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Roundtable

Audit Committee and Risk Management

What the Credit Crisis Has Wrought

Who's Who

Ashley R. Altschuler
Partner
Weil, Gotshal & Manges

Dennis R. Beresford
Professor
University of Georgia's Terry College of Business
Director
Fannie Mae, Kimberly-Clark, Legg Mason

Deborah A. Coleman
General Partner
Smart Forest Ventures
Director
Applied Materials, Synopsys

J. Michael Cook
Former Chairman and CEO
Deloitte & Touche
Director
Burt's Bees, Comcast, Eli Lilly

Kenneth Daly
President and CEO
NACD

Charles M. Elson
Professor and Director
University of Delaware's Weinberg Center for Corporate Governance
Director
AutoZone, HealthSouth

Holly J. Gregory
Partner
Weil, Gotshal & Manges

Laurence Hazell
Director of Governance Services
Standard & Poor's

Henry R. Keizer (left) and Charles M. Elson

Recent risk debacles bring some hard truths and the need for new thinking to boards and audit committees. While most Wall Street firms were caught off-guard by the credit crisis, the related fallout from the subprime meltdown has been a loud wake-up call for board members across the spectrum.

Directors are now coming to grips with a hard-learned lesson: despite a long list of reasons why the board may not bear responsibility, these days in the court of public opinion the boardroom is where the buck stops. Although even the savviest business executives, credit-rating agencies, regulators, and politicians did not see this coming, directors know that now when the next storm hits, no matter the market segment, boards are going to be held to a higher standard than ever before. After all, when the storm washes out the CEO, the board becomes, in effect, the last man standing, and most certainly will be called upon to justify issues of pay, succession, and risk-management processes.

Topmost on this list of priorities that boards and especially audit committees need to get settled is their oversight of risk management, and to answer the age-old questions of who, what, and how. Boards must make a global reassessment of whether management has the right controls and processes in place, whether the company operates a world-class risk-intelligence system, and whether the corporate leadership has set the right tone at the top.

To aid directors in coming to grips with this significant challenge, KPMG's Audit Committee Institute assembled a series of Roundtables earlier this year, as a

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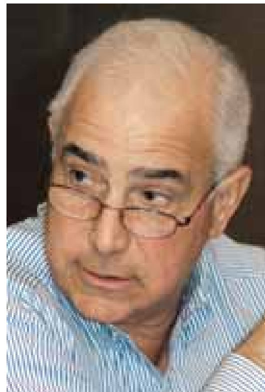
prelude to its 4th Annual Audit Committee Issues Conferences, co-hosted by the National Association of Corporate Directors and law firm Weil, Gotshal & Manges. The panels of experts, which included corporate governance influentials and a cadre of top-notch audit-committee members, explored the implications of the credit crisis for future board and management risk practices, as well as issues concerning audit committees generally. The conclusion of these participants is that risk management and the audit function are not in need of another stint in rehab, but the hangover effect will be painful and long lasting. There are some remedies that need to be implemented which are likely to be neither easy nor simple, but there are other elixirs being bandied about, particularly by regulators, which may do more harm than good.

Edward F. Smith


Joseph Mauriello

Don't Sweat the Small Stuff

You don't need to be a director of a financial-services institution to know that much of the press coverage has centered on who is to blame. But that approach yields very little for boards and management who need to move forward and plan for the next cycle. Henry R. Keizer, global head of audit at KPMG International and U.S. vice-chair of audit at KPMG LLP, points out that while a post-mortem is necessary to figure out what went wrong, boards and audit committees also need to take a more forward-looking approach. "Given the magnitude of the issues we're seeing and their ripple effects, there will be a lot of individuals who want to do a full debrief," said Keizer. "It is natural to ask: 'What went wrong, who should have done what, and what information should we have had?' And while it is always helpful to look back and learn from it, I think the balance of the focus should be prospective. What should be done differently? What are the responsibilities, information, and controls that we need going forward?"

J. Michael Cook, who chairs the audit committees at Comcast and Eli Lilly and is former CEO of Deloitte & Touche, agrees that spending too much time looking through the rubble for answers can be counterproductive. "To the extent that we spend half of this coming year or two-thirds of it trying to figure out why we didn't foresee the last problem, we will just be distracting ourselves from the ones that lie ahead." He argued that it is too easy to get bogged down in what went wrong with the processes. "If we do that, we will miss this issue entirely."

