



## Adapting audit committee oversight to a rapidly changing environment

### Introduction

The North Central Audit Committee Network (NC ACN) met on March 9, 2009, to discuss how audit committee and board governance is adapting to meet the challenges of a rapidly changing market and economic environment. Members discussed how audit committees and boards are shifting their focus to issues related to how companies are surviving a challenging period and revisiting risk management oversight as they look ahead and prepare for more stable economic circumstances.

*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 before and during meetings are not attributed to individuals or companies. Comments in italics represent direct quotes from members made during the meeting or on a teleconference on the same topics following the meeting.

The members of the network present at the meeting were:

- Jim Boland, Audit Committee Chair, Goodyear Tire & Rubber Company
- Glenn Eisenberg, Audit Committee Chair, Family Dollar Stores
- Rick Fearon, Audit Committee Chair, PolyOne
- Dave Flaschen, Audit Committee Chair, Paychex
- David Baker Lewis, Audit Committee Chair, The Kroger Company
- Lauralee Martin, Audit Committee Chair, KeyCorp
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Gary Valade, Audit Committee Chair, Wabtec Corporation

Ernst & Young participants in the meeting included:

- Stephen Klemash, North Central AABS Managing Partner
- Karole Lloyd, Vice Chair of Industry and Knowledge
- Al Paulus, North Central Senior Client Service Partner
- Todd Tueller, Americas Risk Leader

The following members participated in a teleconference on the same topics after the meeting:

- Gordon Harnett, Audit Committee Chair, Lubrizol Corporation
- Kurt Landgraf, Audit Committee Chair, Corning
- Dave McCammon, Audit Committee Chair, Pulte Homes



- George Miles, Audit Committee Chair, HFF
- Jim Vandenberghe, Audit Committee Chair, Federal-Mogul

## Executive summary

- **Board and audit committee focus and engagement has shifted and deepened** (Pages 2-3)

Boards and audit committees are responding to market and economic challenges by refocusing their oversight activities to help management ensure short-term business survival by engaging more deeply in issues that could threaten the financial health of the company, while also considering long-term strategic planning. As the financial crisis continues, audit committees often find themselves acting as de facto finance committees, digging into issues such as liquidity and cash management.

- **Audit committees face ongoing accounting and reporting issues** (Pages 3-5)

As companies completed year-end reporting, they dealt with a number of accounting and reporting issues that network members expect to continue. Many of these can have broader business implications, especially those related to fair value accounting in cases such as asset impairments. In a period of limited visibility, audit committees are “peeling back the onion,” to ensure they are comfortable not only with the accounting treatments used, but with the underlying assumptions driving accounting judgments and forecasts.

- **Risk management is being refocused and enhanced** (Pages 5-8)

Acknowledging that the financial crisis and the lack of preparation for the current recession represent in part a failure of risk management, boards and audit committees are working with management to assess the best way to enhance risk management processes going forward. Members say developing a balanced, coordinated approach, with the appropriate level of top-down risk identification and management, processes, with clear support and ownership on the part of the CEO, is required.

## Board and audit committee focus and engagement has shifted and deepened

In a conversation before the meeting, one audit chair said that in these unprecedented times, “It’s not business as usual, so what am I – as a director – doing that is not business as usual?” NC ACN members said they are combining “*more business as usual*” – increasing scrutiny of and focus on normal oversight activities – and spending more time on issues that have not typically garnered significant attention from audit committees, such as focusing on liquidity and access to capital. Most members are spending more time in between meetings having conversations with management and preparing for committee meetings and presentations to the full board.

Network members note the following trends in audit committee and board responses to market and economic turmoil:

- **Focusing on short-term financial health.** One member said, “*First, we’re in survival mode, [considering] what can tip us over.*” For many companies, that means ensuring balance sheets are



robust and continually reviewing cash positions and liquidity, even in companies with strong balance sheets.

- **Acting as de facto finance committees.** On boards that lack a finance committee, many financial issues are discussed by the full board, but members say the audit committee is *“a better forum to get into the details.”* Several members agreed that credit markets really are as bad as portrayed in the media and that they are regularly reviewing debt covenants. One member suggested all companies should be testing their lines of credit by taking them down to ensure they are actually available.
- **Blurring the line between management and the board.** Most members see the board becoming more deeply engaged with management as they *“peel back the onion”* and ensure that *“the breadth has been covered, all angles, all aspects.”* Management teams are generally under significant stress and for the most part appear to welcome this deeper engagement as many companies are facing *“life-and-death”* issues and can benefit from the deeper board engagement and experience.
- **Increasing coordination and communication among committees.** Giving an example, one member said chairs of various board committees are meeting informally in between board meetings to discuss committee agendas, areas of overlap between committees (to ensure the appropriate oversight attention is given to key issues), and the interconnection of the issues the various committees address.
- **Encouraging management to look ahead.** Although almost every company and board is focused on managing short-term challenges and ensuring the survival of the business, members say the board has an additional obligation to ensure short-term decisions don’t hamper long-term strategic objectives. One member said, *“You need to protect the balance sheet and get through the next 18 months, but you don’t want missed opportunities or to make long-term strategic errors to get through the short term.”*

