

Few Directors Expect a Return to “Business as Usual;” Audit Committees, Boards Reassessing Risk Oversight Processes, Roles

With perhaps the worst of the economic storm receding—and a tenuous recovery ahead—companies and their boards are surveying a changed landscape. Cost-cutting has transformed business models and created new risks. Expectations for effective risk management have many boards (and audit committees) rethinking their risk oversight practices. And a raft of public policy and regulatory reform initiatives—from new proxy disclosures to healthcare, energy, environment, and financial services reforms—pose new compliance and governance challenges.

“We’re thinking about the business and the board’s oversight from a clean slate,” notes one director. “Enough has changed—or will change—to warrant taking a hard look at how we do things.”¹

Indeed, more than 50 percent of the 1,200-plus board members and business executives attending KPMG’s Fall 2009 Audit Committee Roundtable Series—*Going Forward: Risk, Reform, and Recovery*—do not expect a return to business as usual in the near-term.

Survey results from the 28-city roundtable series indicate many boards and audit committees are concerned about the impact of cost-reductions on talent and training, internal controls, and fraud risk. Nearly half expressed concern that cost-cuts have not been “properly targeted and strategic.”

As summarized below, the roundtable discussions highlighted five key challenges—and emerging practices—for boards and audit committees to consider

as they refine their oversight and help guide their companies forward.

Boards are taking a hard look at their risk oversight processes.

Risk oversight has become a key area of focus not only for boards, but for investors, lawmakers, regulators, and rating agencies. The SEC’s new proxy disclosure rules on compensation, governance, and risk oversight; the IRS’s focus on risk appetite as a potential indicator of a company’s tax-risk profile; and various governance reform proposals have prompted many boards to reassess their risk oversight processes.

Several leading practices are emerging:

- The full board has primary responsibility for oversight of risk. *“The audit committee’s agenda is full...and risk ultimately has to rest with the full board.” “Be very careful about the use of a risk committee... it could create complacency on the board.”*

¹ All comments in quotations reflect views of Roundtable participants, and are used under the Chatham House Rule, whereby comments are quoted without attribution (to encourage candid discussion).

New business environment

As the economy “recovers,” do you believe that American companies will return to “business as usual,” or will they operate in a new business environment?

9%

Will return to business as usual within two years

25%

Will return to business as usual within three to four years

66%

Will not return to business as usual and will operate in a new business environment for at least the next four years

Survey results reflect responses from approximately 1,200 directors and senior management attending Audit Committee Roundtable sessions in 28 cities in December 2009.

- Each standing committee has oversight responsibility for risks inherent to its area of oversight. *“Board committees need to communicate and coordinate effectively to be sure risks don’t fall through the cracks.”*
- A basic framework for risk oversight should include clarifying the board’s risk oversight objectives, understanding the risk-strategy link, clearly aligning risk oversight responsibilities, and reassessing risk oversight processes periodically. *“The SEC’s proxy disclosure rules will require boards to take a good hard look at how they oversee risk...if there isn’t a clear framework in place, that’s probably job number one.”*
- Leading boards are becoming more engaged in strategy to better understand risk. They are insisting that management provide alternatives and choices regarding the company’s strategy (versus a “review and concur”), and some are helping develop/determine the company’s risk-appetite. *“It takes time, effort, and calories to do this right, but digging into the strategy is the only way to really understand what risks the company should or shouldn’t be taking.” “The CEO should look to the board as an asset in the strategy process.”*

(These practices are discussed in more detail in the National Association of Corporate Director’s recent Blue Ribbon Commission report: *Risk Governance: Balancing Risk and Reward*, available at nacdonline.org.)

The audit committee has a unique role.

The audit committee clearly has primary responsibility for oversight of financial reporting risks, and often other categories of risk, such as legal/regulatory compliance; but it may not have the expertise, time, or resources to deal with broader strategic and operational risks. As they reassess their risk oversight processes generally, leading boards are:

- Rethinking the role of the audit committee, with an eye to narrowing

the scope of its risk oversight responsibilities. *“Audit committees have been on the front lines through the worst of the [economic] crisis... it’s time to step back and take a look at what’s on their plate.”*

- Benefiting from the audit committee’s line-of-sight on risk to more effectively align risk oversight responsibilities among the board and its committees. *“The audit committee is an ideal catalyst for helping the board sort out roles and responsibilities—and for getting a pulse on risk oversight generally.”*

Fully leveraging internal audit.

While internal audit typically is not accountable or responsible for risk management, it can/should provide added assurance regarding the adequacy of the company’s risk management processes. Recognizing the increasingly important role that internal audit can play, audit committees are:

- Asking whether the internal audit plan is risk-based and focuses on the critical risks to the enterprise. *“Internal audit should also be looking at strategic and operational risks—not just controls and compliance.”*
- Maintaining or increasing internal audit’s budget. *“Ask the internal audit head, privately, if the department has the resources necessary to do the job.”*
- Helping to clarify/coordinate the roles of internal audit and the chief risk officer (CRO).

Cost-cutting has likely changed the company’s business model and triggered new risks.

