



Midwest Audit Committee Network fall meeting – October 7, 2008

On October 7, 2008, the Midwest Audit Committee Network convened in Chicago. During the meeting, members discussed the following topics:¹

1. Reactions and response to the financial crisis
2. The evolution of internal audit
3. Deriving maximum value from the audit and the external auditor
4. International Financial Reporting Standards
5. Risk management

Reactions and response to the financial crisis

Midwest ACN members shared ways in which boards and management might respond to dynamic events as the financial crisis continues to unfold:

- Pay close attention to liquidity risks, including sources and uses of capital
- Pressure test the balance sheet with a line item review of assets and liabilities
- Request additional details from management about exposures resulting from financial instruments
- Move selected technical and disclosure discussions from the audit committee to the full board
- Be vigilant about financial controls, as management may be tempted to shift losses forward
- Add “*changes in [the] risk [profile]*” to every audit committee and board agenda
- Revisit the external audit plan in light of a changing risk environment
- Consider withdrawing annual earnings guidance in light of economic uncertainty

The evolution of internal audit

Members agree that an effective internal audit function is invaluable to the audit committee. The discussion highlighted several important themes:

- **Internal audit is increasingly important, and it continues to evolve.** Members agree there has been a meaningful change in the scope, value, and perception of internal audit over the last three to five years. Even though internal audit’s role (ensuring effective financial and operating controls) is fundamentally unaffected by the financial crisis, several members questioned whether the function should be more “*nimble*” in responding to changing circumstances.

¹ This note is a summary of key themes from the meeting. A more complete synthesis of selected topics can be found in *VantagePoint* which will be published later this month.

Summary of Themes



- **Many companies are actively upgrading internal audit capabilities.** Several members said their companies have sought to raise the stature of internal audit by recruiting higher-quality staff and rotating talented finance executives through the function. Chief audit executives are increasingly seen as key members of the senior executive team. The most successful upgrade efforts are often initiated with the support or encouragement of the CEO. The audit committee can play an important role, ensuring internal audit resources are aligned with needs.
- **Co-sourcing can help ensure adequate capabilities.** Even though members agree it is preferable to keep most internal audit talent in-house, they say it is often desirable to strategically co-source selected talent. In particular, members highlighted the benefit of sourcing external IT and international audit talent when it is impractical or uneconomical to develop those capabilities in-house.
- **The audit committee's relationship with internal audit goes beyond oversight.** Members acknowledge the relationship between internal audit and the audit committee should be one of mutual support. Such a relationship requires a level of director involvement that goes beyond some interpretations of the word "oversight." Audit committee chairs rely on internal audit to be their eyes and ears in the company; audit chairs also play an important role in supporting the professional development of key internal audit executives.

Deriving maximum value from the audit and the external auditor

Network members agree that an effective relationship with the external auditor is critical if the audit is to provide value beyond a mandated assurance activity. In particular, they observed:

- **The relationship between the audit committee and the external auditor cannot be viewed in isolation.** *"Four parties need to be involved for there to be an effective relationship: internal audit, external audit, the audit committee, and senior management. The [more involved those four parties are], the better the audit committee and external audit relationship is."* It is especially important to establish multiple points of contact between the audit firm and key members of management.
- **Audit committees value business counsel and advice from the audit firm.** Beyond the *"table stakes"* of technical competence, members seek more business judgment from the external auditor: *"I have a belief that auditors have a lot more value to give to me than I'm getting."*
- **Consultation with the national office is a major source of differentiation between audit firms.** Members value audit firms' deep technical expertise, but express frustration that some firms' national offices are *"a big black hole where [technical accounting questions] get dropped in and ... never seen again."* Firms vary in the autonomy given to local account teams and in the direct access clients are granted to national resources.



- **Partner rotation does not have to be painful.** Although members generally lament the regulatory requirement that audit partners rotate off the account every five years, they identified several best practices to ensure a smooth transition: (1) start early, ideally 12–18 months before the rotation; (2) work with audit firm leadership to agree on characteristics and identify candidates; (3) involve the audit committee in the final round of interviewing; and (4) focus on cultural fit.

International Financial Reporting Standards

Members are in the early stages of planning for a conversion to International Financial Reporting Standards (IFRS) by 2014. Even though the Security and Exchange Commission’s proposed IFRS Roadmap has not yet been released, members expect companies will need to have capabilities in place by 2012. In the meantime, members agreed it was helpful to understand the effect of IFRS on financial statements and to scope system changes required to support IFRS. Most members agreed the external auditor could participate in an IFRS assessment without impairing independence.

Members did not endorse early adoption, and most advocated a policy of following developments closely in order to *“not be ahead or behind [other companies].”* Several members plan to include IFRS on every audit committee agenda in order to ensure adequate attention.

Risk management

During the network’s April 14, 2008, discussion of enterprise risk management (ERM), one member observed, *“[At my company], we have been involved in ERM for three or four years, but when I reflect back on the big surprises, not one of them was predicted by our ERM process.”* For many members, the limitations of existing risk management practices were confirmed by the current credit crisis. Companies continue to seek an effective system for identifying, quantifying, and managing risk.

- **Risk management is the biggest issue for audit committees today.** *“Frankly, I find [enterprise risk management] to be the single most difficult thing I’m dealing with as an audit committee chair.”*
- **Directors question whether risk management efforts should focus on better reporting management’s current activities or on guiding a different set of activities.** One member asserted that as a natural part of their responsibilities, *“good managers manage risk.”* Directors therefore seek explicit information that captures management’s tacit judgments. However, others questioned whether boards should so readily accept management’s understanding and prioritization of key risks, noting the prevalence of Rumsfeldian “unknown unknowns” that may significantly impact shareholder value.

Dr. Daniel Diermeier, a professor of managerial economics and decision sciences at Northwestern University’s Kellogg Graduate School of Management, joined the network to discuss the challenges of managing crises that result from reputational risks.



Dr. Diermeier made three key points:

- Companies are placing a much higher value on trusted relationships with their customers. A failure is increasingly viewed by customers as betrayal, with strongly negative consequences.
- Companies have less influence over reputation as third parties (such as activists, journalists, and Internet bloggers) become more important and supply chains become more global.
- Managers haven't recognized that systemic risk is increasing while their ability to manage perception and reputation is decreasing, so crises are becoming more common.

Dr. Diermeier argued that third parties can help management and the board to better identify reputational risks. He encouraged audit committees to ask, "What are the ten things management is not thinking about that could come back and haunt us?"

Meeting participants

- Tony Anderson, Midwest Area Managing Partner, Ernst & Young
- Howard Carver, Audit Committee Chair, Assurant
- Kevin Cole, Area Director of Business Development and Marketing, Ernst & Young
- Daniel Diermeier, IBM Distinguished Professor of Regulation and Competitive Practice, Kellogg School of Management (*guest*)
- Cheryl Francis, Audit Committee Chair, Morningstar
- Brenda Gaines, Audit Committee Chair, Office Depot
- Sandy Helton, Audit Committee Chair, Covance
- David Landsittel, Audit Committee Chair, Molex
- Jim Logothetis, Global Client Service Partner, Ernst & Young
- Cary McMillan, Audit Committee Chair, Hewitt Associates
- Rich Roedel, Audit Committee Chair, Brightpoint
- Dennis Van Mieghem, Audit Committee Chair, AEGON USA
- Ron Weissman, Senior Partner, Financial Services, Ernst & Young (*guest*)

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