## Audit committees face ongoing accounting and reporting issues

Most companies in the network had completed year-end reporting, and network members outlined a number of reporting issues they dealt with in the process. Unfortunately, until economic and market conditions improve, most expect many of these issues to continue to be on the audit committee agenda. Specifically, members discussed the following problems, which many audit committees are addressing:

- **Asset impairments.** Every member said their companies face questions regarding impairment charges or asset write downs as market values have declined. One member noted how rapidly impairments can take place: markets have collapsed around the world, requiring more frequent testing. Some argued that some long-term assets are being written down that could well recover in the future; one member said *“a majority”* of companies are writing off goodwill, a course of action required by accounting standards, but that some members believe may not be justified over the longer term.
- **Going-concern questions.** Members see *“a lot of energy”* and discussion around going-concern issues for some companies. These issues are often triggered by debt covenant violations, or an inability to secure future borrowing to finance the business going forward. In some cases, company performance may be adequate, but major customers and suppliers are facing going-concern opinions,



an issue of particular uneasiness for companies with significant revenue from industries hit hardest by recession.

- **Pension funding shortfalls.** Several members said they expect “*huge cash outflows in the next several years*” as companies are forced to shore up underfunded pension funds. Credit Suisse estimated the total amount underfunded among the companies that make up the S&P 500 at \$362 billion, compared with a surplus of more than \$58 billion last year.<sup>1</sup> Some companies are making well over \$100-million cash payments into their pension funds this year. In some cases, the level of cash funding required is challenging companies with limited liquidity: one member reported that large cash payments into pension funds could be the “*last straw*” for some companies that are on the verge of insolvency. Another member noted that while pension funds look underfunded now, if the company makes a large cash payment, and markets recover, pension funds could be overfunded, yet they won’t be able to get the money back. Though Congress passed the Worker, Retiree and Employer Recovery Act (WREERA) of 2008 to temporarily adjust pension funding rules, Watson Wyatt estimates that while the law freed about \$16.4 billion from the pension pipeline, required pension fund contributions for 2009 still total \$108.7 billion; about triple the \$38 billion paid in 2008.<sup>2</sup> Several members said they are closely watching political developments concerning potential extension of funding requirements.

#### **Anticipating regulatory change**

In addition to questions about changes to pension funding requirements, members raised questions about the potential direction of other regulatory and policy changes as the Obama administration, Congress and regulators respond to the financial crisis and recession. Specific questions include:

- How might the Securities and Exchange Commission’s (SEC) approach to enforcement change under new chairman, Mary Schapiro?
- How might the SEC’s Roadmap for the adoption of International Financial Accounting Standards (IFRS) change?
- What other regulatory or policy changes are being considered and how can companies prepare for potentially significant changes?

#### **Fair value accounting is contributing to challenges, but no significant policy change is expected**

Securities and Exchange Commission chairman, Mary Schapiro has said mark-to-market was not a significant factor in the current crisis, and on March 10, 2009, Ben Bernanke, chairman of the Federal Reserve, said, “I

<sup>1</sup> Jonathan Stempel, “Corporate America faces big pension shortfalls,” *Reuters*, January 8, 2009, 1. Available at <http://www.reuters.com/article/domesticNews/idUSN0854172520090108>.

<sup>2</sup> “Temporary Pension Relief Will Aid Economy, Protect Workers,” AICPA Economic Crisis Resource Center, March 6, 2009. Available at <http://economy.aicpa.org/2009/03/temporary-pension-relief-will-aid-economy-protect-workers.html>.



strongly endorse the basic proposition of mark-to-market.”<sup>3</sup> Members generally disagree, and many quite strongly. One member stated, *“I’m not a huge fan of mark-to-market when there is no market. It has basically put us in a death spiral. Lower valuations lead to lower valuations. We don’t have anyone saying anything optimistic. Where does it stop?”* This member noted that *“when market value triggers [a write-down], who knows what’s driving that? People forget that we have operations distinct from public market valuations ... If debt covenants are tied to those [valuations], then the company is in default for reasons outside the operations.”* Another network member said, *“On long-term assets, the mark-to-market is fictitious.”* Speaking even more broadly, a member remarked, *“Mark-to-market issues have a huge impact on the sustainability of companies.”*