Impacting everything from IT and marketing to sales force and meeting/travel budgets, cost reductions made in response to the economic crisis have been deep and wide—and not necessarily strategic. Unlike previous recessions, characterized by short-term belt-tightening and a quick return to normal, current cost reductions may be much longer-term (or permanent).

Cost-cutting

How concerned are you that the cost reductions undertaken by your company in response to the economic crisis have not been properly targeted and strategic?

6%

Very concerned

39%

Concerned

48%

Not concerned

3%

Not sure

4%

Company has not implemented cost reductions

Risk appetite

What role does your board/audit committee play in the development of the company’s risk appetite?

6%

Approves a formal, written statement of the company’s risk appetite

35%

Approves the company’s risk appetite generally, but not a formal statement

37%

Discusses company’s risk appetite at least annually

22%

Does not discuss the company’s risk appetite

Impact of cost reductions

In what areas are you most concerned about the impact of recent cost reductions undertaken by your company?
(Select three)

67%

Employee talent and training

36%

Internal controls

25%

Fraud risk

24%

Management of outsourcing/
extended supply chain

22%

Financial reporting integrity

13%

Company has not implemented
significant cost reductions

9%

Foreign Corrupt Practices Act and
legal/regulatory compliance

Risk oversight

In addition to financial reporting risks, for what categories of risk does your audit committee have primary oversight responsibility?
(Select all that apply)

70%

Financial risks (e.g., access to capital, cash flow, debt covenants)

63%

Legal/regulatory compliance risk

58%

IT security and privacy risks

27%

Operational risks

18%

Strategic risks

12%

HR/labor risks

6%

Not clear

Boards and audit committees will need to consider whether these cost reductions—often combined with reorganizations and restructurings—can be sustained:

- Have we cut too much? Have parts of the infrastructure been affected too severely? *“Eventually, you have to grow the top line. How long can cost cuts and increased productivity sustain the company?”*
- Do we have the flexibility to respond to changing customer and market demands? How quickly can we ramp-up and restore critical infrastructure and staffing? *“Frankly, we may have cut too much muscle and bone. When orders increased, we weren’t able to respond fast enough.”*
- Have internal controls or financial reporting been affected? *“More than likely, headcount reductions will impact internal controls. Gaps will occur.”* *“Be sensitive to the adequacy of the financial team’s resources.”*
- How far have we extended the organization (through outsourcing, off-shoring, vendors, etc.) and what are the risks? *“You might save by outsourcing, but you lose some control—and you take on new risks.”* *“FCPA is my top international worry.”*
- Do we have the right leaders to move the business forward? How have we treated our people, and how do they think we’ve treated them? *“The only thing as important as your liquidity is your people. Loyalty and commitment can suffer in times like these.”*

Roundtable participants emphasized the importance of getting quality information and having frank discussions about the state of the business, including the company’s risk management processes. *“Internal transparency—information flow, communication, clarity—is critical to understanding the company’s risks and whether risk management and risk oversight processes need to be adjusted.”*

Preparing for the impact of public policy changes.

Major public policy initiatives—on healthcare, the environment, energy, and financial services regulation—will

Internal audit plan

How satisfied are you that your company's internal audit plan is risk-based and focuses on the critical risks to the enterprise—strategic and operational risks, as well as financial reporting and compliance risks?

24%

Very satisfied

34%

Satisfied

29%

Somewhat satisfied

13%

Not satisfied

New SEC proxy disclosures

In the event of SEC-mandated risk disclosures for the 2010 proxy season, how confident are you that your board is prepared to disclose how it oversees risk?²

19%

Very confident

35%

Confident

34%

Somewhat confident

12%

Not confident

Returning to pre-crisis growth

In your opinion, when will the U.S. economy return to pre-crisis growth in terms of investment, employment, and productivity?

1%

Within one year

15%

Within two years

45%

Within three to four years

22%

Within five to six years

17%

Will not return to pre-crisis growth for foreseeable future

Positioned for recovery?

How confident are you that your company is well-positioned to take advantage of an economic recovery?

27%

Very confident

41%

Confident

27%

Somewhat confident

5%

Not confident

likely impose additional reporting, transparency, and compliance obligations on a broad cross-section of companies and industries.

These, in turn, may require new or modified compliance, risk, and governance oversight processes. Already, the adoption of the American Recovery and Reinvestment Act of 2009, new federal programs, and the availability of stimulus funds have created complex mandates to which companies are adjusting their compliance programs.

To help ensure management is prepared for the impact of new initiatives and requirements, boards are:

- Staying apprised of developments through regular discussions with general counsel, auditors, and others—with a focus on new reporting, transparency, and compliance obligations. *"Companies should be adjusting their strategies and risk management processes to factor-in these public policy changes."*
- Helping to ensure that management has updated the company's compliance, risk, and governance/oversight processes to meet these new obligations. *"Additional reporting and compliance means additional time and effort—make sure you have the resources you need."*

² On December 16, 2009, the SEC approved [rules to enhance proxy disclosures](#).

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 leaders in 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 resources and events offered by ACI, visit auditcommittee@kpmg.com, or call 1-877-KPMG-ACI.

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