



## Keeping pace in times of rapid change

### Introduction

The North Central Audit Committee Network<sup>1</sup> met on September 17, 2008, to discuss how audit committees and boards can keep up with rapid changes in accounting standards amid volatile economic and market conditions. Members focused on the potential implications of accounting changes and identified issues for the audit committee stemming from the credit crisis and broader economic challenges. They also discussed ways to keep the audit committee from succumbing to scope creep and ways to stay focused on core responsibilities. Separately, members discussed the role of the audit committee and audit committee chair in the development of the audit plan and fee negotiation process (see Appendix on page 9 for details).

The members of the network present at the meeting, who sit on the boards of 14 large-, mid-, and small-cap public companies between them, were:

- Jim Boland, Audit Committee Chair, Goodyear Tire & Rubber Company
- Rick Fearon, Audit Committee Chair, PolyOne
- Dave Flaschen, Audit Committee Chair, Paychex
- Bill Lawrence, Audit Committee Chair, Ferro Corporation
- Dave McCammon, Audit Committee Chair, Pulte Homes
- Mike Monahan, Audit Committee Chair, CMS Energy
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Gary Valade, Audit Committee Chair, Wabtec Corporation
- Jim Vandenberghe, Audit Committee Chair, Federal-Mogul

Ernst & Young participants in the meeting included:

- Al Paulus, Senior Client Service Partner
- Steve Blowers, Partner, Professional Practice Director for the North Central sub-area

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<sup>1</sup> The North Central Audit Committee Network is a group of audit committee chairs 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. This document uses a modified version of the Chatham House Rule whereby names of contributors to the research and their companies or organization affiliations are a matter of public record, but the comments made in the conduct of the research are not attributed to individuals.



## **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:

- **What are the implications of accounting changes?** *(Pages 2-4)*

Audit committees have found it hard to keep pace with accounting pronouncements and the technical changes those pronouncements have brought with them. They rely on management and their external auditor to help them focus on the potential impact on their companies, which could go beyond financial reporting.
- **Understanding the impact of a switch to IFRS should not be put off** *(Pages 4-5)*

The Securities and Exchange Commission (SEC) has released its proposed Roadmap for a transition to International Financial Reporting Standards (IFRS). Despite some members' perception that it will be some time before most companies are required to make the switch from U.S. Generally Accepted Accounting Principles (U.S. GAAP), audit committee chairs realize they must begin preparing now by at least understanding what impact IFRS is likely to have on their companies and how they can ensure the company will be ready.
- **In the current environment, cash is king** *(Page 5)*

Due to the upheaval in the financial markets and the ongoing credit crisis, companies are increasingly focused on liquidity and ensuring they have a strong cash position. Members recognize credit is more difficult to access, it is costlier, and, in some cases, existing credit lines may not be accessible. Supply chain, key-customer, and pension risks are also in need of review in light of the credit crisis.
- **Audit committees struggle to balance their role with that of the full board** *(Pages 6-7)*

Given the pace of change, audit committees would be kept busy enough if all they were doing was ensuring the accuracy of financial reporting. But members say their committees often become the default committee for handling a broad range of business issues because they have financial expertise and either implicit or explicit responsibility for oversight of risk management processes. This creates a major challenge in managing the committee's workload.
- **Economic challenges heighten audit committee sensitivity to ethics and compliance** *(Page 7)*

Because the audit committee is responsible for ethics and compliance oversight, members say they need to be vigilant in ensuring executives and employees don't succumb to increasing economic pressures.

## **What are the implications of accounting changes?**

Over the last few years, a number of significant accounting changes and pronouncements have come from regulators and standard setters in the United States, impacting accounting in a variety of areas, including fair value, business combinations, income taxes, and loss contingencies. Meanwhile, companies are considering the impact of a shift from U.S. GAAP to IFRS.



NC ACN members suggest audit committees must focus on the impact and implications of these changes rather than try to develop a deep understanding of the technical details. Network members also note that the impact of these changes varies significantly by industry and by company. They expressed concern that, given the current economic and market environment, some of these changes may have implications that go beyond financial reporting: *“The audit committee needs to understand the impact and the risk of any accounting pronouncement.”*

### **Audit committees rely heavily on their external auditors to keep up with accounting changes**

Audit committee meetings have full agendas, and keeping up with changes to accounting standards takes time away from other work. Because few members set aside time outside of audit committee meetings for information and education sessions, one member wondered, *“Do we need to add an extra hour to audit committee meetings [for updates]?”* As for sources of information on these changes, although management plays an important role, especially with regard to the impact of accounting changes on their company’s financial statements, network members say they count on their external auditor to coordinate with management to bring the audit committee up to speed.

