



Shifting audit committee priorities in a turbulent business environment

Introduction

The Pacific Southwest Audit Committee Network (PSWACN) held its 12th meeting on April 15, 2009, in Marina del Rey, CA. Network members discussed ways audit committees and boards are adapting their priorities and oversight responsibilities in an effort to keep pace with rapid changes in the capital markets and the economy.

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. Quotes in italics are drawn directly from comments made by PSWACN members during and after the meeting.

The members of the network present at the meeting, who sit on the boards of 35 large-, mid-, and small-cap companies between them, were:

- Roxanne Austin, Audit Committee Chair, Abbott Laboratories and Target Corporation
- Frank Biondi, Audit Committee Chair, Amgen
- Richard Dahl, Audit Committee Chair, DineEquity
- Ray Dittamore, Audit Committee Chair, Life Technologies
- David Engelman, Audit Committee Member, Fleetwood Enterprises
- Stephen Frank, Audit Committee Chair, Northrop Grumman
- Bala Iyer, Audit Committee Chair, IHS
- Diana Laing, Audit Committee Chair, Macerich
- Marty Melone, Audit Committee Chair, Internet Brands
- Mike Meyer, Audit Committee Member, City National Corporation
- Stephen Page, Audit Committee Chair, Lowe's Companies
- Michael Stein, Audit Committee Chair, AIMCO
- Paul Unruh, Audit Committee Chair, Symantec Corporation

The following members took part in post-meeting discussions but were not able to attend the meeting:

- Lou Lavigne, Audit Committee Chair, BMC Software
- Sue Redman, Audit Committee Chair, The Apollo Group



Ernst & Young partners participating in all or part of the meeting included:

- Bill Browning, Pacific Southwest Sub-Area Accounts and Business Development Leader and Los Angeles County Office Managing Partner
- Peter Griffith, Pacific Southwest Sub-Area Managing Partner

Executive summary

Participants expressed an interest in discussing three broad themes related to their audit committees' priorities in light of extraordinary market and economic uncertainty:

- **The increased focus on funding and liquidity** (*Page 2*)

Network members agree that oversight of funding and liquidity has become a central focus for the full board, not just the audit committee. They continue to monitor cash management, debt covenants, stock buybacks, and pension plans, and most agree that scenario planning can help identify liquidity vulnerabilities. Members also discussed the increased value a diverse board and audit committee can bring to scenario planning.

- **Risk management: an ongoing challenge** (*Page 5*)

Most audit committees still seek a practical approach to risk management. Members agree that while *"conceptualizing is easy,"* taking steps to integrate risk management into the business has proven a significant challenge. They believe the active engagement of the senior management team is fundamental to an effective enterprise-wide risk management (ERM) process. Network members discussed ways companies might operationalize risk management, including reviewing risks in the 10-K, implementing a walk-through approach, identifying single points of failure, and getting a more diverse group of people involved in brainstorming worst-case scenarios.

- **Managing audit committee priorities and agendas** (*Page 7*)

Members believe audit committees must reprioritize their agenda, given their increasing involvement in forward-looking, strategic financial and risk issues. They say audit committee meetings are more efficient and effective when the agenda incorporates the input of all audit committee members. Network members highlighted several techniques to ensure audit committee time is used well, including coaching management to be more focused, improving pre-meeting reading materials, and increasing the use of dashboards.

The increased focus on funding and liquidity

The ongoing global recession and banking crisis continues to concern members, and they discussed the broader impact of funding and liquidity problems on corporate operations and strategy. Participants noted that audit committees are now more involved in the oversight of funding and liquidity, including an increasing focus on cash management. One member said, *"Liquidity has now become a part of every conversation ... it seems like it's permeating everything we discuss at the board level."* Another member



had remarked prior to the meeting, “Clearly the number one thing people are wrestling with right now is liquidity and the impact of the economy on the financial aspects of the company. In addition to doing everything we typically do, it’s important for the board and audit committee to make an extra review of any area that’s affected by the economic downturn we’re in.”