Cook believes much of the focus will be trained on the traditional areas of risk management, such as systems, controls, processes, and oversight, or on risk-management issues specific to financial instruments, insurance, and taxation, and not on where the real problems lie. "These have been on our plate for a long time and I think that risk management in these areas works reasonably well." Instead, Cook thinks the focus needs to be on "Risk with a capital 'R'," he said. "If you ask me, as audit committee chairman, what I am going to be paying attention to for the next 6 to 12 months, it is not the system and checks and balances and all of that; I am going to pay a lot of attention to the tone at the top, culture, and incentive compensation," he said.

"I could not agree more that the tone at the top and the integrity of the individuals that are actually setting the policies and procedures is the key here," said Paul Robinson, general counsel and corporate secretary for Seacor Holdings, and former COO, general counsel, and corporate secretary at Comverse Technology. "The role of the board and audit committee in tempering management's enthusiasm for increased margins and profitability associated with what may be imprudent risk is not something you can legislate. It requires reliance on interpersonal skills and judgments about the incentive environment and the culture in which management

Who's Who

Michele Hooper
Managing Partner
The Directors' Council
Director
PPG Industries, Warner Music Group, UnitedHealth, AstraZeneca

Cynthia Jamison
Partner
Tatum LLC
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Reference Desk

A Work in Progress

Survey respondents say risk management is better today than in the past, but some areas still need improvement.

How do you rate the overall effectiveness of your company's risk-management processes today as compared to three to five years ago?

31%
Much more effective today

51%
Somewhat more effective

18%
About the same

0%
Less effective

Source: KPMG Audit Committee Institute's 4th Annual Audit Committee Issues Conference

decisions are being made and also about management's integrity and values."

Risk Appetite

Some panelists agreed that there might be a disconnect between the board's and management's understanding of appropriate risk appetite. One way to get at it, suggests Cynthia Jamison, a partner with executive services firm Tatum LLC and a director at Tractor Supply Co. and B&G Foods where she chairs the audit committees, is to have open and detailed discussions with management on the real risks posed by the market, competitors, and natural disasters. "Listening to the discussion around the table, you can learn an awful lot about the tone at the top and who has a higher tolerance for risk and who has a lower tolerance. And they can be incredibly insightful meetings," she said.

Holly Gregory, a partner in the Corporate Governance Group of law firm Weil, Gotshal & Manges, concurs that boards need to focus more on risk appetite as it relates to strategy. "I'm hoping that in the next year or so, boards become more focused on understanding risk in the context of strategy. Boards should spend real time discussing issues like: 'What is our strategy and what are the inherent risks, and what is our risk appetite?' Boards should challenge management to assess the risks that could affect the company's strategy. The board should ask management to detail the assumptions that the strategic plan rests on, and what the likely outcomes are if those assumptions prove wrong. Without engaging in a hearty discussion of risk as a component of strategy, the board may miss the opportunity to fully understand both the company's strategy and its risk profile."

Indeed, Charles Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware and a board member at AutoZone and HealthSouth, warns that the typical reaction will be to put more systems in place. "This is going to create huge additional layers of bureaucracy around risk managers, which is not going to do any good," he said.

Elson thinks audit committees would do better to look for signs that something doesn't add up. One of those leading indicators that something is amiss and needs more risk management and attention from the audit committee, he said, is exorbitant compensation: "Over various financial debacles I have seen, it all comes down to a common denominator: When you begin to see too much money being made in odd ways, it is an indication that something is off."

Elson broadens that idea to include those instances when divisions or whole companies are doing suspiciously well. When something just looks too good to be true, it just might not be true. In other words, outsized returns, by definition, come with outsized risks that need to be investigated. While that may seem like a no-brainer on the face of it, there are certain realities that make it harder to comply with such advice, particularly when a company is forced to measure up to competition whose risk irrationality may not be apparent at the time. "If you were a director of a bank and every other bank is out there making X percent of their income on fees for originating a certain kind of mortgage and then securitizing it, and you are sitting there making half that level without that mortgage business, it is nice to be able to say, in hindsight, 'Gee aren't we smart. Look how careful we were about risk management,' but I have to tell you, I'm willing to bet that there would have been a serious discussion at the time, and appropriately so, about 'What are we doing? Why are we 50 percent behind?' " said Irwin Warren, co-head of the Securities/Corporate Governance Litigation practice at Weil, Gotshal & Manges. "I think the point is that as a director, you have to know your company and your business, and you have to ask questions. Can you look back and see a pattern or a change or even a break in your historic pattern? If you are a lender, are you suddenly changing your income, or its source or

"This is going to create huge additional layers of bureaucracy around risk managers, which is not going to do any good." —*Charles Elson*

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mix? But I think there is a danger to always searching for a common thread to explain things, because you might find a common thread that is not there," he said.