One member said their auditor regularly updates the audit committee: *“The external auditor brings information to every meeting and distributes materials beforehand.”* Those materials help audit committees answer questions such as *“What is [the accounting change]? What does it mean? How will it impact the company?”* One member said auditors are being asked by committee members to provide more detailed training to them and the company’s accounting staff than was common in the past. Another member said the chairman of their audit firm comes to their board meetings once a year to provide a high-level summary of the current and expected future state of the accounting and regulatory environments. Members say it is *“not so much the technical aspects [of accounting changes] as the implications”* that are important to understand.

### **Accounting changes may have unintended consequences**

At first glance, many accounting changes do not appear to have a drastic effect on members’ companies. One member suggested the accounting changes were unlikely to impact management behavior negatively, commenting, *“Where do you have situations where you want people to do something to create value that may have a negative accounting impact? There are not that many.”*

However, one member suggested that accounting changes may have unintended consequences: *“More accounting pronouncements lately are related to the health of the business,”* such as fair value and disclosure of loss contingencies. Similarly, several members noted that past changes, such as changes to options accounting, have had a bigger impact than they expected and so recommend that they spend more time ensuring they are prepared for the impact of any new changes. One member said that the number and extent of accounting changes may lead to confusion, which could result in increased litigation. This member observed, *“Accounting pronouncements don’t drive changes in behavior; lawyers do.”*



Members discussed the potential impact of the following accounting changes:

- **FAS 157 (Fair Value Measurements).** According to one member, *“FAS 157 is one of the most profound accounting changes in my lifetime. It requires companies to mark things to market that aren’t for sale and for which there is no market ... The audit committee really needs to understand this.”* Another member said FAS 157 had a potent impact on his company’s industry: *“It changed capital ratios drastically. It’s really wagging the dog.”* Another suggested it could have a significant impact on long-term corporate strategy in industries such as banking and have a *“serious negative impact on investment strategies.”*
- **FIN 48 (Interpretation on Accounting for Uncertainty in Income Taxes).** According to at least one network member, tax minimization strategies have become much less aggressive as a result of changes to tax accounting.
- **FAS 141R/160 (Business Combinations/Accounting for Noncontrolling Interests).** Several network members expressed dissatisfaction with the new standards for the accounting treatment of certain transaction costs. One member said having to report advisory costs up front, prior to consummation of the deal, could run up prices on potential acquisitions, as savvy investors guess at likely targets once they see transaction-related costs within the financial statements.
- **Amendment to FAS 5 (Accounting for Contingencies).** The goal of the proposed amendment to FAS 5, according to the FASB, is to “make sure companies are providing adequate information for investors, analysts, and other financial statement users, regarding the ‘likelihood, timing, and amount of future cash flows associated with loss contingencies.’”<sup>2</sup> A meeting participant said, *“I hope the amendment doesn’t see the light of day in its current form,”* because it could produce stress relative to risk disclosures.

As a result of accounting changes, some members expect additional restatements that could negatively impact their companies’ share prices, even if the restatement is simply in response to a new accounting treatment, such as accounting for convertible debt. Whatever the reason for a restatement, one member said, *“The investment community thinks you screwed up.”* Given that any restatement could have serious stock price implications as well as potentially provide lenders with a reason to reduce access to liquidity, another member noted that his company has *“zero tolerance for foot faults.”*

## **Understanding the impact of a switch to IFRS should not be put off**

On August 27, the SEC issued for comment a proposed Roadmap for transitioning from U.S. GAAP to IFRS, which Chairman Christopher Cox referred to as “cautious and careful.” The plan calls for early, voluntary use of IFRS by the largest U.S. multinational firms in 2009, followed by an SEC vote in 2011 on whether to require all U.S. companies to make the switch.<sup>3</sup> Companies that are among the top 20 in their

<sup>2</sup> Marie Leone, “Contingent Liabilities Draft Stirs It Up,” *CFO.com*, August 4, 2008. Available at <http://www.cfo.com/article.cfm/11876028?f=search>.

