



Keeping pace in times of rapid change

Introduction

The Midwest Audit Committee Network is a group of audit committee chairs drawn from leading Midwest companies. The fourth meeting of the network was held in Chicago on February 10, 2009. The meeting focused on the challenge audit committees face in keeping pace with rapid changes in the regulatory, market, and economic environments.

This document reflects a synthesis of the key issues that emerged from the meeting. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues such as these. Anyone who receives this publication may share it with those in their own network. The more broadly this information can be disseminated to board directors, management executives, and their advisers, the greater the value created for all.

The members of the network present at the meeting, who sit on the boards of 25 large-, mid-, and small-cap companies between them, were:

- Howard Carver, Audit Committee Chair, Assurant
- Blake Devitt, Audit Committee Chair, Baxter
- Olivia Kirtley, Audit Committee Chair, U.S. Bancorp
- Laurette Koellner, Audit Committee Chair, Sara Lee
- George Off, Audit Committee Chair, Telephone and Data Systems
- Rich Roedel, Audit Committee Chair, Brightpoint
- Al Smith, Audit Committee Chair, Simon Property Group
- Dennis Van Mieghem, Audit Committee Chair, AEGON USA

Ernst and Young partners participating in the meeting included:

- Tony Anderson, Midwest Area Managing Partner
- Kevin Cole, Area Director of Business Development and Marketing
- Jim Logothetis, Global Client Service Partner

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. Members' remarks appear in italicized quotes.



Executive summary

Members discussed how audit committees are managing their role in an environment of rapidly changing regulation, economic downturn, and market upheavals. Conversation focused on the following topics:

- **The economy and credit markets are unlikely to improve significantly in 2009** (Page 2)

Network members universally agree that market and economic conditions will continue to get more challenging before they improve. They see a prolonged decline with little chance of improvement until some of the “*fundamental errors*” that led to the recession are addressed. They predict more bankruptcies in 2009 and are concerned about the levels of uncertainty and the impact on attempts to budget effectively. Still, members believe boards and audit committees are ready to “*dig in*” and address the challenges head-on, despite significant uncertainty and that boards and audit committees are better equipped to handle adversity than they were a decade ago.

- **Audit committees are placing a heightened emphasis on fundamentals** (Page 3)

Audit committee members increasingly find themselves the “go-to” directors for a range of issues because of the expertise they’ve gained dealing with major financial issues in the past. They also noted that on boards that lack finance committees, the audit committee has taken on that role. Financial and economic developments have caused many audit committees to dig deeper into fundamental questions about liquidity and accounting. Members highlighted several other issues they are monitoring closely, including increasing the degree of transparency in company disclosures, improving risk assessment, addressing fraud risk through more vigilance by internal audit, and tracking accounting developments such as those impacting goodwill impairment and going concern analysis.

- **Improving processes, relationships, and policies to enhance oversight** (Page 6)

Network members discussed several aspects of audit committee responsibilities that they are focusing on in light of the current crisis, including ensuring the committee agenda emphasizes the important issues, addressing succession planning within the finance organization, utilizing their relationship with the external auditor’s independent review partner to bring more seasoned thinking into the audit committee, and raising questions about the validity of earnings guidance.

The economy and credit markets are unlikely to improve significantly in 2009

Members are acutely aware of the impact of the economic crisis: corporate earnings have suffered, layoffs have escalated, real estate values are down significantly, the banking sector is being fundamentally restructured, liquidity and credit have vanished, despite massive government infusions of cash and a federal funds rate near zero, and consumer spending continues to plummet. In this dynamic context, audit committee chairs are looking ahead to ways they can preserve shareholder value and improve corporate performance.

MWACN members agree that these are “*unprecedented times*” and see few bright spots in the near term: “*A year ago, the world was turned upside down and inside out. I’m usually a glass-half-full kind of guy, but*



when 2009 is over, 2008 will pale in comparison. I think we're in for a very difficult next 12–18 months.” Moreover, many members predict that in spite of the challenges to date, *“the other shoe has yet to drop.”* Another member went so far as to say that *“this will be the year of the bankruptcies.”*

One member explained why the downturn might be prolonged: *“I’m typically an optimist, but I see a lot more negatives ahead of us because we haven’t seen any of the fundamentals change. A lot of the problems that caused this recession are still out there.”* Still, others see cause for hope: *“I no longer see the panic we saw in the third and fourth quarter of 2008. People have now gotten over that and are rolling up their sleeves and asking how we’re going to deal with all of this.”* Another member noted, *“Capital markets have started to open up a bit.”* However, one member pointed out that *“the credit markets are still locked up; they’re just locked up for different reasons today than they were a year ago. Now, everyone is frozen in fear about their future because there’s so much uncertainty.”*