Others say that boards at least need to be asking the question. "The thinking is: 'We're making returns in the high teens, so why pull back?' But it would have been great if someone asked just one more question: 'We're making returns in the high teens, why?'" noted Kenneth Daly, president and CEO of the National Association of Corporate Directors (NACD).

Holly J. Gregory

Deborah Coleman

Unknown Unknowns

Part of the problem is that recent trouble spots, like options backdating and the subprime lending crisis came out of the blue, or in Rumsfeldian terms, are the unknown unknowns. In some ways they are one-offs that are unlikely to happen anytime soon. That's because they don't fit the mold of traditional risks that risk-management processes guard against—things like accounting games, outright fraud, or rogue trading. Predicting these non-traditional risks can be nearly impossible. "How can you manage what you don't know about? What process can you put in place to stop a risk that you can't perceive?" asked Dennis Beresford, an accounting professor at the University of Georgia's Terry College of Business and chairman of the audit committees at Fannie Mae, Kimberly-Clark, and Legg Mason. Beresford, who is also the former head of the Financial Accounting Standards Board, said some boards and risk managers try to brainstorm or scenario plan to think about what could go wrong and think about how to prepare for it. "It's easy to say, but very hard to do," warned Beresford. Some risk managers refer to these outliers as "fat tails," because on the bell-curve they are out at the extremes and have little chance of occurring, but when they do, they can have a massive impact on the organization.

"You never know what you don't know. That's what worries me the most," says Richard Lochridge, founder of Lochridge & Co., a management consulting firm based in Boston. "So there are going to be errors. I think that you can't do much about that, so you have to be adaptive and clever," he said.

J. Michael Cook

Irwin H. Warren

Michele Hooper, co-founder and managing director of The Director's Council and a board member at PPG Industries, Warner Music Group, UnitedHealth, and AstraZeneca, said that one of the things boards can do is to try to devote time to specific areas that could be problematic. "We take a subject that we think could contain hidden risks and we do a deep dive to try to fetter out those risks." She said the board and management will spend a whole session on this kind of scenario, even bringing in outside experts.

The fact that risks are unlikely to occur probably won't stop regulators from putting rules in place to guard against them. In some ways, the reactions of financial regulators are like those of airport security officials reacting to isolated terror threats. Shoe bomber? Everyone takes their shoes off through security. Possible liquid bomb? No more shampoo allowed. These are not holistic solutions to the problem, explained Beresford. "By the time the regulators issue specific rules, the crisis is over and now everyone is stuck with these new rules that just add to

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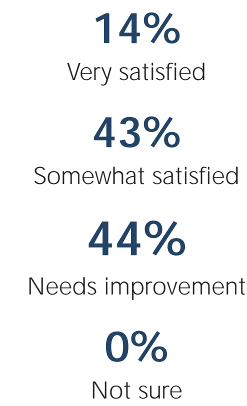
How satisfied are you that your company has an effective process to identify significant business risks facing the company?*



* responses may not add to 100 due to rounding

Source: KPMG Audit Committee Institute's 4th Annual Audit Committee Issues Conference

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the cost and complexity of accounting, but don't necessarily guard against the next problem."

That said, some new rules or at least new thinking will be needed to guard against specific abuses in the credit system. "There was a fundamental change in the way we use credit. We went from being balance-sheet lenders to securitizing this credit and selling it as structured debt obligations. As a result, the person who originated it no longer worries about it," Edward Smith, executive director of KPMG's Audit Committee Institute pointed out.

audit committee, is to question the assumptions that go into the models."

The complexity of the financial instruments is also an issue that will rightly get close scrutiny over the coming months. "The question should be, 'Can anyone in the organization tell me how this stuff works?' The reality is that sometimes they couldn't find someone to come to the table and explain it," said Daly.

