



Setting the audit committee agenda for 2010

The North Central Audit Committee Network (NCACN) met on September 29, 2009 to discuss considerations for setting their audit committee agendas for 2010. Over the last two years, audit committees have adapted their oversight on the fly, focusing on issues like liquidity and finance as their companies navigated challenging economic and market conditions. Amid signs of market stabilization and macroeconomic improvement, audit committees and boards now have an opportunity to consider how to set their agendas for 2010, by shifting to more “normal” committee functioning, while applying lessons learned from the recent economic and financial crisis.¹ For a full list of participants, see Appendix 1.

Executive summary

NCACN members who attended the meeting expect limited change to their annual audit committee agendas for 2010. Instead, members say meeting agendas are event driven and set quarterly, as management raises new issues or the business environment changes. They do expect some change in how their audit committees focus their time in 2010 and are adopting a range of practices for managing their time more efficiently. Core audit committee responsibilities are outlined in audit committee charters and are partly defined by federal regulatory and New York Stock Exchange (NYSE)-listing requirements. Yet audit committees, and especially audit committee chairs, need to consider what areas they need to review in depth in order to fulfill those core responsibilities.

- **Heightened regulatory scrutiny is motivating audit committees to increase their review of financial reporting, disclosures, and communications** (*Pages 2-4*)

Network members see increasing regulatory scrutiny, especially from the Securities and Exchange Commission (SEC), and expect that to continue into 2010. Audit committees need to determine their role in reviewing expanded governance and compensation disclosures. They also are beginning to review broader financial communications more thoroughly – increasing the vigilance of their review of quarterly and annual disclosures, earnings releases, and in some cases, earnings call scripts to ensure consistency in message and tone.

- **Audit committees are focusing risk oversight on areas within scope** (*Pages 4-5*)

Network members report progress in shifting primary responsibility for risk oversight to the board, and believe the audit committee can act as a catalyst to ensure that risk management receives sufficient board attention, and that other committees take on risk-related responsibilities where appropriate. They are focusing audit committee oversight on key business risks related to areas within the scope of audit committee oversight, including financial reporting and compliance risks, environmental regulation and sustainability reporting, and emerging risks related to information technology (IT) security.

¹ *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.



▪ **Finance and liquidity will remain on audit committee agendas** (Pages 5-6)

Network members expect audit committees to retain some responsibility for oversight of issues related to finance, liquidity, and capital structure, unless there is a board-level finance committee. As companies begin to consider strategic growth opportunities in 2010, audit committees will likely spend time reviewing the financial implications of transactions, in addition to the due diligence, financial reporting, and internal control considerations related to acquisitions.

▪ **Developing a practical agenda requires flexibility** (Pages 6-8)

Network members say that the annual agenda-setting process is unlikely to change significantly, as they plan for 2010. Instead, they say their challenge is managing evolving meeting agendas on an ongoing basis throughout the year, including efficiently fulfilling core oversight responsibilities to allow time for emerging issues and audit committee member education.

Heightened regulatory scrutiny is motivating audit committees to increase their review of financial reporting, disclosures, and communications

The recent financial and economic crisis has increased pressure on companies to ensure that financial statements and other disclosures are accurate and that overall reporting quality improves. As a result, audit committees have spent significant time reviewing financial disclosures, especially the management discussion and analysis (MD&A) section, and issues affected by fair-value accounting, such as goodwill impairment charges. Members expect to continue a trend toward deeper engagement in the full range of financial communications in 2010, driven partly by increasing regulatory scrutiny.

Regulatory scrutiny is increasing

Members describe increasing regulatory scrutiny, especially from the SEC, which is responding to criticism from perceived failures surrounding causes of the financial crisis and the high-profile failure to detect the Madoff fraud. Robert Khuzami, the new director of the SEC's Division of Enforcement, has set out a broad agenda of proposed changes and requests for additional powers to upgrade the SEC's enforcement capabilities.² The SEC is also proposing an array of new disclosures related to director credentials, leadership structures, risk oversight, and compensation.³ Some suggest that the SEC is looking to make an example of any company that fails to comply fully with regulations and disclosure requirements.

