

Audit committees consider the expanding risk landscape, the pressures of regulatory reform, and the final push to IFRS

- 58% feel recent risk management investment has had limited payoff in identifying emerging risks
- 69% say the audit committee has already reviewed and approved IFRS accounting policies and elective exemptions

Risk management and ever-evolving board oversight responsibilities continue to pose major challenges for audit committees of Canadian companies. As they attempt to define roles and responsibilities, a slate of critical issues are passed through the filters of operational risk and regulatory reform. Canadian markets continue to recover from recent turbulence while the US continues to struggle with unemployment and financial instability. In Europe, several countries have been exceptionally impacted by the economic downturn, and combined with a rash of man-made and natural disasters—from product recalls and the BP oil catastrophe to the volcano in Iceland and flooding in Australia—markets and consumers have faced a series of economic broadsides.

“Many crises can be predicted, but some simply can’t,” said one of the executives attending the KPMG Audit Committee Roundtable Series. “The main thing is to take a systematic approach, not only to identifying risk when possible but to translating that intelligence into mitigation strategies.”

Attendees were somewhat positive about their current approaches to risk, with 53 percent indicating that recent investment in operational risk management has paid off to a limited extent. But only 20 percent of those cite a “great” investment payoff—and 27 percent indicate that the company makes no significant investment in this area at all. Attendees also expressed doubt about how well committees/boards really understand management’s operational risk control activities, with only half satisfied that adequate understanding exists.

With risk management policies and procedures in flux, regulatory reform increasing, and IFRS measures soon to be more stringently tested, most organizations’ audit committees can clearly benefit from in-depth discussion, new insight, and procedural improvement around risk.

These were the goals of the recent KPMG roundtable series “Risk and Regulatory Reform – Critical Issues for the Audit Committee Year-End Agenda.” Designed to help audit committee members guide the companies they serve through the challenging times ahead, this report recaps key focus areas, discussions, and comments from roundtables across the country.

Risk

In the face of recent business disasters and product recalls, boards face a number of ongoing challenges. The risk of operational failure may have been increased by recent focus on reducing costs and maximizing profits, while low probability/high impact risks may not be getting enough attention.

“Balancing operational and financial risk controls with cost has been a real issue for many boards. They’re near the end of their tether when it comes to the price of change. But monitoring risk is still a priority, and we are seeing yellow and red flags raised in a timely fashion—meaning controls are working.”



In what capacity are you here today?

Audit Committee Chair

51%

Audit Committee Member

26%

Director (not on the Audit Committee)

7%

Management

9%

Other

7%

Is the investment that your company has made in risk management over the past 2 or 3 years “paying off” in terms of improving the company’s ability to identify, assess, and manage the significant operational risks facing the company?

Yes, to a great extent

20%

Yes, to a limited extent

53%

No significant investment

27%

What are your views on forming a separate “risk committee” of the board of directors that focuses on enterprise risks (i.e. operational, market, credit, reputational, regulatory, IT) other than financial reporting?

Agree with the concept

25%

Disagree – Belongs at the audit committee

14%

Disagree – Belongs at the full board level

61%

Are you satisfied that your committee/board understands whether management has implemented effective controls around the company’s significant operational risks?

Yes

50%

No

23%

Not sure

27%

Is the investment that your company has made in risk management over the past 2 or 3 years “paying off” in terms of improving the company’s ability to identify, assess, and manage the significant emerging risks facing the company?

Yes, to a great extent

12%

Yes, to a limited extent

58%

No, investment has not paid off

5%

No investment in risk management

25%

“Boards are taking a more holistic strategic approach, and in today’s broad risk landscape, that’s necessary. Low probability, high-impact risks, for example, have to be dealt with in board strategy sessions, not as a last-minute, audit committee formality.”

“Our organization tends to assess risk in terms of likelihood, but not often magnitude, which is probably something that should change.”

While many boards have made strides in identifying and prioritizing risk, it remains difficult to embed risk management emphasis throughout the company.

“Doing what has to be done is, of course, the most important thing, but for long-term survival, management needs to implement specific risk controls because they’re invested in the process and can justify the costs and because they believe it’s good for the business—not because the board is demanding it or it’s part of a regulatory check list.”

