

Recession-related risks

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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 organisation are being cited as top oversight concerns by audit committee members.

With a slowing economy and the ongoing ‘credit crunch’ as a backdrop, attendees at Audit Committee Institute events are discussing 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 points summarised below shed important light on some of the top oversight concerns for audit committees in 2008.

‘Recession-related risks’ require increased attention by boards and audit committees 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, ageing 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. Whichever body takes prime responsibility for oversight, 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.
- Attendees at recent ACI events overwhelmingly identify recession-related risks as their top oversight concern for 2008. A number are very concerned that their board has not clearly delineated the risk oversight responsibilities of the full board and its standing committees.

Risk management and the quality of 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 registers and the adequacy of risk monitoring and reporting systems. Audit committee members are asking: *How good are our risk management processes? Can we identify early-on the risks that may pose the next crisis for the company?*
- Many audit committees and boards want a better understanding of the processes used by management to identify 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. Audit committee members are asking: *Did our risk management processes highlight the effects of the credit crunch early enough? How can we make sure the next 'big-picture' risk is identified early enough to take mitigating action?*
- Eleven percent of audit committee members responding to a recent ACI survey believed that the audit committee's understanding of management's processes for identifying and assessing the significant risks facing the company 'needs improvement'. Eighteen percent said the information and reports that management provides to the audit committee regarding the status of its risk management efforts 'needs improvement'

In response to the 'one-two punch' of the sub-prime lending crisis and the economic downturn, many 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 cutbacks may be 'excessive' and adversely affect the long term performance of the business and the quality of the finance function. Many audit committees are discussing 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 remuneration 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 behaviour and risks that the company's incentive plans encourage and whether such risks are appropriate.
- Many audit committees recognise 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.
- While attendees at recent ACI events appear satisfied with the role their audit committee plays in reinforcing an appropriate tone at the top, a significant minority believe their audit committee could do more to address the risks associated with incentive compensation plans.

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 vary in practice, audit committees want to ensure that internal audit has the necessary resources and skill sets, particularly given today's tight talent pool.
- Survey findings: Only twenty percent of audit committee members responding to a recent ACI survey said they are very satisfied with their company's succession plans for the CFO; but sixty three percent were very confident that the CFO had the resources to carry out their responsibilities effectively. Less than half were very satisfied that there is a shared vision for the role of internal audit in their company.



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