Responding to regulatory scrutiny will require significant audit committee time in 2010

Members expect that heightened regulatory scrutiny will increase the audit committee time devoted to reviewing disclosures and potential follow-up requests from regulators. A network member recounted the scrutiny his company received related to a recent SEC filing: *"There was a significant review of the 10-K,*

² Robert Khuzami, "Testimony Concerning Strengthening the SEC's Vital Enforcement Responsibilities" (testimony before the US Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment, May 7, 2009). Available at <http://www.sec.gov/news/testimony/2009/ts050709rsk.htm>.

³ Securities and Exchange Commission, "Proxy Disclosure and Solicitation Enhancements" (proposed rule), July 10, 2009. Available at <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>.



the proxy, etc. I was taken by the number of comments, and specifically, by the requirements for responding. I expect more and more of this.” The same member noted that the SEC is looking for greater detail in general: *“It’s not whether you got the numbers right, it’s how much detail have you provided.”*

Almost every member said his company received comment letters in 2009 and several members noted that they have seen a stronger focus on both assumptions affecting significant recorded estimates and assumptions driving forward-looking information, raising important questions for companies about how they respond to this scrutiny. A member questioned, *“How much forward-looking information should you provide? What are you putting out there? Exactly how should you respond?”* Another member noted that the more forward-looking information companies provide, *“The greater the chance it will be wrong,”* so the audit committee likely would spend more time assiduously reviewing financial disclosures and responding to regulators’ requests for clarification or new information: *“The audit committee needs to spend a lot more time really reading all materials and looking for inconsistencies.”*

Meeting participants highlighted three disclosure areas where they expect increased diligence from the audit committee in 2010:

- **Segment reporting.** A meeting participant observed, *“[The SEC] spends a lot of time looking at the press release to see how that lines up with ... your segments ... If they determine that it’s wrong, you would need to do an impairment analysis, and that could lead to restatement.”* Another noted that the SEC seems to be looking for some risk analysis by segment.
- **Fair value.** The SEC is expecting detailed information about how fair-value amounts have been calculated, and is going a step further in requesting disclosure about how changing assumptions would affect the amounts recorded.
- **MD&A.** Members expect more detail in the MD&A, including less boiler plate information and more in-depth analysis of company information, especially related to risk factors, than was common in past years.

Audit committees are expanding their review of financial reporting disclosures and financial communications

The need for increased scrutiny from the audit committee has provoked some audit committees to take a more active role in reviewing a broader range of financial communications, including earnings call scripts and other communications to the market. Most audit committees review earnings press releases, 10-Qs and the 10-K for consistency of message and tone, and, as one member put it, to *“ensure management doesn’t over-promise.”*

In addition, though not a regular practice among members, several said that, as a result of the meeting discussion, they would consider one member’s practice of reviewing earnings call scripts in advance of the call. More commonly, members use the CEO and CFO presentations to the audit committee to get a sense of what the executives will discuss on earnings calls, not unlike *“a rehearsal,”* which allows the audit



committee to ask questions. This helps management prepare for analysts who might ask probing or leading questions on the call, especially related to forward-looking information.

Most members' companies do not provide earnings guidance, or they provide it only on an annual basis. So, the audit committee can help ensure that management does not inadvertently provide information that equates to providing guidance during quarterly earnings calls.

Audit committees are focusing risk oversight on areas within scope

Of the more "discretionary" board and audit committee responsibilities, risk management continues to capture the most attention. NYSE listing requirements call for the audit committee report to "discuss policies with respect to risk assessment and risk management."⁴ Responsibility for ensuring risk policies are in place is very different from overseeing the risks themselves, and while members report some progress in allocating oversight of key risks across the board and its committees, several agreed that defining the optimal model for risk oversight is still very much a work in progress.

