



Keeping pace in times of rapid change

Introduction

The Mid-Atlantic Audit Committee Leadership Network¹ (MA ACN) met for the 13th time on May 6, 2008. Discussion focused on how audit committee chairs can keep up with an increasingly rapid pace of change in accounting standards and unpredictable economic and market conditions. Network members considered the challenge of ensuring the audit committee and the board stay focused on issues of greatest impact to the company in the midst of so much change and potential distraction.

The members of the network present at the meeting, who sit on the boards of 23 large-, mid-, and small-cap companies between them, were:

- Bill Albertini, Audit Committee Chair, Airgas
- Paula Cholmondeley, Audit Committee Chair, Dentsply
- Jay Morse, Audit Committee Chair, Host Hotels and Resorts
- George Muñoz, Audit Committee Chair, Marriott International
- Mike Ressler, Audit Committee Chair, Magellan Health Services
- Paul Shapiro, Audit Committee Chair, Toll Brothers
- Jim Zug, Audit Committee Chair, Amkor Technology

Also participating in this meeting were:

- Mark Bartlett, Managing Partner, Baltimore office, Ernst & Young
- Rich Jeanneret, Mid-Atlantic Managing Partner, Assurance & Advisory Business Services, Ernst & Young

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.

¹ The Mid-Atlantic Audit Committee Network is composed of audit committee chairs drawn from leading companies based in the Mid-Atlantic region of the United States. 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 audit committee environment.

VantagePoint is a synthesis of some key issues arising from a facilitated discussion among members of the Mid-Atlantic Audit Committee Network. It is intended 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, executives, and advisers who become systematically engaged in this dialogue, the more value will be created for all.



Executive Summary

Even as the focus on Sarbanes-Oxley (SOX) abates, MA ACN members report a sustained level of activity among their audit committees. Accounting pronouncements are coming increasingly quickly in the midst of the credit crisis and potential recession, and audit committees continue to be at the center of many emerging issues for corporate boards. Members considered the challenges of keeping pace in a rapidly changing environment. Discussion centered on the following areas:

- **Audit committees should focus on accounting changes likely to have the greatest impact** *(pages 2-4)*

With so many changes to accounting rules, members say it is important to focus on those changes that will have the most impact on their industry and company. Audit committee members do not need to become technical experts, but should work with external advisers and company management to stay informed of the potential impact of accounting changes so they may fulfill their oversight responsibilities. Audit committees also have to ensure the finance organization is properly resourced to handle major accounting changes.

- **Accounting changes often have unintended consequences** *(pages 4-6)*

Members expressed concern over how accounting changes may impact business decisions as management considers how strategic decisions might impact financial statements. In considering the impact of accounting and regulatory changes, members also discussed the effects of SOX, which they say has increased companies' focus on risk and improved company processes.

- **Now is the time to begin discussing the adoption of International Financial Reporting Standards (IFRS)** *(pages 6-7)*

Members acknowledged that the debate on IFRS had moved from whether adoption will happen to when. There are significant hurdles to be overcome, which may delay adoption in the United States. Nonetheless, members anticipate that the shift from U.S. Generally Accepted Accounting Principles (GAAP) to IFRS will be a major undertaking, and they say that now is the time to begin preparing for that shift by asking management how their companies will be impacted.

- **The audit committee can be a catalyst for board engagement** *(pages 7-8)*

Members want to ensure that their audit committees don't become so focused on accounting rules and disclosure that they lose sight of underlying business risks. They affirmed that oversight of business risks is the responsibility of the full board, but say the audit committee often has a heightened sensitivity to important business risks and can ensure they get due attention from management and the board.

Audit committees should focus on accounting changes likely to have the greatest impact

A number of pronouncements have recently come from the Financial Accounting Standards Board (FASB), including FAS 157 (fair value), FAS 141R/160 (transaction accounting), and FIN 48 (income taxes), and a network member noted, *"The FASB agenda is still loaded."* Finding the right balance between keeping informed about these accounting changes and other issues of relevance to audit committees without losing



sight of big-picture business issues requires constant effort, especially on the part of the audit committee chair. Network members suggested a variety of ways they can stay informed about technical accounting changes, but generally questioned the need to have deep technical accounting expertise. Instead, they emphasized staying reasonably well informed about changing accounting principles, ensuring management is prepared to handle those changes, and focusing attention on the changes that are likely to have the greatest impact on their companies.

How much knowledge is enough?

