

Conference Report

4th Annual Audit Committee Issues Conference

KPMG LLP (U.S.)

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"Recession-related Risks" a Top Concern for Audit Committees in 2008

Risk Intelligence, Culture of the Organization, Incentives Also Concerns

While audit committees will continue to focus on refining their oversight of financial reporting, internal controls, and risk management in 2008, they also will be paying close attention to "recession-related risks"—and there may be many.

Recession-related risks—including liquidity, access to capital, and the increased risk of earnings management during an economic down-turn—as well as the quality of the company's risk intelligence and the culture of the organization were cited as top oversight concerns by audit committee members attending the 4th Annual Audit Committee Issues Conference.

With a slowing economy and the ongoing "credit crunch" as a backdrop, the 140 audit committee members attending the conference discussed a range of issues affecting their 2008 agendas, including credit crunch-related financial reporting issues, developments in risk management, and the challenges faced by CFOs and internal auditors.

The conference dialogue and survey findings (summarized below) shed important light on some of the top oversight concerns for audit committees in 2008.

1. "Recession-related risks" will require increased attention by audit committees and boards in the months ahead.

- While opinions may vary about the magnitude or length of the economic downturn, audit committee members agree that recession-related risks are a top agenda item for boards and audit committees. From financial risks—such as liquidity, access to capital, aging

receivables, and cash management—to strategic, operational, and third-party risks such as reliance on suppliers and other business partners, boards and audit committees are focusing on management's plans to manage these risks. These risks may be exacerbated by volatility—of markets, earnings, commodity prices, and supply and demand—as well as political uncertainty.

- The responsibility for oversight of critical recession-related risks varies from company to company, and may involve the full board, the audit committee, and the finance or risk committees. However these oversight responsibilities are aligned, it is essential that there is a clear delineation and alignment of responsibilities—and to this end the audit committee can serve as a catalyst.
- **Survey findings:** Conference attendees overwhelmingly identified recession-related risks as their top oversight concern for 2008. And nearly one-third of attendees are very concerned that their board has not clearly delineated the risk oversight responsibilities of the full board and its standing committees.

2. Risk management and the quality of the company's risk intelligence continue to be top concerns for audit committees.

- Audit committees have a number of concerns about risk management—including the quality of risk inventories and assessments, as well as the adequacy of the company's risk monitoring and reporting systems. They're asking: *How good is our risk management program? Can we identify early-on the risks that may pose the next crisis for the company?*
- Many audit committees and boards are encouraging management to assess the effectiveness of risk management processes; they want a better understanding of management's processes to inventory and assess significant strategic, financial, and operating risks. At the same time, they are sensitive to the risk of missing the "big picture"—i.e., understanding the key risks facing the business—even with a robust risk management process.
- **Survey findings:** 44% of attendees said the company's processes to identify significant financial and non-financial risks need improvement; and 18% said the risk reports that management provides to the audit committee are not meaningful/useful.

3. With the "one-two punch" of the subprime lending crisis and the economic downturn putting tremendous pressures on many companies, audit committees are paying close attention to tone at the top, culture, and incentives.

- For most companies, the current business environment poses a major challenge for management—and the pressures to meet expectations will likely



increase. With these increased pressures come increased risks—such as the increased risk of earnings management, as well as the risk that budget-cutting may be “excessive” and adversely affect the long term performance of the business and the quality of the finance organization. Many audit committees are addressing these issues now with the CFO, and their expectation is that the CFO and the senior finance team will clearly communicate the company’s commitment to financial reporting integrity in this difficult business environment.

- While oversight of compensation plans may generally fall within the responsibility of the compensation committee, audit committees are also focusing on the risks associated with the company’s incentive compensation structure. In addition to risks associated with an emphasis on short-term earnings, audit committees want to better understand the behavior and risks that the company’s incentive plans encourage and whether such risks are appropriate.
- Leading audit committees recognize that the company’s tone at the top, culture, and incentive plans may pose critical risks to the business—particularly if incentives and business strategy are not properly aligned—and these risks should be managed and overseen accordingly.
- **Survey findings:** While more than 90% of conference attendees said their audit committee is very effective or somewhat effective in reinforcing an appropriate tone at the top, 44% are not satisfied that their audit committee/board helps address the risks associated with incentive compensation plans.

4. Increased complexity and pressures on companies—financial, regulatory, and strategic—make it imperative that the CFO, internal audit, and financial management team have what they need to succeed.

- The demands on the CFO—and the scope and complexity of the job—have increased markedly in recent years, with many CFOs playing a leadership role in strategy, risk, IT, M&A, and compliance. As a result, audit committees are probing into the adequacy of the CFO’s resources—including budget and finance staff with the necessary skills—and they are placing more emphasis on evaluations and succession plans for senior finance staff.
- Audit committees are also taking a harder look at the role and function of internal audit, and many are asking how involved internal audit can or should be in risk management and operational audits while maintaining the requisite focus on financial audits and internal controls. While approaches will vary, audit committees want to ensure that internal audit has the resources and skill sets for the job, particularly given today’s tight talent pool.
- **Survey findings:** Only 12% of attendees said they are very satisfied with their company’s succession plans for key members of the finance team, and 26% said they are not satisfied that there is a shared vision for the role of internal audit in their company.

5. Increased stakeholder demands for governance have important implications for board and committee oversight.

- According to attorneys participating in the conference, recent Delaware and federal court decisions highlight the importance of director “independence” and oversight “processes,” and point to the increased scrutiny that courts will likely give

related-party transactions. The attorneys emphasized that boards and committees should pay particular attention to meeting minutes, which may someday be used as evidence of the adequacy of oversight activities.

- Institutional investors, proxy advisors, and rating agencies continue their efforts to influence corporate governance, with an array of governance reform proposals, including pay for performance, majority voting, proxy access, and “say on pay.”
- **Survey findings:** While only 5% of attendees said the policy positions of proxy advisors and rating agencies are extremely important to their board’s decision to implement governance changes, 55% said these policy positions are important but not determinative.

About the Conference

The Annual Audit Committee Issues Conference is sponsored by KPMG’s Audit Committee Institute, the National Association of Corporate Directors, and Weil, Gotshal & Manges LLP. Now in its fourth year, the conference brings together audit committee members from around the country to discuss the challenges, practices, and priorities shaping audit committee agendas. For more information about the conference and other events and resources offered by the Audit Committee Institute, visit www.auditcommitteeinstitute.com or contact ACI at 1-877-KPMG-ACI.

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