One member stated, *"The audit committee has addressed financial risk. Strategic risk has not been addressed as well as it could or should be. We probably don't spend enough time considering the downside risk of strategic decisions, the hole in the boat that could sink us."* Though members agree that strategic risk management is a board responsibility, several agreed that the audit committee could act as a catalyst for more risk management discussion among the full board. One member reported, *"I have started pushing for a more formal risk management discussion at the full board; to push it from the audit committee through to the board."*

Members emphasized the need to identify which areas of risk oversight should remain within the scope of the audit committee in order to allocate responsibility for other risks to the board and other committees. A network member asserted, *"You need to split up risk into pieces. The audit committee has responsibility for legal, ethical, and financial risks. Broader risks probably belong elsewhere."* Members highlighted three areas of risk oversight they expect their audit committees to focus on in 2010:

- **Improving coordination.** A network member shared a practical way to align the focus of internal and external audits with risk-management processes to help ensure that nothing important falls through the cracks: *"We brought in an independent firm to conduct an assessment of current and future state of internal audit. Then we brought in the internal auditor, external auditor, audit committee chair, and operating executives to improve coordination among these groups, and better drive audit scope. The internal and external auditors both found out what risks the operating executives were worrying about."*
- **Taking a fresh look at IT and security.** An article in the *Harvard Business Review* states: "It's clear that IT has to be a critical piece of the audit committee's risk analysis."⁵ Most members felt they had spent sufficient time on IT risks related to business continuity. Several members expressed

⁴ Final NYSE Corporate Governance Rules, 303A.07(c)(iii)(D).

⁵ H. David Sherman, Dennis Carey, and Robert Brust, "The Audit Committee's New Agenda," *Harvard Business Review*, June 3, 2009. Available at <http://hbr.harvardbusiness.org/2009/06/the-audit-committees-new-agenda/ar/1>.



concerns about the threat presented by IT security risks, with one highlighting cyberterrorism as an underestimated and underappreciated risk for many companies worth reviewing with the audit committee and the board. One member's company uses a third-party firm to test if the company's systems can be hacked.

- **Complying with a changing regulatory environment.** Some members are considering strengthening the audit committee's role in environmental and sustainability compliance and disclosure matters. Members generally agreed with one who commented, *"It's a risk that is hard to plan for. The rules are being rewritten every day."* Another member emphasized the importance of documenting all legal, ethical, and compliance activities to protect the company and the board.

As companies are applying lessons learned from the financial and economic crisis, network members are working to ensure that risk management improves without producing risk aversion that threatens their companies' ability or willingness to pursue strategic growth opportunities.

Finance and liquidity will remain on audit committee agendas

During the last two years, the financial crisis brought finance and liquidity to the fore of most board agendas. The audit committee has often taken a lead role in digging deeper into these issues, particularly liquidity, capital structure, and related topics, especially in the absence of a finance committee. A network member said, *"Clearly with companies that didn't have a committee to deal with these issues, like liquidity, it became a board issue, but it didn't get enough time. Then everyone hit the brick wall and they realized they didn't understand the risks, so the audit committee had to step into that role."*

A member suggested that while the audit committee may spend less time on these issues going forward, finance and liquidity likely would remain on audit committee agendas: *"Once you step into that role, you're in it. It's a continuing obligation, though maybe not in the same depth."* Part of the continuing role of the audit committee in this area is to apply lessons drawn from the financial crisis by delving more deeply into specific questions that may not be addressed by the full board. A member said, *"With [earnings] down, are you at risk for tripping covenants? How do you avoid getting into the same situation as before?"*

More strategic discussions in 2010

As the economy recovers, companies are beginning to consider strategic growth opportunities. To a degree, members say that board discussion of finance issues are *"more strategic now, less event-driven,"* and one member said discussions center more on the question, *"If there are opportunities, how do we manage [liquidity and capital structure]?"* Some predict the next 12 months could produce significant merger and acquisition activity and that audit committees may spend significant time in 2010 reviewing transactions. Ultimately, several members agreed that the strategic considerations always trump financial considerations in the success of transactions: *"By far, it is what you're getting versus [the price] you are paying or the financing [of a transaction]. You can't pay little enough for a bad company."*