One member expressed concern about legal liability and the level of understanding of accounting changes and their impact on financial reporting that audit chairs are expected to have. This member said, *“As the audit committee chair, I fear litigation ... What if you are the financial expert? What is the assumption of board members, stakeholders about my understanding of these [accounting changes] as the audit committee chair? ... There have been so many recently.”* Prior to our meeting, several members suggested the key is knowing enough to be able to ask the right questions of management, but one member indicated that this may be insufficient: *“It’s not that I can’t ask the questions; it’s that I [may not] understand the answers.”*

What is the appropriate level of understanding for audit committee members? One member stated, *“We’re not going to become experts, but we need a sense for if the company is prepared to deal with change that is coming increasingly fast.”* Members also noted that the makeup of the board and the audit committee may impact how deeply audit committee members attempt to understand accounting changes in detail. One member said, *“[CEOs] on the board tend to have less tolerance for technical issues, even when they’re on the audit committee,”* and are more interested in understanding implications. Another said, *“CEOs are often flying at 30,000 feet; CFOs are often too deep in the weeds.”*

Members generally agreed that more is expected of the audit committee chair than of other audit committee members. According to one member, *“Clearly, if you’re the chair, you need more granular knowledge.”* Given their time constraints, audit committee chairs must help focus discussion in the appropriate areas at the appropriate time.

Ultimately, participants agreed with one member who said the audit committee should focus on *“which pronouncements are likely to have the greatest impact.”* Another member added, *“We’ve gotten too technical. What are the impacts? What will or could happen differently as a result of [a given accounting pronouncement]?”* Another member said, *“What I’m interested in is having somebody explain to me what’s out there – in terms of rule changes – that is likely to have an impact on our industry.”* By probing about future major accounting issues, audit committees can ensure the issues get an appropriate level of senior management attention. As one member put it, *“As soon as it’s on the radar, the CFO and external auditor have to figure out the potential effect and not just worry about the compliance angle.”*

There are many ways to stay informed

Members agreed with one member’s assertion that *“staying on top of the issues is a significant obligation.”* Members use various resources to keep informed. Several members turn to financial management and their external auditors for tutorials for the audit committee. As the pace of change has increased, some members



are adding additional time to their committee agendas or adding sessions prior to audit committee meetings for additional committee education. One member said, *“About every second audit committee meeting, we spend two hours in advance with the external auditor or financial management. We try to stay one [financial] quarter ahead [of when changes need to be implemented], but [the audit committee discussion] is often commensurate with when the change is being implemented. We may need to devote one hour at every meeting.”* Others spend time individually researching accounting changes through publicly available resources they can access online.

A member noted that the full board will often look to the audit chair to provide guidance on these issues as well: *“It’s not just education of the audit committee, but you need to deal with the board. They want to know where the \$50 million swing came from.”* Most members said they are spending more time on their presentations to the full board. One member said, *“We’re having longer board discussions now. We send all audit committee materials to all board members. They may not read it all, but it is triggering more questions in board meetings.”*

Some members are looking for additional guidance from their external auditor. One member said, *“There is no tutorial on what questions we should ask. You scramble to read what you can, pronouncement by pronouncement. The Big Four could give us more help on what questions the audit committee ought to be asking.”* Another said, *“I’d love to hear, ‘Here are five or ten things from this pronouncement audit committees ought to consider.’ You see more on the technical side in materials.”* Others were wary of too much prescriptive external guidance: *“You need to be careful with a menu of questions to ask. Often the random question gets people going.”* Members agreed that the external auditor can highlight key judgment areas included in their report to management and the potential impact of any new accounting standards, which can help provide a “road map” to guide the audit committee’s discussions with management.

Accounting changes may require additional finance resources

Members agreed that an important question for audit committees to address with management is *“Are we staffed internally to deal with these pronouncements?”* One member said, *“We’ve had to beef up the financial staff. You need to stay ahead of that, but I’m not sure that you can.”* Another said, *“With FIN 48 we needed to build up our tax teams and link them with someone from finance. Fair value [also] caused some additional expertise to be needed.”* The speed of change presents risks. As one member noted, *“There is a lot of risk of error in implementation without the training, software, and infrastructure in place.”*

Accounting changes often have unintended consequences

Members agreed that in addition to managing their financial reporting responsibilities, audit committees must also be aware of the effect that accounting changes may have on executive behavior and market dynamics.

