AUDIT COMMITTEE INSTITUTE

Spring 2009 Audit Committee Roundtable Report

KPMG

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Directors Concerned About Information Quality, KPIs, Rigor of Boardroom Discussions

60 Percent: No Formal Process Linking Change and Risk Management

Even as we hear that signs of economic recovery may be emerging, it is increasingly evident that the current economic crisis is fundamentally different from past recessions—and that board and audit committee oversight is changing, perhaps permanently, as a result.

As one business leader sees it, "We are experiencing not merely another turn of the business cycle, but a restructuring of the economic order… When we finally enter into the post-crisis period, the business and economic context will not have returned to the pre-crisis state."[1] That's likely to hold true for the "governance context" as well, according to many of the 1,300 directors, senior executives, and governance luminaries attending KPMG's Spring 2009 Audit Committee Roundtable Series—*Economic Crisis, Change, and Uncertainty: A New Era in Governance and Oversight*.

In addition to helping management adapt to the changing and uncertain business environment—the "new normal"—we see more boards and audit committees adjusting their own practices to ensure effective oversight and offer meaningful advice as a sounding board for management. Audit committees—given their unique line of sight on key risks and alignments—have a pivotal role to play in these efforts.

As highlighted below, KPMG's Audit Committee Roundtable series provided important insights for audit committees, boards, and senior management to consider as they help their companies move forward.

Mobilizing Management (Don't Expect a Return to Normal)

It is evident from our Roundtable discussions that more boards and audit committees are helping to mobilize management to think things through from a fresh perspective, identify necessary changes, and guide the company during this period of dramatic change.[2]

Management may assume that dramatic change is not warranted, and that the company will get back to business as usual when the economy recovers. Recognizing the "new normal" that is emerging, boards and audit committees are helping to mobilize management by questioning fundamental assumptions about the company's business model, strategy, and industry. One prominent business organization recommends a radical mindset: "Treat your company like a turnaround."[3]

In Brief

The "new normal" demands a new mindset. Leading boards and audit committees are helping their companies navigate the economic crisis and understand the changes (perhaps transformational) that may be necessary to stay competitive. But effective oversight—which is front-and-center for shareholders and policymakers alike—requires that directors have quality information about the business, where it's headed, and the risks it faces, as well as the ability and willingness to challenge management. That may mean shaking things up in the boardroom.

To this end, directors can help management think about…

- Critical near- and long-term changes affecting the company and the industry. *"It takes discipline to stay focused on what could undermine the company's performance next week—like liquidity—and in the next year—like new technology."* [4]

[1] Ian Davis, Worldwide Managing Director, McKinsey & Co. in "The New Normal," *McKinsey Quarterly*, March 2009.

[2] "The Crisis: Mobilizing Boards for Change," Andrew Campbell and Stuart Sinclair, *McKinsey Quarterly*, February 2009.

[3] "Collateral Damage: Underestimating the Crisis," Boston Consulting Group, April 2009.

[4] All comments in quotations reflect views of Roundtable panelists or participants, and are used under the Chatham House Rule, whereby comments are quoted without attribution (to encourage candid discussion).

- Changes the company may have to undertake to survive and remain competitive in the new business environment. *"Pay close attention to what your competitors are doing and the KPIs they're reporting."*
- Potential risks posed by an economic recovery, such as access to financial resources and talent to capitalize on the recovery, and the continued viability of the company's supply chain, distribution channels, and customer base. *"This recovery won't be risk free."*

Recalibrating Oversight

The board and audit committee may need to "shake things up" in the boardroom, and recalibrate their oversight to meet the demands of the emerging business and governance environments.

From meeting more frequently with the CEO, CFO, treasurer, auditors, and finance team, to having more-rigorous discussions about risk, we see more boards and audit committees changing the way they work in response to the increased pressures on the company and the elevated expectations for effective governance.[5] In short, oversight has become more focused and intense.