Given regulators’ support of mark-to-market, however, members do not expect fair value accounting rules to be suspended, though the Financial Accounting Standards Board provided additional guidance on how fair value accounting rules should be applied on March 17, 2009 intended to help companies determine when a market is active or inactive, whether a transaction is distressed, and to communicate when other-than-temporary impairments (OTTI) have occurred.<sup>4</sup> Yet, one member asserted, *“No change is coming in accounting standards,”* and another suggested there were limited options available, asking, *“A change to what? There is no viable alternative.”*

### **Key areas of judgment increase audit committee concern**

Many of the issues related to market valuations involve forecasting and other judgments being made during a time of uncertainty and limited visibility of key data. This raises the level of concern for audit committees, who find it difficult to get comfortable with those judgments without a deeper understanding of the underlying assumptions going into them. One member suggested that audit committees will be challenging revenue recognition and ensuring earnings are real. Another said, *“Audit committees have stepped into areas of judgment where you’re relying on management, auditors, maybe a third party. You, as audit chair, approve something, and then three weeks later it could change.”* This is leading some to rely more heavily on external valuation experts to validate those assumptions.

A member questioned whether audit committees were sometimes overly reliant on the external auditor’s perspective: *“On a forward-looking basis, how is the external auditor’s judgment any better than someone else’s? What is the appropriate cost of capital? There is some give and take, but in this environment, boards and managements will weigh the external auditor’s opinion. Will the external auditor err toward conservatism?”*

### **Risk management is being refocused and enhanced**

While risk management has been a subject of much discussion in recent years, a meeting participant suggested we are still relatively close to the beginning of an S-curve in the maturation of risk management practices. A network member agreed: *“If there is one area where you will see increasing effort from now*

<sup>3</sup> Michael Tsang and Rachel Layne, “Nobody Says Mark to Market Doesn’t Matter as GE Falls,” *Bloomberg.com*. Available at <http://www.bloomberg.com/apps/news?pid=20601082&sid=aanSlg9Vo6hA&refer=canada>.

<sup>4</sup> “FASB Issues Proposals to Improve Guidance on Fair Value Measurements and Impairments,” *FASB News Release*, March 17, 2009. Available at <http://www.fasb.org/news/nr031709.shtml>.



*on, it will be risk management.*” In a conversation prior to the meeting a network member said, “The economic crisis has done more to catapult talk on risk management to actually doing something about it. Boards have been forced into dealing with liquidity, cash flow management, debt covenants, asset valuations, customer/vendor risks, etc. Within a complex, global business, it is not easy to get your arms around it.”

In response to the financial crisis, which many see as in part attributable to a massive failure of risk management, audit committees are changing their approach to risk management oversight: *“Audit committees used to ask, ‘Are the controls working?’ Now, we’re asking, ‘Are these the right controls? [Have we identified] the the right risks?’”*

### **Boards are encouraging a more forward-looking approach**

According to one network member, *“Historically, companies measured risks by looking in the rearview mirror,”* but, as another member observed, at present *“the movement and pace of change is so rapid that you can’t validate a point in time without a view of the future.”*

As boards consider the causes of the current economic and financial troubles, a member said there *“is an emphasis on avoiding going through all this again as part of increasingly forward thinking ... We need to look for telltale signs that things are happening and consider how we can prepare.”* One board asked management to form an ad hoc *“scanning committee”* to consider *“what may come next.”* The result has been *“anticipatory actions”* by management because *“they know [the board] will ask them, so they are trying to stay ahead of that.”*

### **A more balanced, top-down approach may be more effective**

Members have begun identifying some of the flaws in past approaches to risk management as they consider alternatives. A meeting participant commented, *“Many companies have controls in low-likelihood, low-priority risks and lack high-level, more-strategic controls.”* Another member noted that many of the controls in financial reporting and compliance are lagging indicators: *“If something’s already there when you catch it, you’re in trouble.”* A network member described the beginning of a shift to a more top-down approach: *“A lot of early risk management work was bottom-up, producing large lists of risks, which companies tried to rank. Now, I see a more top-down approach. Many risks we’re identifying now weren’t identified before or weren’t thought to be likely. How do boards and management reengage and be value-adding and aimed at identifying risks that could truly impact the business?”*

A key to this increasingly top-down approach is CEO ownership of risk management. Most members agreed with one audit chair who insisted, *“The CEO must drive this.”* Another member said that of all the companies he is involved with that discussed improving risk management processes through 2007, *“few did it well, and those that did had the CEO driving it.”* This top-down approach makes it easier for the board to engage on a smaller number of *“key risks to shareholder value,”* and *“then the CEO and the board get more engaged.”* One member said he encourages CEOs to serve on the audit committee of another company because that gives them a greater appreciation of the need to take ownership of risk management. Several members also contended that a single chief risk officer, in role if not in title, reporting directly to the



CEO, needed to be responsible for risk management processes to ensure a single point of contact for information to be compiled and fed to the CEO.