Accounting may influence management behavior

Most members view recent accounting changes as *“more and more diverged from economic reality.”* One member went as far as to ask, *“Who cares [about the accounting changes]? Fair value doesn’t change*



decisions the company makes. It doesn't help you decide. It's more a compliance issue." Another member asserted, *"It shouldn't impact the deals you do, but you need to understand the impact."*

Some believe changes in the way companies report financial information are likely to have some impact on executive attitudes and behavior, such as increasing executives' sensitivity to disclosure, and they suspect financial reporting requirements will affect business decisions and vice versa: *"It shouldn't change behavior, [but] I worry that it might."* One member noted, *"Financial engineering is not limited to financial services."* That being so, audit committees need to remain vigilant about the areas of greatest subjectivity in accounting treatment. As one member put it, *"There's an awful lot of opportunities to change things, for example, in derivative accounting ... and management knows these decisions affect their pocketbooks when it comes to compensation payouts."* However, the same member summarized several members' views by saying, *"Perish the executive that makes a decision based on one of these accounting pronouncements."*

Some audit committees are beginning to explore how accounting changes might drive future business decisions. As an example, one member, who serves on the board of an acquisitive company, said they reviewed a year's worth of merger and acquisition (M&A) activity to *"look at what the accounting would be like under the new [M&A] standards, the impact on financials, and how that would impact the deals you do."*

Changes in accounting rules may exacerbate the impact of the credit crisis

Members believe new accounting rules, especially those related to fair value and mark-to-market requirements, are likely to impact stock analysis and share price. One member noted, *"[Mark-to-market accounting] introduces a lot of volatility ... most companies don't know how to deal with it."* Several members agreed with one who stated, *"I don't think the Street really understands mark-to-market accounting."* Members are concerned that explaining financial statements to analysts and investors is becoming increasingly difficult. Management is spending more time on educating investors and analysts on accounting, but as one member pointed out, *"you need to provide much more disclosure, [but that] produces more volatility."* The same member wondered, *"Do you give guidance? How? Is this a whole new dynamic?"*

Everyone agreed that there is a risk that too much attention will be paid to disclosures and investor presentations and too little to the real issues created by the credit crisis. One member noted, *"These issues can be consuming for management. They can create business issues; covenants can get tripped by the [mark-to-market], even though it may not reflect the economic reality. Getting the presentation right is important, but it is dwarfed by concerns that you cannot fund your operations."* Another member agreed, saying, *"It's the tail wagging the dog. The issue is illiquidity, having assets that are illiquid. You have excess cash that you thought was invested in safe [cash-equivalent] securities, and now you can't access the capital. There will be companies staring down going-concern opinions. There are a lot of ramifications of that."*

Several members observed that companies are being more conservative with cash reserves, focusing on liquidity rather than yield. One member said, *"Having access to capital is more important than yield ... We're not a bank."* Another suggested that as risk is repriced, the market will value companies that are prudently run. According to this member, *"This is a good time to be the good guy."*



Sarbanes-Oxley created discipline, which helps in times of change

Did SOX help companies prepare for the current environment? Members noted several benefits of Sarbanes-Oxley, despite persistent concerns about the costs. One member said simply, *“We’re sleeping better.”* Another said, *“[SOX] triggered management to strengthen systems [and] forced better integration of acquisitions.”* Others agreed with the member who said SOX was a *“shock to the system ... It was a thrust to get people to pay attention.”* That attention produced more disciplined processes and standardization that created efficiencies in many companies. Perhaps most importantly, as one member stated, *“[SOX] created more accountability, and with that comes better focus on risk.”* But other members are not convinced that SOX addressed the biggest business risks. As one member put it, *“In many cases, the focus on internal control documentation didn’t help much with the real risks; the elephants [are] running around while everyone’s looking for the ants.”* Another member said, *“I’m really interested in how we deal with the elephants running around.”*

Now is the time to begin discussing adoption of International Financial Reporting Standards (IFRS)

Looking beyond the current raft of accounting changes and economic concerns, members discussed the impact of shifting to IFRS from U.S. GAAP. There was general agreement that the regulatory discussion appears to have shifted from if there will be a move to IFRS to when that move will occur. Therefore, audit committees now must determine when they should begin a dialogue with management about the transition. Members generally agree that though it may be early to begin discussions about implementation in earnest, *“This is an area where some knowledge is better than none. At least start asking questions.”*

In particular, several members felt that companies going through a major enterprise-wide information technology rollout may want to urge management to consider including IFRS features in the system design. Ensuring that new accounting or reporting systems are compatible with both accounting standards may avoid expensive conversions in several years’ time.

Some questions audit committees can begin asking management include:

- What are the central differences between U.S. GAAP and IFRS that will have the greatest impact on our company?
- How will IFRS impact our financial statements and investor relations?
- Do our competitors use IFRS or U.S. GAAP for their reports?
- In what areas are there likely to be more or fewer judgments under IFRS?
- What will IFRS mean for our IT systems?