<sup>3</sup> Judith Burns, “SEC Issues a Plan to Move To International Accounting,” *Wall Street Journal*, August 28, 2008. Available at <http://www.efinancialnews.com/homepage/content/2451630745>.



industry by market capitalization could begin filing statements in IFRS for fiscal periods ending after December 15, 2009; the SEC estimates this would mean approximately 110 companies in about 34 industries.<sup>4</sup> A staggered implementation could follow, with large U.S. companies making the shift in 2014, followed by mid-sized companies in 2015, and small companies in 2016. Some members suggest that this provides their companies with a fairly long runway to prepare for implementation. As such, several audit committee chairs initially said it was too early for audit committees, whose agendas remain full amid an uncertain economic and market environment, to devote much time to this issue, but they increasingly realize that *“that light in the tunnel is an oncoming train.”*

Even if they can’t spare too much of their time, most members agree that now that the SEC has released the Roadmap, they must at least consider the possible implications of the switch for their company and engage the full board on the subject. One member suggested that conducting a diagnostic of how reporting under IFRS would impact financial statements and developing a high-level project plan for what a switch to IFRS would require is sufficient for now.

One member said, *“IFRS reminds me of Y2K ... Most companies are woefully unprepared on awareness. That’s the easy part. Talent turnover is the hard part.”* This member suggested that many senior finance executives may plan to retire before implementation becomes mandatory. Others noted that their companies are spending more time working with their external auditor to begin training their finance staff on IFRS.

Members expressed some concerns about the increase in judgment under principles-based accounting standards, the increasing use of fair value accounting, and the increased disclosure requirements under IFRS. A meeting participant highlighted inventory accounting as an area companies need to be particularly aware of because LIFO (last in, first out) accounting is not allowed under IFRS, and that could have a significant impact on some companies.

While audit committees work to adjust to a number of new U.S. GAAP standards, one member wondered, *“How many of these [new accounting standards] will go away under IFRS?”* But another member said that because the IASB and the FASB are working on increasing convergence, *“it’s unlikely most of these [new U.S. accounting standards] will go away.”* There are likely to be *“slight tweaks”* rather than wholesale changes.

### **In the current environment, cash is king**

The network meeting came at a time of great volatility in the financial system. The *Economist* described it thus: “Ten short days saw the nationalisation, failure or rescue of what was once the world’s biggest insurer, with assets of \$1 trillion, two of the world’s biggest investment banks, with combined assets of another \$1.5 trillion, and two giants of America’s mortgage markets, with assets of \$1.8 trillion.”<sup>5</sup> Though financial

<sup>4</sup> Michael Cohn, “SEC Proposes IFRS Roadmap,” *WebCPA*, August 27, 2009. Available at <http://www.webcpa.com/article.cfm?articleid=28983&page=1>.

<sup>5</sup> “Global finance is being torn apart; it can be put back together,” *Economist*, September 20, 2008. Available at [http://www.economist.com/opinion/displayStory.cfm?Story\\_ID=12263158](http://www.economist.com/opinion/displayStory.cfm?Story_ID=12263158).



institutions have suffered the worst of the carnage, all companies expect to feel the impact of the market turmoil. One member expects *“some big losers and big winners”* to emerge in his company’s industry.

Members say the key issue for most audit committees is ensuring companies have enough liquidity: *“Liquidity is king right now.”* Many noted that certain securities, such as auction rate securities, which have hitherto been listed as cash deposits, are being reevaluated. Credit conditions continue to tighten. One member said, *“Leverage in the mid-market is available at one-third the levels and at 50% higher cost than one year ago.”* Additionally, some members warned that their existing credit lines may be in jeopardy: *“We don’t think our lines are actually still good.”* This concern has led some to suggest companies pull down all of their revolving credit line and hold it on their balance sheet, *“before the bank says it’s not there anymore.”* Members also noted that there is no room for accounting errors because they could trigger credit issues or breach covenants.

Beyond liquidity, members from non-financial institutions noted a number of areas where more board or audit committee oversight is needed as a result of the credit crisis:

- **More expansive “what-if” scenario-testing.** One member said his company is running scenarios, asking, *“What if Morgan Stanley or Goldman [Sachs] go bankrupt?”* This member stated, *“Things you never thought were possible are possible.”* Several members remarked that they planned on engaging their management teams more on such scenarios.
- **Pensions.** Companies are reviewing their investments, including pensions, to see how conservatively they have been invested and to try to determine what difficult-to-value assets are worth. Some companies had investments in AIG and Lehman Brothers.
- **Counterparty risk.** Several members also expressed concern about counterparty risk on derivatives. One member said it’s important for the audit committee to hear from the treasury function regarding the company’s gross position on counterparties because the net position is meaningless. Another member expanded that analysis to joint ventures, noting, *“It’s important to know if your joint venture is being affected by the credit crisis, and if so, how.”*
- **Supply chain or key-customer risk.** Several members noted the need to evaluate any problems that may materialize in their companies’ supply chains or with any of their key customers.
- **Risk management.** Most members believe it is time for a full review of their companies’ risk management practices and said they must get a clear picture of their companies’ risk appetite.

