



WEIL, GOTSHAL & MANGES LLP

AUDIT COMMITTEE INSTITUTE

Highlights from the 5th Annual Audit Committee Issues Conference

Setting the 2009 Agenda

February 2009
Miami, FL
Phoenix, AZ

KPMG

About the Audit Committee Issues Conference

Now in its fifth year, the Annual Audit Committee Issues Conference brings together audit committee members from around the country to discuss the challenges, practices, and priorities shaping audit committee and board agendas. The conference, which takes place on the East and West coasts, is hosted by KPMG's Audit Committee Institute, the National Association of Corporate Directors, and Weil, Gotshal & Manges LLP. For more information about the conference visit www.auditcommitteeinstitute.com or contact ACI at 1-877-KPMG-ACI.



Contents

- Managing Through the Crisis5
- A More Focused and
Intense Oversight6
- Overseeing Risk:
The Emerging Environment.....8
- The Changing Regulatory
and Governance Landscape9

Just as rising tides lift all boats, economic crisis and uncertainty focus all agendas.

In 2009, every audit committee agenda will be focused on job number one: helping the company get through the next 18 months.

Understanding the impact of the economic crisis on the company—and on its financial statements, disclosures, and internal controls—will require monitoring financial forecasts closely, focusing on liquidity and cash management, and assessing the company's risk profile as conditions change.

Yet, just as businesses are rapidly adjusting their own strategies and operations to deal with unprecedented pressures and mounting uncertainty, boards and audit committees also are undertaking a more focused and intense level of oversight.

Top Concerns for Audit Committees in 2009¹

When asked which issues would cause the greatest concern for their audit committee in 2009, conference attendees identified the following as their top five:

1. Liquidity, access to capital, and cash flow
2. Risk management (including forecasting, testing, scenario planning)
3. Financial statement issues (including fair value, asset impairments, disclosures)
4. Maintaining internal controls
5. Alignment—of business goals, incentives, culture, compliance, controls, and risk

1. All survey results are based on responses from approximately 150 audit committee members and directors surveyed on February 3 and 10, 2009 in Miami, FL, and Phoenix, AZ, respectively.

As emphasized by prominent audit committee chairs and corporate governance luminaries at the 2009 Audit Committee Issues Conference, oversight is very different than it was a year ago.

Audit committees and boards are carrying out their responsibilities with greater intensity and vigilance—and with a sharp focus on accountability. They also recognize that being effective in their oversight role—particularly in a volatile and uncertain environment—requires a solid, real-time understanding of the business, the people who run it, and the board. In other words: the “basics.”

In this report from the conference, we highlight critical areas of audit committee focus—including managing through the crisis, the nature of oversight today, overseeing risk, and the changing governance landscape—and

share related practices and insights as discussed by 150 audit committee members and governance luminaries attending the forum.

While one size rarely fits all, clearly all can benefit from considering this collection of practical, timely insights from audit committee members who are committed to strengthening oversight and “lifting all boats” in the governance community.

To be sure, 2009 will mark a critical inflection point for governance and oversight. Audit committee agendas will be notable not only for what's on the agenda, but also for how those agendas are carried out.

Managing Through the Crisis

Business leaders and economists are painting a sobering picture of the depth and likely duration of the economic crisis and its impact on companies. While the crisis has placed tremendous stress on virtually all companies, that stress is now compounded by unprecedented uncertainty—about the U.S. and world economies, the markets, our financial system, and many of the fundamental assumptions underlying company strategies.

Helping to guide the company through the crisis, and deal with the uncertainty ahead, is now a top priority for boards and audit committees—and audit committee members attending the Issues Conference emphasized a number of important oversight activities, including the following:

Closely monitor the impact of the economic crisis on the company.

- Timely and accurate forecast information is critical to obtaining a clear picture of where the company is heading. Identify possible red flags, and closely monitor the company's performance, including forecasted earnings and cash flow, and compliance

with debt covenants. Be sure to test the forecasting models being used, and develop worst-case scenarios.

- Given the increasing consolidation in the financial industry, consider the need to diversify sources of capital and establish new lines of credit; expect to operate with tighter debt-to-equity ratios and more restrictions on use of capital.
- Monitor the impact of the crisis on the company's ability to hedge (against currency, interest rate, and commodity price volatility).

Assess the company's exposure to third parties affected by the economic crisis.

- The impact of the crisis on the company's supply chain, key customers, and other third parties is a major area of exposure for most companies. Monitor the company's exposure to all companies in financial distress; in addition to the supply chain and sales and distribution channels, key third-party dependencies include customers, banks, lenders, underwriters, insurers, guarantors, and counterparties. Identify critical dependencies, such as foreign suppliers and key customers.

