliers or customers?
- ?** How do you evaluate the capital structure at the board level?
- ?** What lasting impact might the financial crisis have on financial statements and disclosures?
- ?** Has the role of the audit committee and the audit committee chair changed in response to the current environment? In what ways? In what ways should it change? How can audit committees ensure they are balancing oversight of strategic financial issues with ongoing compliance and reporting?
- ?** How has interaction among the full board, the audit committee, and management changed in response to the financial crisis and recession? What lasting changes do you expect? Are you spending more time with the CFO? How much time do you spend with management outside the finance organization?
- ?** How is your company rethinking its risk management processes in response to the financial crisis and recession? What lessons can be derived from failures of risk management at other companies? Has board oversight of risk management changed? If so, how? What changes would you like to see?
- ?** How can boards ensure companies are not only managing short-term risks, but preparing for economic and market recovery?
- ?** What does effective oversight really mean? Have boards focused on the right issues? What, if anything, needs to change to ensure boards are more effective in the future? How do you balance the need for deeper board engagement with the need to avoid interfering with management?