### **Audit committees struggle to balance their role with that of the full board**

Some audit chairs report that they expected that as Sarbanes-Oxley compliance became more routine, audit committee agendas would open up, and they would be under less pressure. Unfortunately, however, this has not been the case for NC ACN members, who report spending more time with auditors and management, in some cases on topics that may actually fall outside their purview. For example, several members mentioned that liquidity has become an audit committee issue by default because the CFO naturally turns to



the audit committee with related financial items. Another network member said the audit committee tends to meet more often and have more interaction with management than other committees or directors, which may lead management to turn to it first.

### **Financial expertise on the board is limited**

Most companies only have one or two financial experts on the board. That can put added pressure on the audit committee and audit committee chair, who is often one of those experts. According to one member, *“The only thing the full board might know is whether [a new accounting pronouncement] is good news or bad news [for the company].”* But some say expertise lacks real meaning in a rapidly changing world: *“The idea of [a financial] expert is fleeting now.”* Members are concerned that in some cases the board may defer too much to the audit committee, assuming the audit committee will delve into the technical details of accounting changes and financial issues. One member said, *“The board counts on the audit committee to watch the store”* when it comes to accounting changes and financial issues, but another member asserted, *“Watching the store is one thing, being a technical expert is another.”*

### **Audit committees have responsibility for overseeing management of a broad range of risks**

Part of the broadening scope of audit committee activity emerges from its risk management responsibilities. The New York Stock Exchange listing rules state, *“While it is the job of the CEO and senior management to assess and manage the company’s exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company’s major financial risk exposures and the steps management has taken to monitor and control such exposures.”*<sup>6</sup> While those requirements note that it is not the sole responsibility of the audit committee to oversee risk, some members think this requirement has pushed the bulk of risk management oversight onto the audit committee. One member said, *“You know if your company gets hit, they will ask, ‘What did the audit committee do?’ The audit committee needs to ensure there is a framework. In the current environment, the audit committee needs to raise questions and ensure management is doing it.”*

### **Core audit committee responsibilities must not be neglected**

A network member declared, *“We need to be sure the audit committee agenda doesn’t get so full of business issues. Accounts are complicated enough, [and] the audit committee’s role is to make sure the accounts are right.”* Members say that the rapid changes to accounting standards and the challenging financial climate make for a full audit committee agenda without straying too far from their core responsibilities. One member recommended boards disperse risk oversight to other committees to prevent the audit committee from becoming the default committee for risks that the committee may lack the expertise to oversee. Members discussed how best to allocate the risks associated with the credit crisis (listed above) to other committees. For example, one member noted, *“Supply chain viability is important and needs evaluating. But is that really the audit committee’s role?”*

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<sup>6</sup> Final NYSE Corporate Governance Rules 303A.07(c)(iii)(D), <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>.



## **Economic challenges heighten audit committee sensitivity to ethics and compliance**

In an economic downturn, executives may feel more pressure than ever to hit targets, and employees may be financially squeezed by inflation. Network members recognize that *“under a highly pressurized environment, people and companies can go off the rails.”* Members expect that the renewed focus on compliance and ethics training of recent years will pay off in the current environment. One network member quipped, *“The bad news is incident reporting is up four times since 2007. The good news is incident reporting is up four times since 2007. The message is out about compliance ... Awareness is up.”* Another said that setting the right tone at the top was also paying off at his company and that employees felt empowered to raise issues directly to the audit committee: *“We have 10,000 internal auditors, not 28 ... There’s a large cadre of people encouraged to raise their hand to point out potential problems.”*

## **Conclusion**

Companies are operating under the stress of an economic slowdown and unprecedented financial market disruption, while facing a seemingly constant flow of new accounting pronouncements and standards. As a consequence, audit committees find themselves pulled in several directions, needing to balance core financial reporting oversight responsibilities with those associated with a broader range of business risks. Audit chairs are working to ensure audit committees retain the proper focus on accounting issues while acting as a catalyst to engage the full board on broader business risks and ensure the appropriate dispersal of responsibilities. With the potential for additional market challenges and the switch to IFRS looming on the horizon, there is no doubt audit committees will need to continue to balance priorities for some time to come.