"When I look at the risk management around subprime and the broader securitization of these products, I will say the seller as well as the buyer didn't

Laurence P. Hazell

Kenneth Daly

Cynthia Jamison

Richard K. Lochridge

Models that are used to predict risk are one target for reform efforts, as is a better understanding of complex financial instruments. "When the situation was benign, everything was wonderful, but once sentiment changed, the ensuing market disruption showed how these kinds of securitization had made the market much more interconnected and how much more difficult any correction would likely be. That interconnectedness is, I think, the most profound thing we are learning about in this particular cycle," said Laurence Hazell, director of governance services at Standard and Poor's in New York, who emphasized that his role at the firm means he is not a credit market expert. Nevertheless, he does think financial-services firms and others will need to rethink how they rely on modeling. "I believe that one of the problems is that market participants relied on models in a way that made them forget that models are an aid to understanding, not a substitute for it. I believe a critical role that board of directors have, particularly on the

understand the product," contended Joseph Mauriello, audit committee member of XL Capital, a member of the board of trustees of Fidelity Funds, and former deputy chairman and COO of KPMG. "They generally knew what it was. They had the models that showed what it should do, but now that it blew up—and I've looked at a few—when you peel that onion, you can't easily understand these instruments and so you can't explain them. These are very complex and I don't know how you manage it when it is so complex, other than to stay away or limit your exposure," he said.

Another problem with reliance on complex instruments designed to disperse risk, noted Gregory, is that it may provide false comfort. "It is tempting to assume that the complex and mysterious models used to hedge against risks account for all potential risk scenarios. It appears that reliance on complex instruments to manage and offload risk may have led people to assume falsely, 'We don't really need to worry about what happens when interest rates shoot up or when

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the economy goes south or both and mortgage default rates go up; the model will protect us,' " she said.

Where Does It Sit?

In addition to considering how to react to the credit crisis, audit committees and risk managers will need to rethink who owns the responsibility for risk management. For example, do boards need a separate risk committee?

KPMG's Keizer worries about a bandwidth problem. "I think we should all be concerned when very hard-working, well-intentioned people worry that 'Here is yet another item on the audit committee's agenda.' " said Keizer. "It's analogous to what can happen to CFOs: whatever needs a home gets parked at the CFO's doorway. So from my viewpoint, one of the guiding principles absolutely has to be: make sure you have the time, resources, and experience to take on this responsibility. I do worry that that if there is going to be a further extension of the audit committee's responsibility for risk management, you are going to run into a bandwidth problem. That's not to say that it shouldn't be done, but we have to be careful about how we approach it."

> "We take a subject that we think could contain hidden risks and we do a deep dive to try to fetter out those risks." — *Michele Hooper*

Important risks should get the attention of the entire board. "If we have a risk that is pervasive and that is important to the business, the whole board should be focused on it," Cook added. "If I can't tell you as a director, not as an audit committee member, the 5 or so most important risks that this business is facing, then I am not doing my job as a director."

Said Jamison: "I think we have to get much crisper about air time: what goes to the full board and what goes to the audit committee? How much prep time do you give the CFO and other senior executives to prepare for these meetings when they should be focused on the business."

One of the most important concerns for audit committee members and directors is protecting themselves from the liability that, with 20-20 hindsight, could result from risk management-related disasters. "In my experience, the Feds and shareholders don't ask, 'How are you going to manage risk?' They are going to ask, 'Why didn't you manage risk?' and in a way, that defines the problem," said Weil Gotshal's Warren.

Elson sees no increased board vulnerability to litigation resulting from the risk-management aspects of this issue, largely because of the adequacy of the systems already in place. "I will bet that few directors are successfully sued on subprime issues alone and I'll tell you why: Following [Sarbanes-Oxley] and the bureaucratization of the audit committee and the bureaucratization of risk management, the record that the audit committee will present will almost be bullet proof," he said.

"Process, process, process," said Ashley R. Altschuler, a partner at law firm Weil, Gotshal & Manges. "Independence is key, but the process by which outside directors exercise their duties also will be essential to a reviewing court asked to second-guess a transaction."

Yet the threat of being sued could be a huge distraction going forward and that has some panelists worried. With the economy heading south and the continued pressure on management to meet expectations, many are concerned about the increased risk of earnings management. "We are going to head into an economy where earnings management and the things that can happen with press releases and the [material] things that don't get said. I'll take tone at the top, culture, and incentive systems and you can have any of the other tools you want. If I can get my part right, I have a 90 percent chance of preventing the problems that are most likely to happen this year, not the ones that happened last year," said Cook.

Warren said it comes down to basic truths: "Directors have to do their best to understand their own businesses, try to determine where the most likely risks lie, and then try to figure them out. Maybe that means that the meetings run long or maybe you have to create a separate committee." Whatever boards decide, they will likely have to take some action on risk management. The stakes are high and the scrutiny is getting more intense. D

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How concerned are you that your board has not clearly delineated the responsibilities of the full board and each committee for the oversight of risk management?

32%
Very concerned

52%
Somewhat concerned

16%
Not concerned

Source: KPMG Audit Committee Institute's 4th Annual Audit Committee Issues Conference

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