Financial Forecast Information

How satisfied are you that management has timely and accurate financial forecast information about the company's earnings and cash flow?

26%

Very satisfied

36%

Satisfied

27%

Somewhat satisfied

11%

Not satisfied

Discussing Management's Assumptions

How engaged is the audit committee in discussing the assumptions that underlie management's material accounting judgments and estimates that might be impacted by the financial crisis?

50%

Very engaged

43%

Somewhat engaged

7%

Not engaged

Vendor/Outsourcing Risk

How concerned are you that your company may not have adequate contingency plans to ensure business continuity in the event of a vendor failure?

6%

Very concerned

45%

Somewhat concerned

34%

Not concerned

15%

Not engaged in outsourcing

Earnings Guidance

In light of the uncertainties posed by the financial crisis and the emerging environment, has your audit committee reconsidered the company's policies regarding earnings guidance?

31%

Yes

36%

No

33%

Company does not issue earnings guidance

- Understand who in management is responsible for managing these risks, and ensure that the company has an inventory of its third-party exposures.

Focus on internal controls, particularly as the company cuts costs.

- As management seeks to reduce costs and implement layoffs, maintaining internal controls may pose a particular challenge. Test management as to whether proposed cost cutting and layoffs may adversely affect internal controls.
- With the economic crisis placing tremendous pressure on management and employees, there may be an increased risk of fraud. Inquire about the adequacy of fraud controls.

Understand the impact of the financial crisis on the company's financials—particularly the balance sheet.

- Understand how vulnerable the company's investment portfolio is to changes in value in this environment—and help ensure that all exposures have been identified and quantified.
- Consider how changes in financial markets have impacted the valuation of pension plan assets and funding requirements.

- Focus on possible asset impairments: Has management identified all assets that should be tested for possible impairment? Has management identified triggering events that may warrant impairment assessments of goodwill and other intangibles? If so, are the values that are determined realistic based on current market conditions—or were they based on historical assumptions?
- Test the assumptions that underlie management's accounting judgments and estimates that might be impacted by the economic crisis.
- Help ensure that disclosures (MD&A) accurately describe the impact of the financial crisis on the company, including the company's liquidity risks, and the application of fair value.

A More Focused and Intense Oversight

Just as the economic crisis and unprecedented uncertainty have placed tremendous stress on companies, so too have the demands and pressures on audit committees and boards increased. Indeed, because of the gravity and urgency of the situation, board oversight today is very different than it was a year or two ago. Whether it's the nature of the

board's interactions with management, the discussions at executive sessions, or the review of disclosures and earnings releases, audit committees and boards are applying greater focus and intensity to their oversight activities. Accountability and vigilance are the hallmark.

Suggesting that they were perhaps overly focused on "process" in recent years, a number of audit committee members reported a renewed focus on the "basics" of effective oversight.

Among the basics they stressed:

Know the people.

- Directors need to develop strong, personal relationships with the CEO and CFO—understand how they think and what makes them tick. (Are they generally optimistic, pessimistic, or realistic in their views?) Some audit committee chairs have regular weekly calls with the CEO or CFO, as well as periodic calls "whenever the information changes." In a time of crisis, a director's effectiveness is enhanced by such informality.
- Similarly, get to know the internal and external audit teams, and business unit heads through frequent and informal communications. Listen to what they say (or don't say), and establish an open line of communication. Expect them to contact you promptly about significant developments, or when they find that the information they have previously provided is wrong or incomplete.
- Developing these relationships takes time, but the relationships are critical to effective oversight, and in helping to foster an appropriate tone and culture throughout the organization.

Understand the business.

- Effective oversight, including a constructive dialogue with management, cannot take place unless directors have an understanding—a solid understanding—of the company's business and industry, and are diligent in staying abreast of the issues and developments affecting the company.
- Find the time to read—about the business, the industry, and the competition. Carefully read reports from the analyst community—both buy- and sell-side reports—about the company and its competitors, as well as the SEC filings of competitors. Set aside time—whether formal agenda time or informal time—to educate audit committee members about the critical issues and risks facing the company.
- Consider having each business unit head meet with the audit committee periodically (perhaps once a year) to discuss the unit's strategy and the risks to that strategy. Visit foreign offices and meet with local business unit leaders, as well as internal and external auditors—and even local regulators of the business.

Exercise skepticism.