*The views expressed in this document represent those of the North Central 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 counselors 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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## Appendix: Getting involved with audit scope and fee discussions

Members also discussed the role of the audit committee and audit chair in the development of the audit plan and fee negotiation with the external auditor. Most members are comfortable that their auditors coordinate effectively with management to determine a fee that is appropriate for the required scope of the audit. Most have seen a reduction in fees following the implementation of Auditing Standard No. 5 (AS5), as more work is undertaken by internal audit.

However, one member wondered, *“Since the audit committee is the hiring agent for the external auditor, how does the audit committee chair or the audit committee get into the negotiation of fees? Historically, management negotiated, and the audit committee gave a stamp of approval. That was fine before it became our obligation to hire the auditor ... Should I be more involved?”*

Most network members say the answer is “not necessarily,” but they did identify several potential triggers for increased audit committee involvement:

- **Concerns about internal resources.** Though AS5 allows the external auditor to rely more on work done by internal audit, members acknowledge this is only possible if internal audit has the necessary skills and resources, which is not always the case, and whether the audit committee wants to allocate internal audit resources to those activities.
- **Change in management.** Several members noted that a new CEO or CFO, taking a fresh look at overall advisory costs, may seek to reduce audit fees. One member noted that a new CEO may ask the audit committee, *“How do we feel about audit fees? What is the benchmarking?”*
- **Changes in audit scope or fees.** Members recognize that additional fees are to be expected throughout the year, particularly in response to new accounting pronouncements from the FASB or if the company makes acquisitions. However, if additional fees represent a material change in scope, or if the audit committee feels the new work should have been included in the original audit plan, it may get more involved. This is also true if the proposed fees represent either a large increase or decrease from the prior year or are inconsistent with the direction of fees at other companies with which audit committee members are familiar. One member suggested that audit partners should proactively contact management and the audit committee prior to any significant fee increases or changes to scope. Another member noted, however, that scope changes constantly and that it is difficult for the audit committee to get too involved because it lacks knowledge of the details behind most changes.
- **Disagreement between management and the auditor.** Audit committees expect fees to be negotiated in a professional manner amongst the key managers and the external auditor. When management, internal audit, and the external auditor cannot agree on scope or fees, the audit committee often becomes more involved in the negotiation process to help bring the parties together.
- **Request for proposal.** Obviously, if the company is considering a change in auditor, the audit committee is much more likely to be closely involved in discussions regarding scope and fees.



Some members believe the audit committee and the audit committee chair can play the role of “bad cop,” ensuring audit fees are constrained while ensuring management’s relationship with the auditor is not threatened by contentious negotiations. Others believe a more appropriate role for the audit committee is to ensure that the fees are adequate to provide for a high quality audit.

Members recognize that fees are very much influenced by the makeup of the audit team: “*We know that a cheaper audit can mean a less qualified team,*” noted one member. Nonetheless, audit committees do review fees, and members reported that one real challenge in doing so is the lack of useful benchmarking data. One member noted that “*fees are the combination of a range of factors, including company size and complexity, the number of statutory audits, the company’s key locations, and so on.*” Those particulars mean that benchmarking data on fees is of limited value. Instead, audit committees refer to the company’s risk assessment to determine if the audit scope is appropriate and fees justified. They probe on the coverage of high-risk areas and ask about any proposals to reduce or increase coverage of those areas. One member noted that a change in scope may highlight areas of increasing risk and provide insight into the future direction of the company. Audit committees also evaluate the rationale behind high-cost elements in the audit plan.

Several members noted a current focus on ensuring that the audit plan sufficiently covers emerging markets, suggesting that increases in this area are justifiable. One member said his company has confronted issues of fraud at “*tier-three locations*” in emerging markets that were not initially included in the external audit plan because they are relatively small operations. Because some of these markets, especially China, India, and Brazil, may represent strategic growth platforms, the audit committee has engaged in conversations with management and the auditor about expanding the scope to include them.

Given all of the changes in accounting standards and the diversity of risks noted in the previous section of *PreView*, audit committees need to ensure the appropriate audit scope and associated fees. If the audit committee gets more involved in setting the scope of the audit up front, its involvement in fee negotiations may be more fruitful, because it will have better insight into the nature of any fee changes.