In response to the economic crisis and emerging environment, boards/audit committees are…

- Meeting more frequently with management to stay apprised of economic crisis-related developments affecting the company. *"This is about proactive and prudent balance-sheet management—there's much less passive reporting now."*
- More thoroughly and candidly discussing how the economic crisis affects fundamental strategic assumptions. *"It was hard to imagine how bad the worst-case scenario was for our company—until it was presented to us."*
- Challenging management's information and assumptions more rigorously—but in an appropriate way. *"Give everyone a heads-up about what you're going to ask. The objective is not to embarrass anyone—it's to get to the heart of the issue."*
- Asking more open-ended questions—Why? How? Who?—to generate thorough and insightful discussion. *"Have different directors play Devil's advocate—argue the pros and cons."*
- Developing a deeper understanding of the business (by visiting customers, distributors, and local facilities) and building stronger relationships with the CEO, CFO, auditors, and others through more frequent and informal communication and interaction.
- Devoting more time to considering strategy and risk, and serving as a sounding board for management. *"Consider the amount of time you spend looking backwards, versus forward. You need to help management consider the opportunities and the what-ifs."*
- Increasing their involvement in the review of financial communications—e.g., earnings releases, analyst calls, and shareholder communications. *"We invite our full board to review drafts of the 10-Q and 10-K."*
- Holding executive sessions both before and after the audit committee meeting. *"This helps us agree on what we want to achieve in the meeting, and whether we achieved it."*

Raising the Bar on Information Quality—and Boardroom Discussions

To better understand the business and the risks it faces, boards/audit committees are working with management to improve the quality of the information they receive. And they're challenging management more rigorously on the implications of that information.

Many directors are concerned that the quality of the information they receive may not give them a clear or complete picture of the company's performance and where it's headed. Directors say the information (including pre-meeting materials) could be clearer, more focused, and better prioritized, with more industry benchmarking and less extraneous material; and information overload continues to be a problem. As one Roundtable participant suggested, the board should

[5] See "The Crisis: Mobilizing Boards for Change," *McKinsey Quarterly*, February 2009.

Management's skills

How confident are you that management has the appropriate skills to manage the business through the economic crisis?[6]

35%
Very confident

41%
Confident

20%
Somewhat confident

4%
Not confident

Board effectiveness

Generally, in what areas are today's boards "falling short"? (Select two)

8%
Leadership

16%
Commitment/engagement of individual directors

27%
Ability/willingness to challenge management

19%
Board composition and skill sets

26%
Willingness to address board performance

4%
None/other

[6] Survey results reflect responses from approximately 1,300 directors and senior management attending Audit Committee Roundtable sessions in 29 cities during May/June 2009.

Information quality

How concerned are you that your board's ability to provide effective oversight is hampered by the quality, timeliness, and credibility of the information it receives?

9%
Very concerned

24%
Concerned

42%
Somewhat concerned

25%
Not concerned

KPIs

How satisfied are you that, given the current economic environment, your company has identified the appropriate metrics (KPIs) to track and assess the performance of the business?

15%
Very satisfied

40%
Satisfied

35%
Somewhat satisfied

10%
Not satisfied

periodically "put a fresh set of eyes on the pre-meeting materials."

To improve information quality, leading boards and audit committees are…

- Determining, with management, the critical information the board requires, including the company's key performance indicators (KPIs) and risk information.
- Providing management with a "template" for the types of KPIs and other information—on internal controls, risks, compliance, tax, litigation, environmental, etc.—the board requires. *"Focus on the five or six critical judgments and estimates that are most important to the audit committee."*
- Requesting information in a format that is clear and meaningful—e.g., graphs, heat maps, or other visualizations that show how different assumptions affect forecasts (what-if scenarios), concentrations of high/low performance, and industry/competitor comparisons.[7] *"A third of the charts were a mystery, another third I think I understood, and another third were pretty clear. What the board needed was more narrative behind the charts."*
- More rigorously questioning, testing, and challenging management about the implications of the information for the company's strategy, risks, operations, financials, and performance. *"As directors, we need to apply professional skepticism—that's the job."*
- Obtaining information from third parties, e.g., auditors, outside counsel, consultants. *"But be careful not to overdo it; information overload is the other side of this coin."*

Linking Change and Risk, Monitoring Critical Alignments

Change poses risk. During times of dramatic change, there's a higher risk of *misalignment*—of the company's strategy/goals, risk, controls, compliance, incentives, and people.