Indeed, members see a lack of certainty as one of their greatest challenges in the current economic environment: *“I remain pessimistic because the level of uncertainty is high. Usually we rely heavily on information, but all there is now is uncertainty.”* Added another member, *“We’re trying to make projections, and we can’t. [These are] just unprecedented times, and we can’t see a thing.”*

Audit committees are placing a heightened emphasis on fundamentals

Some industries are more impacted by the economic crisis than others, and members described different audit committee responses, based on expected risks and their implications. Some members are worried about how the crisis will impact the broader economy and consumer spending; others wonder about the availability of credit and what this may mean for companies’ liquidity. All are attending closely to accounting developments that will affect the companies they serve.

The audit committee is serving in the finance committee role

A number of audit committee chairs have said that audit committee members increasingly find themselves the “go-to” directors for a range of issues because of the expertise they’ve gained dealing with major financial issues, whether during economic downturns or through compliance with Sarbanes-Oxley. Audit committee members have often spent more time with management, dug into more areas of the business, and developed a deeper understanding of the details of the business than many other directors. Indeed, one member remarked during the meeting, *“The level of involvement of the audit committee has never been greater. [Section] 404 work pales in comparison.”*

Members noted that on boards that lack finance committees, the audit committee has stepped into the breach in these difficult times: *“So much of what we do today is in the role of the finance committee. There’s so much more focus on the balance sheet and making sure there’s a strong foundation of credit. All companies care about is making sure they have the wherewithal to weather this long and difficult storm.”*



Specifically, members reported that they are focusing on several financial issues:

- **Liquidity.** Prior to the meeting, one member remarked, “I think everybody has come to the realization that things have gotten a lot worse than we initially predicted. We never would have imagined that we wouldn’t have access to credit.” Another member shared, *“We’ll be dealing with the availability of capital and whether – if we have access to cash – it’s even safe.”*
- **Budgeting.** *“I’m trying to wrestle with strategy and operations. How do you even design a budget these days?”*
- **Counterparty risk assessment.** *“Counterparty risk is something I’m pretty concerned about right now. I find that very worrisome in this environment, so we’ll be watching that closely.”*
- **Debt covenants.** *“There are a lot of people out there with debt right now. Many of them come with covenants.”*

Heightened focus on disclosure

The financial crisis has increased the pressure on companies to ensure that their financial statements and disclosures are accurate and that overall reporting quality is high – both primary audit committee responsibilities. Members said that coherent and effective disclosures are particularly important in the current market environment, given increasing public skepticism regarding companies’ liquidity: *“It’s so important to convince the public you have no capital problems, but it can be very hard to do so.”*

Network members considered ways in which boards and management are altering their approach to external communications in these unpredictable times. Two significant changes included:

- **Increasing transparency around financial statements.** *“Nowadays we’re always erring on [the side of] more disclosure – sometimes we’ll say something three or four times [in a document].”* One member pointed out, *“The level of clarity you try to engineer into the document today is so different compared to five to seven years ago. [Disclosure documents] used to be so ambiguous, but people are really trying to be more transparent today.”* Another member added, *“We’re trying to get more balance. You can’t just focus on the good – you need to balance [the positives] with reality.”*
- **Improving investor relations.** Some members spoke of positive experiences interacting directly with investors and analysts on specific issues: *“For the first time, I was asked to speak with Standard & Poor’s. It was extremely interesting to hear what their concerns were, and what they’re focusing on.”* While members who interacted with investors and analysts were *“very well prepped going into the call,”* many still expressed concern about ensuring compliance with Regulation Fair Disclosure (known as Reg FD). Some members felt the issue warranted further discussion: *“I’m very struck by the fact that an audit committee chair would ever be involved in a conversation with Standard & Poor’s. That never even occurred to me. I’ll make sure to follow up on that.”*



Risk management continues to be a top priority

Risk management has been high on the audit committee agenda in recent years, and the current crisis has confirmed the need for an effective system for identifying, prioritizing, and managing a range of strategic, operating, financial, and compliance risks: *“A lot of my big questions are around risk management. We try to test the operating plan, but all of our worst-case scenarios have happened, so what is the worst case scenario? How do you test that?”* Added another member, *“I think risk assessment remains one of our greatest challenges. What are the early warning signs we should be looking for? How do you monitor for that in this economy?”* While members all agreed risk management will be a significant issue in 2009, they also cautioned against becoming too risk averse. As one member remarked prior to the meeting, *“One thing that concerns me [about this environment] is if you overreact and encroach on good business because you are being too risk averse. That’s what bothers me the most about this whole atmosphere.”*