While most members say that the full board reviews transactions for strategic fit before the audit committee gets involved, one member said his audit committee initially reviews transactions in advance of the full board



review. This member said, *“We keep the board-level review at a higher level and let the audit committee act as an advisory committee to management.”* However, most members say transaction reviews benefit from the broader perspective of all board members, and one said, *“If we insert the audit committee too early, the focus may become too much about the details versus the strategic decision.”*

Yet, the audit committee clearly takes a lead on some elements of the review process. One network member described significant informal interaction with the CEO and CFO in discussing transactions. Others said if financial issues are identified as a high-risk area in a potential transaction, the audit committee can ensure the proper focus on those issues. Audit committees often get involved in the due-diligence process, especially when internal audit is engaged, as well as in understanding the financial reporting and internal control implications of the proposed transaction. (For companies that do have a separate finance committee, members said responsibilities in potentially overlapping areas should be clearly defined between that committee and the audit committee.)

Developing a practical agenda requires flexibility

As audit committees clarify the scope of their oversight activities and highlight areas for increased focus in 2010, they are prioritizing agendas, identifying areas for committee and board education, and determining how best to manage their time. A network member said, *“The core stuff isn’t the hard part. Flexibility and prioritizing issues as they arise is most important.”*

Audit committees are identifying ways to improve efficiency and identify emerging issues

Network members agreed with one who stated, *“The basis for the [annual agenda] is what we’re required to do. But the agenda is really set quarter-to-quarter.”* They expect little change to the annual agenda-setting process, and focus instead on efficiency improvements to allow for flexibility in setting meeting agendas throughout the year. Several members said they solicit committee members for input into meeting agendas and generally agreed that the agenda-setting process is *“more event-driven from meeting-to-meeting,”* as issues arise or questions are raised that need to be addressed at subsequent meetings.

Members identified a number of ways they are determining issues to include on meeting agendas and better managing their time to allow for flexibility:

- **Improving pre-reading materials.** Members agreed that the quality of pre-reading materials provided by management, the internal auditor, and external auditor has improved, allowing audit committee members to feel better prepared heading into meetings, therefore requiring less time for in-meeting preparation and explanation.
- **Limiting in-meeting presentations.** As one network member noted, audit committees are encouraging management to *“discuss, not present,”* to get the committee more engaged in the content rather than simply presenting materials included in pre-reading packets. Members still see value in having *“young stars”* present, but work with management to ensure *“they make key points quickly”* in order to reserve time for discussion.



- **Holding executive sessions prior to meetings.** Several members have added an executive session before audit committee meetings in addition to those typically held after meetings. A network member observed, *“It elevates concerns and issues for discussion in the meeting or for follow-up [after the meeting].”*
- **Putting high-priority issues first on the agenda.** Over the last two years, audit committees have been identifying ways to fulfill routine, core oversight activities more efficiently to allow for discussion of timely issues, including using question-only consent agendas. A network member recommends, *“Put high priority items first, rather than the rote stuff, then use consent agendas at the end.”*
- **Using teleconferences when appropriate.** In a conversation prior to the meeting, an audit committee chair asserted, *“It’s [inconsistent] to say, ‘This is important, we need to discuss it, so we’re going to have a phone meeting.’ Only absolute emergency or absolutely routine items should be done over the telephone.”* Yet, one network member noted that in cases when timely issues need to be dealt with quickly, teleconferences have advantages: *“Telephonic meetings actually help keep the focus and limit time for repetition, in-meeting presentations etc.”*

Education has to be integrated into audit committee agendas

Members emphasized the need to keep the audit committee informed about emerging financial issues and changes to accounting standards and other regulations. A network member stated, *“Education is prioritized in the current environment,”* and another said, *“We need to take a more disciplined, methodical approach [to education].”* Audit committees require two main types of education:

- **Company-specific education.** Some issues are specific to the company, benefitting most from discussion with management and the company’s external auditor. Some audit committees are looking for education about areas of the company in which they may have had limited exposure in the past: *“We’re asking to see people we haven’t seen, for example, we had the credit head join a meeting.”* Most members felt that training tailored to the company’s specific circumstances is most valuable, because it enables the committee to better oversee the company.
- **Generic, external education.** Audit committee members also require education about issues that affect the business environment more broadly, especially those related to financial reporting, compliance, and capital markets. Members report relying on materials developed by audit firms, including reading materials and webcasts, in addition to those developed by law firms and other sources. A network member also noted, *“audit committee members have different needs. They’re not all financial experts.”* Some committee members attend conferences or university business school programs for directors. Network members also are looking for insight from members’ experiences across boards and perspectives from their external auditors from across their client bases.