Sixty-one percent of attendees felt that all risk oversight—including enterprise risks outside of financial reporting—should remain at the full board level.

Panellists were not surprised by this vote and in general supported that position. Some supported the possibility of a separate risk committee where industry-related expertise is required—financial services, for example. It would report to the board to provide added opinion and analysis but would not be responsible for full oversight.

The extended organization brings with it a host of risk areas. With global supply chains, customers, and distribution channels now extending across different cultures and legal frameworks, corporations must address an expanded risk framework, including fraud; corruption; inferior product quality; IT risk; and issues of corporate responsibility, such as human rights, fair labour standards, and sustainable environmental practices.

“Most Canadian mining companies are doing business globally, in areas like West Africa and Latin America, where the political, social, ethical, and supply chain risks are very different. Understanding these is a full-time operation for companies in that sector.

Identifying the specific risk profiles for dozens of countries requires a tremendous allocation of resources—and it’s necessary.”

“It’s easier to understand operational risk, but the reputational side is harder to grasp. Suppliers are representing your name, so you need to get comfort around that. It takes years to establish a reputation and—with the social network in play—minutes to destroy it. Companies must be aware of the reputational risks that are out there.”

The risk landscape is so broad. Is it possible to “over-engineer” the management process and reach information overload?

“Not really. In the end it’s still about balancing risk and reward. That process requires complete information, then effective prioritization. We’ve all heard that cities might be under water in 100 years. Do we worry about that now? Probably not. But we do have to worry about blue sky and clean air today. So we take all the environmental information we can get, prioritize it, and act accordingly.”

The questions of board-management interaction and how well-informed the board is about controls implementation were discussed. Many risk management failures arise from board assumption that certain controls are in place when they are not.

“It’s a good idea for the board to ask specifically for this information. It can help management with goal-setting and organization if they’re required to clearly articulate what they’re doing, and it’s a productive way for the board to find out if the work is getting done.”

“A great risk, in and of itself, is that boards, committee members, and senior management simply don’t understand the business as well as they should. Communication is important, but given the complexity of today’s corporate environment, if the specific business knowledge isn’t there, you’re in trouble before you start talking.”

A critical task for boards and audit committees is bringing the appropriate focus to emerging risks. Panellists discussed steps to managing operational and emerging risks, including:

- Understand significant operational risks, including changes in operating and IT environments, and risks posed by the extended organization.
- Ensure that awareness of legal/regulatory risk is embedded in the organization—create a culture of risk awareness.
- Engage in periodic workshops to think the “unthinkable” and identify emerging risks.
- Pay particular attention to low probability, high-impact risks—or tail risks.
- Consider retrospective reviews of how well past risks have been managed.
- Work with management to understand activities and promote communications around risk management and business controls.
- Assess compensation structures as potential contributors to risk.
- Create an “early warning” system and disaster preparedness team.

Regulatory reform

Tax authorities are aggressively looking for additional revenues, forcing audit committees to put increased focus on the tax agenda: tax structure, planning, understanding where the issues are, and risk management. At the same time, securities regulators are also increasing their vigilance.

IFRS and financial reporting have dominated the regulatory scene for a couple of years now, but other regulatory issues continue to be discussed at the boardroom table, such as environmental reporting, going concern disclosure, executive compensation, and the impact of IFRS on other regulatory spheres. For example, under IFRS, companies may be required to accrue more environmental liabilities, at higher amounts, and provide more disclosure regarding these liabilities. Such measures could clearly affect a company’s future financial targets.

“Going concern disclosure is a bit of a sleeper issue for many companies, and there is a range of related questions, particularly for companies with liquidity issues. Audit committees don’t always want to address this matter, but disclosure changes are afoot relating to the quality and level of expected and required going concern disclosures.”

The US *Dodd-Frank Act* is a major regulatory legislation whose impact, according to some analysts, will dwarf that of SOx. Like SOx, it will have global effects on both the financial services industry and corporate accountability in general.

Provisions include:

- Proxy access rule-making authority for the SEC
- New executive compensation disclosures
- Independence of the compensation committee and its advisers
- Disclosure of board leadership structures.