The issues

Members highlighted several specific issues their committees are dealing with as part of their increased focus on funding and liquidity:

- **Cash management.** Members agreed that in the current market, “*cash is king,*” and the tumultuous events of the past year have only heightened the need for audit committees to maintain a rigorous focus on cash: “*The single greatest focus is our cash flow right now, and how we’re managing that in the current environment.*”
- **Debt covenants.** “*We’re looking at covenants two years out and looking at how far we can go before we trigger our covenants.*”
- **Stock buybacks.** “*It may seem like a good time to buy shares, but having just gone through this whole credit crisis, we ultimately decided to [defer any stock buyback]. People are now saying, ‘Let’s keep our powder dry and hold on to some of this cash, just in case [the company needs it later].’*”
- **Pension assets.** Some members see pension plans as a “*ticking time bomb,*” as some now appear to be underfunded: “*We’re getting into much greater depth in the discussion around pension plans in my audit committee meetings. We are doing some worst-case scenario planning and looking at everything, all the way down to the individual fund managers.*”
- **Business partner risk.** “*Our committee has been focused on ... how this crisis is impacting our third parties. That has been an eye-opening experience because even though we are not directly impacted [by liquidity concerns], the companies that we’re involved with are. Going through that exercise and discussion has been helpful.*”

Assessing funding and liquidity pitfalls through scenario planning

Several members said scenario planning and stress testing enable management and the board to better understand the range of funding and liquidity pitfalls that lurk: “*You need to ask from time to time, ‘What’s the worst thing that can happen?’ You can stress test everything in the world, but we never saw that you wouldn’t be able to sell commercial paper!*” Another member pointed out, “*The general view is that there isn’t enough time to plan what you’re going to do if, indeed, one of these major impacts [of the economic crisis] starts to influence your company. Therefore you need to have a plan ready to roll.*”

Some audit chairs report that they have built a scenario-planning discussion into their ongoing board agenda: “*At [one company] we do scenario planning on a regular basis. It has become a very strong part of the board discussion.*”



Many companies are assessing their companies' financing issues over a range of time horizons: *"We take our scenarios out five years on a quarterly basis, [with a more detailed] focus [during] the next two years. We're trying to take advantage of a negative situation [to help us] prepare for the future."* Added another member, *"We're looking out quarterly until we get out to our last significant debt maturity. It keeps you focused. [The right approach] depends on the business and whether the issues with funding and liquidity are preventing you from taking opportunities you want to go after."*

Members also discussed the value a diverse board and audit committee can bring to scenario planning. They agreed that a diversity of perspectives and experiences allows boards to anticipate a broader range of alternatives: *"Having a diverse committee makes you start thinking outside the box. Beyond the obvious, you all start thinking about other things that might drive you down. Having a diverse group of people brings out all those different scenarios."* One member with experience of such a diverse committee recalled, *"It was interesting to see the tension between the different points of view. We had quite an agitated discussion, and I think there's a lot of value in the idea of challenging assumptions. You can't just look at industry-specific issues; you need to look at things from all points of view, and a diverse committee allows you to do that."*

Additional considerations for audit committee chairs

Members discussed specific ways in which, in their capacity as audit committee chairs, they can help their companies minimize funding and liquidity risks:

- **Ensure management is aware of leading practices in cash management.** *"We found a couple of scenarios where management hadn't ever been in a position [where they needed] to challenge the [financial] metrics. We had an accounts receivable expert come in and give a course on cash flow. Management didn't have a good handle on [certain cash management techniques], and that really helped."*
- **Focus the full board on emerging financial issues.** *"The nuts-and-bolts conversations around cash flow should happen in the audit committee context, but the more macro issues like capital structure should be handled by the full board ... We've found that a lot of good lessons come out of having the bigger discussion at the full board level."*
- **Invite board colleagues to attend audit committee meetings.** *"At [one company], all board members come to the audit committee meeting because they want to be part of the more in-depth financial discussion that takes place there."*

Audit committees and finance committees

Since many PSWACN members' companies lack a separate finance committee, the audit committee is often the logical forum for a *"deep dive"* into oversight of the capital structure, liquidity and solvency, and operating cash flow. Some members whose companies at one time had a separate finance committee reported that the two committees *"have now merged because we found we had been talking about a lot of the same things."* One member pointed out that *"for practical purposes, we do many of the things a finance*



committee would do, and my argument would be that they're not separable anymore because of the interplay and overlap of risk."

Members whose boards do have a separate finance committee emphasized the importance of maintaining constant communication between the two committees: *"[As audit committee chair,] I make sure I'm on the finance committee, and I coordinate our agenda to ensure that their work and our work don't overlap."*

Risk management: an ongoing challenge

Risk management has been high on the audit committee agenda in recent years, and the current crisis has driven home the need for an effective system for identifying and managing a range of strategic, operating, financial, and compliance risks. Still, members agreed, *"It's very difficult to bridge the theoretical concept of enterprise risk management to actual action."* Members agreed that boards have struggled with how best to operationalize risk management and noted that increased interest has not always led to increased clarity.

