

Audit Committee Roundup

Maintaining Critical Alignments During Turmoil and Change

By Mary Pat McCarthy and Michael J. Nolan

Even in good times, maintaining critical alignments—of strategy, goals, risks, incentives, performance metrics, and internal controls—throughout the organization is a major undertaking, and poses even greater risk. Much can go wrong between strategy formulation and the ultimate execution of that strategy. Even small deviations can build up over time, and the risk of incremental misalignment cannot be ignored.

While it is the responsibility of management to maintain these alignments, audit committees—particularly given their role in the oversight of financial reporting, internal controls, and compliance—are in a unique position to oversee management's efforts. The audit committee has a good line of sight over many of these critical activities that must be aligned.

The fundamental challenge for audit committees is to help ensure that management has in place the necessary processes for proper linkage between the array of activities that must be aligned (and realigned) as significant changes occur and risks develop. That challenge can be made more difficult by the scope and magnitude of the changes impacting the business, as well as the risks these changes pose. To address this challenge, we suggest four questions for audit committees to consider.

■ **Does management have a formal process to identify the significant changes—planned and unplanned—taking place in the business, and the important risks these changes pose?** Change—whether a change in people, business processes, technology, products, or business models—creates risk. And an important part of any discussion about change

and risk is “complexity:” the greater the complexity, the greater the risk. While a robust change management process to identify and track macro- and micro-level changes impacting the business may be ideal, every company should, at a minimum, consider the need for a formal process to identify the significant changes—planned and unplanned—taking place in the business and the risks these changes pose.

■ **Is there a formal process to link these changes and risks to the company's risk management efforts, its internal control processes, and its compliance program?** All changes pose risk. For example, outsourcing changes pose an array of data security and privacy risks; changes in business processes and practices pose various internal control issues; and changes in the company's footprint may pose a host of Foreign Corrupt Practices Act and other compliance risks. Whatever the change, it is essential that the change—and the associated risks—be communicated so that appropriate risk mitigation activities, internal controls, and compliance initiatives can be implemented. A formal process to ensure that this communication takes place—and that proper linkages are established—is key.

■ **Does internal audit “connect the dots,” and communicate key areas of concern about these linkages?** As the role of internal audit evolves, more organizations look to the internal audit function to observe where change and risk are first seeded in the organization, and to view how these changes and risks are managed across the organization. This requires that

internal audit has a “seat at the table,” is capable of anticipating emerging risks, and that it takes the initiative to adjust audit plans and activities as changes in the business, the control environment, and the economic environment occur.

■ **Given the speed of change—and the velocity of risk—does management assess the company's critical alignments on a regular and frequent basis?** The economic crisis demonstrates clearly that changes are often fast and dramatic, and that there is a real need for management and directors to understand the velocity of risk—the speed at which an emerging risk can be manifested and have a catastrophic impact on the business. In this environment, management should assess the company's critical alignments on a regular, frequent basis; annual or semi-annual assessments may not be adequate.

Of course, the absolutely essential component of alignment is management. And here the audit committee and the full board play a key role in helping to ensure that—from top to bottom—management's goals, objectives, and incentives are properly aligned, that performance is rigorously monitored and assessed, and that the culture throughout the organization is “right.”

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