- Business leaders today understand that we are at an inflection point for corporate governance, and that effective oversight often requires that directors question, challenge, and sometimes test management. Indeed, a fundamental reexamination of the viability of the company's strategy may be appropriate. Healthy skepticism is an important tool for discovering the facts, integrating disparate pieces of information, and understanding the company's risk profile.
- Pay particular attention to accounting judgments and estimates that may be impacted by the financial crisis, and to models that drive important information—such as information about sales, revenue, liquidity, and compliance with debt covenants.

Insist on accountability—for management and the board.

- Make sure that the board's relationship and the "rules of engagement" with the CEO (and likewise, the audit committee's with the CFO) are clear.
- Remember who's accountable to whom—i.e., management to the board, and the board to shareholders—and act accordingly. (As one audit committee chair said, "Management works for me. And I work for the woman in Kansas who depends on those 200 shares she has in our company.")
- Key to the audit committee's effectiveness and accountability is a critical self-assessment—of the audit committee as well as individual members. A focus on the committee's composition, independence, and leadership is essential.

Changing Nature and Scope of Oversight

To what extent has the financial crisis caused your board/audit committee to change the nature and scope of its oversight processes?

27%

To a great extent

61%

Somewhat

12%

Not at all

Overseeing Risk: The Emerging Environment

There is clearly an intense focus on risk management today, given what's happened in the financial markets and the economy. And while risk management has been on the radar—if not a priority—for most companies and boards over the past several years, many are asking whether we are really “moving the ball forward,” and if we need to be thinking about risk management in a different way.

During the Issues Conference, audit committee members took a different approach to the topic, and discussed the types of conversations that boards and audit committees (whoever oversees risk) are having—or perhaps should be having—about risk.

Among their recommendations:

Ask the basic questions.

- Can management provide a holistic view of the company's major risks—both on and off the balance sheet? What are the top five risks facing the business?
- How tolerant is management of risks (including low-probability yet “catastrophic” risks)?
- How rigorously does management stress-test key risk assumptions?
- Are the board's information sources sufficiently varied and objective?
- How does culture—including incentive compensation—impact the company's risk profile?

Insist on a robust conversation about risk—a dynamic interaction and exchange between management and directors.

- Ensure that directors agree on the purpose of the risk discussion—namely, to satisfy the board that management can, and does, identify, assess, and manage risk effectively.
- Invite the right people to the table—the CEO, CFO, chief risk officer, general counsel, auditors, business unit leaders responsible for managing the risks, and others.
- Effective oversight requires that directors understand, question, and test management's core risk assumptions and perceptions; be prepared to ask that incisive “second question.”
- Focus on the models and on the underlying assumptions—and here visualization can be helpful so that directors can see the impact of changing key underlying assumptions.
- Obtain input from third parties—auditors, outside counsel, consultants, and others—to test and validate management's core risk assumptions and perceptions.
- Be particularly sensitive to the effect of compensation/incentives on the company's strategy and risk culture.

Understand the risk culture.

- Directors need to consider whether a more dynamic interaction between directors and management is viewed as “too adversarial” for the boardroom. If so, that may speak to the health of the organization's culture. Consider the nature and flow of information and dialogue about risk within the company, and watch for any reluctance, or “spinning,” when discussing risk.

Oversight of Risk

How satisfied are you that your board has in place effective processes to oversee the company's risk management activities?

12%

Very satisfied

35%

Satisfied

36%

Somewhat satisfied

17%

Not satisfied

Testing Core Risk Assumptions

How satisfied are you that your board/audit committee understands and tests management's core risk assumptions?

9%

Very satisfied

32%

Satisfied

36%

Somewhat satisfied

23%

Not satisfied

Risk Assumptions and Perceptions

How satisfied are you that your board exercises an appropriate degree of skepticism regarding management's risk assumptions and perceptions?

7%

Very satisfied

40%

Satisfied

40%

Somewhat satisfied

13%

Not satisfied

Incentive Compensation Risk

How involved is your audit committee in helping to address the risks associated with the company's incentive compensation plans?

10%

Very involved

29%

Somewhat involved

61%

Not involved

- Periodically talk to the heads of the operating units, who own and manage risk on a daily basis.
- To get a view of the risk culture from outside the boardroom, visit remote locations, "walk the halls," attend employee gatherings, etc.

Consider nontraditional risks.

- Consider nontraditional risks, such as long-term shifts in demographics, climate, or technology; the impact of organizational design on how the company manages risk; the risks posed by the company's culture, tone at the top, and compensation structure; and reputation risk.
- "Management risk"—the risk that management may be unable or unwilling to perform—should be a key area of focus, as should the risks posed by succession planning.
- Use a "mystery shopper" approach to probe for risks and vulnerabilities from the outside-in.
- Consider the risk that the audit committee/board may not be performing its duties effectively.
- Discuss "black swan" risk scenarios and "dark-side budgets"—and play them out on paper.