Many members openly asked, *"Is there a best practice that's been developed around risk management? Is there any sort of one-size-fits-all approach?"* Audit committees recognize that while specific practices can enhance risk management, ultimately *"there is no 'McERM.' No silver bullet or one-size-fits-all approach."*

Risk management needs to be owned by management

Members noted that while the audit committee may take the lead on specific areas of risk oversight, *"[broader] risk management oversight is a group effort."* A member noted, *"At one point, the board tried to say [ERM] was the audit committee's job, and we said, 'No way.'"* Another member remarked prior to the meeting, *"I've had knock-down, drag-out fights about risk responsibility with the chairman [of the board]. I think it's better to utilize the talents of the full board when you're trying to assess business risk. I've had some say that all of risk should be under the purview of the audit committee, and I think that's a big mistake."* Several members observed that oversight of specific risks often extends across board committees, given the influence of corporate culture, decision authority, and executive compensation on risk management practices.

Regardless of how oversight responsibility is allocated, members agree that although the board and/or audit committee can play a key role in kick-starting the risk management process, *"at the end of the day, risk management ownership is the responsibility of management."* One member commented, *"We've asked management to outline for us exactly what's being done inside the company and how risk is being operationalized. They are the ones who are ultimately responsible for driving risk into the business."*

Members emphasized the *"importance of culture"* and discussed the role of tone at the top in ensuring that risk awareness is considered in all business decisions: *"You need to get risk management down to the business units. It used to be only the board would push it, and we just kept pushing it and trying to get [risk management] pushed down as far as we could."* Added another member, *"I really think you have to interface with the people further down in the organization. You can have all the whiz-bang charts in the world, but it's the people down in the organization that actually know what it's about and drive the process."*



Members also repeatedly underscored the importance of integrating risk management into the strategic planning process: *“This idea of separating risk management as something off to the side is a dangerous approach, and companies are falling into that trap. It’s important to remember that risk management really needs to be integrated. Yes, you should know what the top ten risks are, but when someone makes a strategic plan, you need to make sure risk management is integrated. The biggest problem with risk management is that it’s not operationalized, and the senior management team doesn’t integrate it into what they are doing.”*

Even though some companies have designated mid-level professionals to take responsibility for risk, one member observed that risk management is generally more effective when it is clearly driven by the senior team: *“It would be bad if the staff were running risk instead of [the senior executive team]. Only senior management needs to own the process.”*

Operationalizing risk management oversight

Members shared several tangible ways in which audit committees can contribute to effective risk management oversight:

- **Review risks in 10-K.** *“We start with the 10-K and then ask management to rank the [listed] risks. For the audit committee to sit there and rank risk factors, it can be tough, but if you find a way to get management to focus in on a specific issue, it’s much more effective.”* Another member remarked, *“I’m intrigued by this notion of prioritizing risks that you identified in the 10-K. I’m going to go back and make sure the risks listed are actually being addressed by our risk management team.”*
- **Implement a walk-through approach.** *“We had a question around a specific process, and we told management we wanted a walk-through of what they would do to handle it from step one. We spent a whole day going through that one specific risk, including the judgments and decisions at each step. We decided to do a deep dive, and it was time very well spent.”*
- **Identify single points of failure.** Companies in regulated industries may find that compliance or other operating risks can imperil the enterprise. *“For our company, the [risk from a] single point of failure is enormous.”*
- **Get more people involved in brainstorming worst-case scenarios.** *“We usually do a fairly good job of thinking about the worst-case scenarios, so we’ve challenged ourselves for the next meeting. Everyone who participates in the board meeting is coming back to take part in the discussion next time. This includes the CEO, CFO, external and internal auditors. We want everyone to think about what else could be out there that we could be blindsided by.”*



Members reported that the discussion left them feeling energized, with a *“renewed enthusiasm for ERM.”* Still, while members applaud the heightened focus on risk management, many caution against becoming too risk averse: *“It’s important not to lose all your imagination because you’re so afraid of risk. I hope we get back to a place where we’re ready to pounce on innovation and opportunity. I’m a big proponent of the pendulum swinging back.”* Another member agreed: *“I think it’s important that people don’t get so caught up in the current crisis that they aren’t doing everything they can to optimize recovery ... It’s important to make sure the crisis is getting the right and proper attention by the right people, but they shouldn’t be so distracted that they lose sight of the objectives. There are always appropriate risks for the business to take, and it’s important for the board to strike a balance with that.”*

Managing audit committee priorities and agendas

As audit committees are being pulled in more directions, many chairs say they have no choice but to dedicate more time to their oversight responsibilities: *“It takes more time to be on an audit committee today.”* But although it may be true that audit committees should plan on longer and more frequent meetings, members also believe there are opportunities to apply greater focus and use their limited time more effectively.