Maintaining critical alignments in a dynamic environment requires understanding the changes—both planned and unplanned—taking place in the business, and the array of risks these changes can pose. Boards are recognizing the importance of having a formal process to link significant changes with the company's risk management efforts. The audit committee, given its focus on financial reporting risk and compliance, often has a unique line of sight on these issues.

To help maintain critical alignments, boards and audit committees are…

- Assessing the company's critical alignments frequently, given the speed of change and the velocity of risk. *"This should be an ongoing consideration. Annually, or even semiannually, may not be adequate."*
- Considering the adequacy of the company's process for identifying significant change and linking those changes to its risk management efforts, internal control processes, and compliance program. *"Be aware of the cumulative effect of incremental change… it can have a major impact."*
- Looking to the internal audit function to help "connect the dots" and communicate key areas of concern about these linkages. *"Internal audit needs to be in a leadership position… if not, the role is probably not effective."*
- Considering the alignment of roles and responsibilities for risk management—with a particular focus on the duties and reporting relationships of the chief risk officer (CRO) and internal audit function. *"Our CRO owns the risk process and is more forward-looking, while internal audit tends to focus on compliance and testing of what's occurred."*
- Recognizing that the alignment of the company's incentive structure with strategy and risk may warrant close collaboration between the audit and compensation committees. *"The audit committee can help ensure that management is being rewarded based on the right metrics, and the same metrics that are being communicated and disclosed to the public."*

Governance Reform Proposals Put Board Effectiveness Front-and-Center

Directors need to be particularly sensitive to the changing regulatory and governance landscape, and to the demands of investors, regulators, and legislators for governance reform.

[7] See "How Boards Can Be Better – A Manifesto," Robert Thomas, Michael Schrage, Joshua Bellin, George Marcotte, *MIT Sloan Management Review*, Winter 2009.

Challenging management

To what extent does the culture of your organization encourage directors to question, challenge, and test management?

57%

To a great extent

37%

To a limited extent

6%

Not at all

Linking change and risk

Does management have a discrete, formal process that identifies the key changes affecting the business, and links that information to its risk management efforts?

41%

Yes

59%

No

Compensation risks

In what areas is your audit committee involved in helping to address the risks associated with the company's compensation plans? (Select all that apply)

28%

Reviewing compensation disclosures, including CD&A

17%

Defining appropriate and accurate metrics to measure performance

23%

Determining quality of data used to assess actual performance

16%

Ensuring compensation arrangement does not encourage "excessive" risk

16%

All of the above

A number of legislative and regulatory reform proposals—from shareholder/proxy access and majority voting, to "say-on-pay," separation of CEO and chairman roles, and mandated risk committees—suggest at least some significant governance changes lie ahead.

In light of the fluid legislative and regulatory environment…

- Some boards are identifying opportunities to strengthen their oversight, such as those outlined in the National Association of Corporate Directors' *Key Agreed Principles to Strengthen Corporate Governance*, which lays out 10 principles for assessing board practices and priorities (www.nacdonline.org).
- Directors are increasingly focused on their continuing education, as well as ensuring that the board comprises individuals with the right skills, experience, and leadership qualities.
- Audit committees, in particular, may need to consider the impact that additional regulatory/compliance requirements may have on their workload, and ways the committee can use its time more wisely to gain efficiencies while maintaining its effectiveness.

About the Audit Committee Roundtable Series

Launched in 1999, the Audit Committee Roundtable Series is hosted by KPMG's Audit Committee Institute (ACI) in approximately 30 cities every spring (May/June) and fall (November/December). Highly interactive and panel-driven, the roundtable sessions bring together audit committee members, directors, senior executives, and luminaries in corporate governance to discuss challenges, emerging trends, and leading practices affecting the oversight of financial reporting and related risks. For more information about the Roundtable Series and other information and events offered by ACI, visit www.auditcommitteeinstitute.com or contact ACI at 1-877-KPMG-ACI.