### **Risk management and oversight must be connected and collaborative**

Few companies have a risk committee, but the failures of risk management at financial institutions, many of which had risk committees, prompted one member to suggest that having a risk committee may not be the right approach. Another noted that even when a company has a risk committee, you need to coordinate the efforts of the risk committee with those of the audit committee. Several members expressed concern about the audit committee becoming the “*super risk committee*” in practice, but one member said, “*CEO ownership keeps it as a full board issue. They can’t just send it to one committee.*”

To ensure appropriate focus on risk oversight across the full board, one member’s audit committee matches oversight of key risks to the management structure to ensure risk oversight is owned by the appropriate board committee just as ownership of risks is spread among management. This process is revisited regularly to be sure the right risks are being monitored by the right committees. The various committees then report to the full board on an annual basis. In a white paper summarizing key principles to strengthen corporate governance, the National Association of Corporate Directors notes that, “just one out of four boards uses the full board for their risk oversight,” and suggests that, “While risk events may ultimately find their way to the audit committee because of its responsibility for oversight of financial reporting, other committees as well as the full board should participate.”<sup>5</sup>

Members caution that appropriate risk oversight is not simply a matter of spreading oversight responsibility. The key is coordination and developing an understanding of how the risks are interconnected. A network member stated, “*You can no longer look at risks in buckets. You need a single view of risk across the enterprise.*” Another said, “*You need to understand the correlation between seemingly unrelated risks. Things don’t happen one at a time. It’s not one risk, it’s the clustering ... You need a collaborative approach with ownership, visibility, and scenario planning.*” Another member observed, “*Everything’s overlapping across committees now; for example, we’re asking, ‘Will compensation drive behaviors that change risk?’*” According to one member, the process of coordinating various management and board committee risk management activities, and getting them addressed by the full board is “*probably the biggest effort.*”

As risk management processes evolve, boards are considering if their companies have the appropriate skills and resources to manage risks. One member asked, “*Is the internal audit function able to manage a range of major risks?*” In most companies, internal audit lacks the skills and resources to monitor key business risks and tends to focus on compliance risks.

Another member highlighted an issue of specific concern to many boards: cost cutting and staff reductions. Some members noted that these reductions can include internal audit staff, which could impact the monitoring of controls and risks. Another member had a different concern: “*Most companies are laying off*

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<sup>5</sup> National Association of Corporate Directors, “White Papers: Series 1,” March 24, 2009, 8. Available to members at <https://secure.nacdonline.org/source/members/whitepapers/nacd-white-papers.cfm>.



*staff... The pace [of the layoffs] may hamper the thoughtfulness with which it's done. Something is probably not getting done."*

Network members also raised concerns about economic stress increasing the risk of fraud and earnings management. There is always a concern that people under severe financial strain may rationalize actions they wouldn't otherwise take. Patricia Harned, president of the Ethics Resource Center, believes that ethics officers should spend more time with the audit committee, but cautions that "it's difficult to continue talking about the value of high ethical standards and the importance of individual action when the outlook for the company overall is grim ... Employees are nervous, they don't trust the information coming from the top, and they're willing to do what it takes to protect their livelihoods."<sup>6</sup>

### **There is no one-size-fits-all solution**

Ultimately, risk management at most companies remains a work in progress. While members see similar trends and some "*better practices*," most say it is difficult to identify best practices that can be readily applied across different companies, in different industries, with different risk profiles and risk appetites. The risk management mind-set and processes must become ingrained in the way the company does business, not be thought of as part of a stand-alone, annual risk management activity. This transition, noted one member, "*takes years*."

### **Conclusion**

In this unprecedented period of economic recession, bear markets, and an ongoing financial crisis, boards are coming under increasing scrutiny. NC ACN members are working with management to ensure their companies are able to ride out the "*100-year storm*" while remaining forward looking and strategically focused. Audit committees are faced with a special responsibility for oversight of complex accounting and reporting issues that involve considerable judgment and can have significant ramifications for companies. They also have a special responsibility for oversight of risk management processes. Though there is no one right way to go about it, companies need to commit to continuing the long process of developing an effective, tailored risk management and oversight methodology. Audit committees and boards can ensure those processes allow companies to identify and manage key business risks and that the company is prepared for what comes next.

### **About this document**

The North Central Audit Committee Network is a select 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

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<sup>6</sup> Patricia Harned, "Take Time to Convene the Audit Committee," *Compliance Week*, January 27, 2009. Available at <http://www.complianceweek.com/article/5240/take-time-to-convene-the-audit-committee>.



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.

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