Ensuring the audit committee agenda and priorities are focused

One audit chair said prior to the meeting that the annual agenda planning framework may be inadequate during a period of rapid change: *“It’s difficult to plan for anything in terms of the business, because you don’t know what the market reaction is going to be for anything. How do you organize an agenda around that?”* Another member, also speaking before the meeting, urged vigilance against scope creep: *“One of my fears is that audit committees and boards will take on more than they should. We’re fiduciaries; we should not be taking on the role of management. People feel like they have to overreact to this economic climate, but I don’t think we’re ultimately moving too far from where our agenda was last year.”*

Members responded particularly well to the idea of seeking other audit committee members’ input on future meeting agendas. Some audit committee chairs circulate a draft agenda to committee members for comment before it is finalized. Others include a discussion of future priorities at every audit committee meeting: *“We go into executive session at the end of the meeting, and I ask the other audit committee members what they would like to see on the agenda next time.”*

Increasing the efficiency of audit committee meetings

While some audit committees have increased the length or frequency of their meetings, scheduling conflicts often mean that *“audit chairs have to work hard to manage the agenda in the allotted amount of time.”* Members highlighted several specific ways in which they are working to ensure audit committee time is used efficiently:

- **Coaching management to be more focused.** Some members observed that management presentations to the board can be overly long and unfocused: *“The detail can flood out the need to stand back and bring value.”* One member worked with the finance team to develop a more effective



framework for presenting information to the audit committee, which saved time and enhanced understanding. Another said, “Management don’t focus well on the audit committee presentation, so I have extensive pre-meetings to help keep them down.”

- **Ensuring more tailored pre-meeting reading materials.** *“I’ve been working with the CFO and controller, and we have been working to put together a better pre-meeting reading package. We figured out that our audit committee members all like different things, so we’re working to do more executive summaries. Depending on what everyone’s expertise is, it will allow for more efficient reading. Our audit committee has said [this practice] reduces the amount of time that they have to spend, and they’ve really been open to it. Some of us want to read more than others.”*
- **Increasing use of dashboards.**¹ *“I personally think dashboards are totally underutilized and can be very useful. We introduced dashboards so the reviews of routine things could be done thoughtfully but rapidly and so the audit committee would have time to review other important issues. It’s worked very well.”*

Conclusion

A number of audit committee chairs have said that audit committee members increasingly find themselves the “go-to” directors for a wide range of issues because of the expertise they have gained dealing with major financial matters, whether during economic downturns or through compliance with Sarbanes-Oxley. Audit committee members have spent more time with management, dug into more areas of the business, and developed a deeper understanding of the details of the business than many other board directors.

For some, the current financial and economic crisis has served as a call to return to the fundamental responsibilities of corporate governance: *“I think it’s back to fundamentals for everyone. Presumably something we should have been doing all along. We need to stay on top of the dynamics of the business and we need to dig a little deeper.”* Many boards are questioning whether they have the right committees, with the right members focused on the right issues. This is a healthy discussion, with no single right answer. Regardless of evolving board and committee structures, it is clear that directors will have to spend more time, request more information, and be willing to continue challenging assumptions if they are to fulfill their oversight responsibilities most effectively during these rapidly changing times.

¹ A dashboard is a tool to help guide and focus a discussion. It is generally a one-page display that includes significant bullet points, text, charts, graphs, etc. that help synthesize a broader range of information.



Appendix: Questions for audit committees to consider

- ? What new challenges do boards and audit committees face in light of difficult market and economic conditions? How has economic uncertainty impacted board and audit committee priorities? What is the impact on board interactions and on the board's relationships with key executives?
- ? How do liquidity considerations enter into board and audit committee discussions? What information does the board need to ensure effective oversight of liquidity? How much scenario analysis is appropriate? How does management assess counterparty liquidity risks? What are the implications of these assessments?
- ? How well are regulatory risk disclosures and internal risk management practices aligned? Does the board ensure management focuses not only on key risks, but also on opportunities? How is risk management integrated with corporate culture, decision making, and executive compensation?
- ? How might audit committee meetings be more productive? Could the committee use its limited time more effectively?
- ? Is the current board committee structure and process adequate for dealing with the challenges posed by the economic and credit crisis? What is the division of responsibility between the audit committee and other committees, in particular the finance or risk committees? What governance changes might be helpful?

About this document

The Pacific Southwest 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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