Prepare for a crisis.

- More than half of the audit committee members attending the Issues Conference said their committee had been involved in a crisis. The message: be prepared—ideally, with a written crisis response plan.
- In developing a crisis response plan, the audit committee should think about the range of issues that could trigger a crisis—from financial statement errors to compensation issues, fraud or misconduct, and going concern issues.

- Knowing who to involve—independent outside counsel, forensic accountants, auditors—as well as when (and what) to communicate to various stakeholders is critical to ensuring confidence in the process, and a thorough and timely resolution.
- As directors who have been involved in major crises emphasized at the Issues Conference, "getting it right the first time" is essential.

The Changing Regulatory and Governance Landscape

According to attorneys and governance professionals attending the conference, we're likely to see significant changes in the regulatory and governance environment.

On the regulatory front, Congress has already begun holding hearings on the financial crisis—trying to understand the cause, and how to avoid such problems in the future. We can expect that Congress will alter the underlying architecture of financial and market regulation, including possible regulation of credit rating agencies and hedge funds, as well as some modification of the structure and authority of regulatory agencies.

On the governance front, institutional investors, regulators, and politicians have been scrutinizing the actions of boards, particularly in the context of the financial crisis, and we can expect increased focus on issues such as executive compensation, risk management, proxy access, and separating the roles of chairman and CEO. One attorney described it as an effort by some to pursue a more "shareholder-centric" model of oversight.

Conference Speakers, Panelists, and Thought Leaders

Dennis R. Beresford

Director
Fannie Mae, Kimberly-Clark, Legg Mason

James N. Chapman

Director
AerCap Holdings, Scottish Re Group,
Tembec, Chrysler, LNR Property

Debi Coleman

Director
Applied Materials, Synopsys

Jeffrey M. Cunningham

President and CEO
Directorship Magazine

Jeffrey E. Curtiss

Director
KBR

Kenneth Daly

President and CEO
National Association of Corporate Directors

William J. Fallon

Retired Four-Star Admiral
U.S. Navy

Honorable Barbara Hackman Franklin

Director
Dow Chemical, Aetna

William R. Graber

Director
The Mosaic Company,
Kaiser Permanente, Archimedes

Holly J. Gregory

Partner
Weil, Gotshal & Manges LLP

Sidney E. Harris

Director
TSYS, Ridgworth Funds

Mary R. "Nina" Henderson

Director
AXA Financial, Del Monte Foods,
Royal Dutch Shell plc.

Conrad W. Hewitt

Former Chief Accountant
U.S. Securities and Exchange Commission

Irvine O. Hockaday, Jr.

Director
Crown Media Holdings, The Estée Lauder
Companies, Ford Motor Company, Sprint Nextel

Terry E. Iannaconi

Partner
National Office, KPMG LLP

Laban P. Jackson, Jr.

Director
JPMorgan Chase

Henry R. Keizer

Global Head of Audit
KPMG International, and
U.S. Vice Chair – Audit, KPMG LLP

Gad Levanon

Senior Economist
The Conference Board

Mary Pat McCarthy

U.S. Vice Chair, KPMG LLP and
Executive Director, Audit Committee Institute

Ira M. Millstein

Senior Partner
Weil, Gotshal & Manges LLP

Maureen J. Miskovic

Executive Vice President and Chief Risk Officer
State Street Corporation

George Munoz

Director
Marriott International, Altria Group,
Anixter International

Ellen Odoner

Partner
Weil, Gotshal & Manges LLP

J. Thomas Presby

Director
American Eagle Outfitters, First Solar,
INVESCO, Tiffany & Co.,
World Fuel Services

Michael D. Schrage

Fellow
MIT Sloan School

Laurie M. Shahon

Director
Eddie Bauer Holdings, Knight Capital Group

Mark C. Terrell

Director
Comverse Technology

Edward W. Trott

Former Member
Financial Accounting Standards Board

Bart van Ark

Vice President and Chief Economist
The Conference Board

Susan Wang

Director
Avanex, Altera, Nektar Therapeutics, Premier

William J. White

Professor
McCormick School of Engineering and
Applied Science, Northwestern University



The information contained is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2009 KPMG LLP, a U.S. limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International, a Swiss cooperative. All rights reserved. Printed in the U.S.A. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. 19687NSS