Several members agreed with one who stated, upon reflecting on the adoption of IFRS in a foreign subsidiary of one of his companies, *“Voluntary adoption would make sense for large multinationals, but if your company is domestic, you might as well wait until it’s mandatory.”* One discussion participant cautioned, however, that a domestic company might be tempted to adopt early if it felt reported earnings



would look better under IFRS than peers' earnings reported under U.S. GAAP and if it thought investors would not fully understand the impact of the accounting changes.

Members noted that converting from a rules-based system such as U.S. GAAP to a principles-based system such as IFRS is made more difficult by the fact that U.S. GAAP has evolved with so many specialized practices by industry. One member wondered, *"What do you do when you get into a no-man's-land, where there are no rules for something under IFRS?"* Another predicted, *"There will be interpretation after interpretation [from regulators]."* Implementation within companies is likely to be a significant undertaking. One member observed, *"It took 12 to 24 months longer to implement in Europe than companies expected."*

The audit committee can be a catalyst for board engagement

Prior to the meeting, a network member said audit committees, and audit committee chairs in particular, find themselves increasingly the "go-to" directors for a range of issues because of the insight and expertise they gained implementing SOX. This member said audit committee members have spent more time with management; they have dug into more areas of the business and developed a deeper knowledge of the details of the business than other directors. According to this member, *"Checking the boxes and spending those hours [on Sarbanes-Oxley] is like going to school ... You can't help but know more about the business model, the finance organization, and risks."*

Should audit committees share blame for failing to note business risks prior to the credit crisis?

Members expressed concern about missing the forest for the trees by focusing too much on disclosure and reporting rather than on real business risks. Reflecting on the causes of the credit crisis, members pondered whether or where the boards of financial companies may have failed in their oversight. One member stated bluntly, *"Obviously, no one was asking, 'Can any of these off-balance-sheet assets bring the company down?'"* Another commented, *"No one asked the 'what-if?' questions. Nothing ever goes up forever."*

Responding to media reports about shareholder pressure on audit committee chairs at some financial industry companies, a member said, if true, *"That's unfair. It was not a control issue; it was a business risk."* Another member asserted, *"The risk of getting disclosure right is the audit committee's responsibility. The decision to take the risk [belongs to] management and the full board."*

Audit committees can encourage board dialogue on key risk areas

What can audit committees do to improve risk management in a rapidly changing environment? Members noted that in the wake of the credit crisis, more attention is being paid to audit committee meetings and materials from management and the board. According to one member, *"Most audit committees have focused on whether the reporting rules were followed ... but it seems the audit committee should be asking, 'What can bite us? How does this affect operations? Will this add volatility to the balance sheet? How do we explain it to shareholders?'"* Another member said, *"Sometimes the full board doesn't really understand what the risk is ... Often, the only committee that feels an obligation to poke behind the curtain is the audit committee. You discover on the audit committee what risks are really there. Then you can request an*



explanation [from management] to the full board, which has responsibility for oversight of strategy and business risks.”

Members acknowledge that risk oversight is always going to be imperfect. One member said, “*There are many [risks] where you could all sit in a room and think, and never think of them.*” But members agreed that the audit committee tends to have a “*heightened sensitivity*” to financial risks. One member described a practice adopted by one audit committee on which he sits to ensure key risks are discussed: “*At each quarterly audit committee [meeting], management has to report on the six to eight major risks facing the company. The list is routinely refreshed, and management has to explain any changes. If something goes wrong and it wasn’t on the list, management has to explain why. The routine helps management as much as the audit committee.*”

Another member said, “*[The audit committee] may be the catalyst to get financial items on the board agenda. We exchange more business stories and have a financial focus.*” In addition, one member maintained, “*Management uses the audit committee as a testing ground. In the last nine months, we’ve had more casual conversations to get management to explain risks for disclosure, but also to help develop the full board discussion of what’s really important to directors.*”

Conclusion

Audit committees must find ways to stay informed about accounting changes and to understand their potential impact on company disclosure and business decisions. But network members assert that they do not need to develop deep expertise in the technical details. Instead, they should focus on those changes that are likely to have the greatest impact on their business. With continued pronouncements from the FASB and a shift to IFRS looking increasingly inevitable, the pace of change is likely to continue to challenge audit committees’ ability to keep pace. Meanwhile, audit committees look for lessons from the credit crisis as companies continue to deal with asset illiquidity and the continuing economic downturn. Network members see a central role for the audit committee in helping management and the board remain sensitive to disclosure requirements but focused on financial and business risks.

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