Preventing fraud

Research has suggested that fraud increases when there is more intense pressure to hit targets or minimize apparent losses, or when employee morale is low. An online survey of executives at public companies conducted by *Compliance Week* in October 2008 found that 46% expected fraud to increase in 2009, while less than 4% expected it to decrease.¹ The November 2008 issue of *InSights* noted that audit committees need to be especially vigilant with respect to financial controls in the current environment. They should also remind the external auditor to “voice any concerns about the company’s culture and performance environment,” and they should make sure that “messaging to employees reinforces [the] need to operate ethically, and to report and escalate any concerns.”²

For their part, members agreed that *“the issue of fraud is getting a lot of attention in the board room, and we’re certainly spending more time thinking about it. In this environment, what stress does to the system is profound.”* Members noted that there is also a significant role for internal audit to play in monitoring fraud risk: *“I’m going to pay better attention to some of the fraud indicators and place a higher emphasis on that with internal audit. We need to get a level lower, and dig deeper.”*

Monitoring developments in accounting

Over the last few years, US regulators and standards setters have made a number of significant accounting changes and pronouncements. Some of these changes are now in effect or will take effect this year. Others loom on the horizon. Members agreed that the economic downturn has elevated many accounting issues, and they are anxious to stay abreast of relevant accounting and technical developments. Members highlighted two particular top-of-mind accounting issues:

- **Goodwill impairment.** Members reported that reduced asset values have caused goodwill impairment to become a significant issue: *“Goodwill impairment has been a big economic issue for us*

¹ Melissa Klein Aguilar, “Survey: Many Fearful of Fraud Spike in 2009,” *Compliance Week*, December 2, 2008. Available to subscribers at <http://www.complianceweek.com/article/5171/survey-many-fearful-of-fraud-spike-in-2009>.

² Ernst & Young, “The focus of audit committees during the financial crisis,” *InSights*, November 5, 2008, 2. Available at http://www.tapstrynetworks.com/documents/Tapestry_EY_ACLN_InSights_Nov08.pdf.



this year. We usually look at it as the end of the year, but it's probably something we'll look at more often throughout the year now. This will continue to be an issue." Members said that they continue to struggle with getting their arms around valuation in a tumultuous economy: "[The] whole business of impairment – what's going on? We're trying to find a way to figure all of it out, but all of the normal approaches don't seem to apply anymore."

- **Going concern.** *"We're finding in today's environment that [auditors and boards are] questioning [companies' ability to operate as a] going concern. [These discussions] might not be the best for public relations, though."*

Improving processes, relationships, and policies to enhance oversight

Members considered other ways in which their boards and audit committees will be affected by these unpredictable times. Specifically, network members highlighted how they are reconsidering their approach to several key elements of their audit committee responsibilities.

A shifting emphasis in audit committee agendas

Prior to the meeting, some members questioned the committee's ability to set an accurate agenda given the volatility of the market: *"How are you going to plan for 2009 and 2010 when there's so little visibility beyond the end of your nose?"* Others expressed concern that committees would fail to recognize the need for agendas to be responsive to this difficult environment: *"The trap that I see some getting into is committees going back to last year's agenda. There needs to be recognition that we're in a different world than we were a year ago. I think that's where the audit committee and audit committee chair can play a significant role."*

While members agreed that *"you still need to cover everything in the [audit committee] charter,"* they also warned that compliance should not drive the agenda. Instead of focusing on a complete overhaul of the agenda, members suggested that a shift in emphasis is often sufficient: *"I'm not sure the agenda needs to change entirely, just the emphasis on certain items. [Section] 404 still needs to be covered, but that's a five-to-seven minute conversation now."*

Members said that time put in between committee meetings can help with agenda setting and is a key factor in the success of the meetings themselves: *"It not just four meetings you go to a year – it's about what's happening in between those meetings. If you leave it to four meetings a year, you're dead in the water."* Members shared several ways they are working to ensure they have the most effective agenda possible in this rapidly changing environment:

- **Send draft agenda to audit committee members prior to meeting.** *"[This year,] I will be sending out a draft agenda to all audit committee members prior to the meeting. I want to get the input from all members." Another member remarked, "I want all audit committee members involved in these issues. The best question in the room might come from the person I least expected it from, so I want them to be as informed as possible."*



- **Hold pre-meeting calls with all relevant parties.** *“I always have a pre-meeting call with the CFO, head of internal audit, and the external auditor to talk about the things that they’re struggling with. The basic structure of the meeting might not change, but you make sure the most important issues are brought to the front of the meeting.”* Another member added, *“I also talk to the general counsel and the chief risk officer to make sure all the risks are aired in the meeting as well.”*
- **Send out pre-meeting materials earlier.** *“We have all of our audit committee meetings on a Wednesday, and we’re now sending out all materials on the Saturday beforehand. We’ve found that being able to look at the materials ahead of time really helps.”*

Deepening the relationship with the external auditor’s independent review partner

Members believe there may be some value in having greater engagement with the audit firm’s independent review partner as they work to navigate their companies through the bottom of the economic cycle: *“I think in this environment I’m interested in having more involvement with the review partner versus [simply] the engagement partner. [As a seasoned professional,] the review partner might have more battle scars.”* Added another member, *“I’m hopeful we’ll find the audit committee’s expectation of [the review partner] will increase. All of us in the room are better than some of us. I’m not concerned about the quantity of people [participating in audit committee meetings] so much as having seasoned people in the room.”*

Succession planning within the finance organization

Several members emphasized that audit committees would be well served to focus on succession planning within the finance organization: *“When I look in the mirror today, my biggest concern is what I don’t know. The way you protect yourself is with good people – great internal audit function, a great independent auditor, and great financial staff. The risk of unknowns is mitigated dramatically as a result.”*

Members agreed that active succession planning presents *“a good opportunity [for the audit committee] to speak with people deeper in the organization and make sure you’re getting a consistent message. It really helps you assess the quality of people.”* Some have increased their succession planning efforts as a result of recent turnover: *“We’re having a controller from each business unit come through and present, so we can get a better feel for who our next CFO might be.”* One member pointed out, *“I have seen people rise in their careers as a result of one great presentation [to the board].”*

Other members have tried to capitalize on board meetings that take place away from corporate headquarters: *“Two of our four board meetings are held away from headquarters. We always do a breakfast with the local finance staff, and everyone loves it. We don’t have any agenda – we just want to hear who they are and what they do. You find out what great people you have as well as get a feel for who’s out there in your organization.”*

Open questions around earnings guidance

In their 2008 survey of earnings guidance practices, the National Investor Relations Institute and the CFA Institute Centre found evidence that companies may be moving away from quarterly guidance and toward



the provision of annual guidance only, a trend some network members have also predicted. Among the survey respondents, 45% considered it best practice to provide quarterly earnings guidance, while 60% consider it best practice to provide annual earnings guidance.³

Many companies have questioned the merits of issuing quarterly earnings guidance. The economic crisis has added momentum to the case against guidance because volatility in the markets has made it increasingly difficult to predict quarterly and annual results: *“Is this the point in time when we say it’s not even prudent to give guidance at all anymore?”* One member remarked, *“The temptation is to go low or wide [on guidance]. The mentality is that we don’t want to miss, and therefore, when there’s so much uncertainty, giving that wide range almost doesn’t match what you’re saying internally. It’s much easier to give guidance when you’re more confident. It’s just an unusual time, and you have to decide how you match all those considerations.”* Added another member, *“Everyone’s so overwhelmed by the amount of uncertainty out there; for now we’re just trying to put parameters around that.”*

Conclusion

Despite its severity, this is not the first recession that audit committee chairs have seen. They find themselves pulled in several directions: on the one hand, they need to take a more active oversight role without crossing the bright line into management; at the same time, there are opportunities to improve governance practices and provide a much needed source of balance and stability. If there is a silver lining, it could be that recent improvements in corporate governance have fostered more effective boards and audit committees. As one member said, *“The good news is that if the world had to be turned upside down, 2009 is a good year to do it. We’re much better prepared as an audit committee, more sophisticated as boards. It’s definitely better that this is happening in 2009 rather than 1999. [We are] much better prepared to handle the risks associated with the enormity of this situation.”*

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³ Kathy Valentine and Matt Bruschi, “NIRI and CFA Institute Centre Release Results of Joint Study on Public Company Guidance Practices and Preferences,” press release, May 28, 2008. Available at http://www.cfainstitute.org/aboutus/press/release/08releases/20080528_01.html.