Finding time on already-full agendas for committee education can present a challenge, but is essential. To facilitate this, one network member’s board implemented a rule prohibiting audit committee members from serving on any other board committees so that education sessions can be held during other committee meetings. Another said, *“We found it difficult to [hold education sessions] within meetings, so we do 90*



minute or two-hour telephone meetings focused on education. We select from a list of topics developed with input from the CFO, CEO, and audit committee.” Most audit committees have a section in the pre-reading materials for information on relevant subjects, drawn from internal and external sources.

Conclusion

Signs of economic and market recovery are encouraging companies to shift out of cost-cutting mode and enabling members to return to more normal board functioning. This “return to strategy,” as one member called it prior to the meeting, combined with ongoing accounting and potential policy changes, has implications for the focus of audit committee oversight in 2010. Though it is important for audit committees to work with management and the board to define the scope of audit committee oversight as they plan their agendas for 2010, a central lesson from the last two years is that the only constant is change. As such, effective audit committee oversight requires efficiently managing core responsibilities in order to identify emerging issues for discussion, review, and education on a continual basis by coordinating with management, the board and advisers.

About this document

The North Central Audit Committee Network is a 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 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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Appendix 1: Meeting participants

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 Store
- Dave Flaschen, Audit Committee Chair, Paychex
- Gordon Harnett, Audit Committee Chair, EnPro Industries,
- Bill Lawrence, Audit Committee Chair, Brush Engineered Materials
- Bill MacDonald, Audit Committee Chair, American Greetings Corporation
- Dave McCammon, Audit Committee Chair, Pulte Home
- Mike Monahan, Audit Committee Chair, CMS Energy Corporation
- George Schaefer, Audit Committee Chair, WellPoint
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Richard Wallman, Audit Committee Chair, Convergys Corporation

Ernst & Young participants in the meeting included:

- Mary Kane Betsill, North Central Assurance Managing Partner, Ernst & Young
- Al Paulus, Director of Professional Practice – Auditing, Ernst & Young
- Mike Ventling, Vice Chair and North Central Managing Partner, Ernst & Young

The following members participated in a teleconference on the same topics following the meeting. Comments from that call have been incorporated in this issue of *VantagePoint*.

- George Miles, Audit Committee Chair, HFF
- Jim Vandenberghe, Audit Committee Chair, Federal-Mogul
- Gary Valade, Audit Committee Chair, Wabtec Corporation



Appendix 2: Questions for audit committees

- ?** How might audit committees increase the effectiveness and efficiency with which they fulfill core oversight responsibilities? How might the audit committee agenda change in 2010 to reflect innovations to core oversight activities?
- ?** What changes regarding financial reporting, disclosure, and regulatory compliance are of the greatest concern? Which of those changes call for greater audit committee oversight?
- ?** How is board and audit committee oversight of risk management likely to change in 2010?
- ?** Recognizing that many core audit committee responsibilities are prescribed by regulation, what discretionary issues should audit committees take up? How likely is this issue set to change in 2010?
- ?** Should audit committees reconsider their charters?
- ?** What impact will expanded regulation and disclosure have on the audit committee's agenda in 2010?
- ?** When and how will you set the 2010 audit committee agenda? Who will be involved?
- ?** How do you ensure the audit committee agenda is aligned with the agendas of the board and other committees? What challenges does this present? What opportunities?
- ?** How can audit committees get through their agendas more efficiently?
- ?** How can you assess the effectiveness of the agenda?