Despite the fact that the act is certain to have specific and direct impact on Canadian companies registered with the SEC, 57 percent of attendees indicated very low awareness of the *Dodd-Frank Act* with respect to the companies they serve.

“One major focus is on shareholder approval of executive compensation. Boards have not handled executive compensation well, so responsibility is being shifted to shareholders. And compensation can be clawed back under certain circumstances. The documentation is vast and pervasive.”

“The effects of the *Dodd-Frank Act* are evolving in Canada, and boards and audit committees need to stay abreast of developments.”

Consider the concept of a bounty paid to whistleblowers that increases with the severity of the issue. What types of issues do such whistleblower provisions pose for audit committees? Panellists and attendees were dubious.

“I think cash payments are an over-reaction to the issue, which is really leadership integrity. The reality is that the corporation itself needs an integrity culture that comes from leadership and is closely monitored by a board of directors.”

Are the reports your board/audit committee receives about the company’s key compliance and safety risks adequate in providing an effective “early warning” system for possible problems?

Yes
47%
No
25%
Not sure
28%

What level of awareness do you have of the *Dodd-Frank Act* with respect to the companies you serve?

Very low
57%
Some awareness but not in relation to Canadian companies
29%
Very aware
10%
Aware but feel it will be a US issue only
4%

Will the companies you serve be utilizing the 30-day extension for filing the first IFRS financial statements?

Yes
25%
No
61%
Undecided
14%

Has the audit committee already reviewed and approved the company’s IFRS accounting policies and IFRS elective exemptions?

Yes
69%
No
29%
Not sure
2%

Has the audit committee already reviewed the company's opening IFRS balance sheet and related reconciliation?

Yes
50%
No
50%

If the company does not currently engage its external auditor to perform a review of quarterly financial statements, are there plans to engage the external auditor to perform a quarterly review of the first interim IFRS financial statement?

Yes
67%
No
21%
Not sure
12%

Has management provided education or information sessions to the rating agencies and the analysts that follow the company?

Yes and completed
25%
Not yet, but planned for February/March 2011
18%
Not yet, but planned for May/June 2011
57%

About the Audit Committee Roundtable Series

Held across the country periodically throughout the year, these interactive and panel-driven roundtable sessions bring together audit committee members and leaders in governance to discuss the challenges, emerging trends, and leading practices affecting the oversight of financial reporting and related risks. The Winter 2011 Audit Committee Roundtable series was held in late January/early February in Toronto, Calgary, and Vancouver.

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"It's another opportunity for us to shake our heads and wonder what they're doing. Bureaucracy is taking over an issue that should be the responsibility of private enterprise. It will change corporate cultures radically, and boards will really have to consider the repercussions."

Audit committees may also want to keep their eyes on the SEC's increased enforcement authority, rules against sharing non-public materials with ratings agencies, and a generally widening sea of expanded disclosure requirements.

The final push to IFRS

Audit committees and boards need to determine the current status of conversion and whether management and auditors concur on the preparation of Q1 2011 financial statements. To further clarify the picture, gauging readiness in relation to peers is important. The 30-day grace period is for Q1 only. Panellists were mixed in their response to the 25 percent of attendees who indicated they would use the extension.

"These deadlines and the related requirements have been known for a long, long time. I'm just surprised that more companies aren't ready."

"I'm not surprised. Mid-sized and small companies lack in-house resources and have to hire from the outside. This process takes tremendous time and money. But do not wait too long. You can have the templates and estimate the impact, but until you actually plug in the numbers, you won't know the results."

The trend seems to be that larger companies don't want to, and generally will not take, the exemption, while mid-to small-sized companies tend to be less prepared. The majority of attendees' companies had completed the review of IFRS policies and elective exemptions while half had reviewed the opening IFRS balance sheet and related reconciliation. It's important that this happen as soon as possible. The initial balance sheet will be very comprehensive and require significant review in advance of reviewing the Q1 financial statements.

If a company engages an auditor to perform a first-time interim review on IFRS interim financial statements, review procedures must first be performed on the underlying 2010 Canadian GAAP interim financial statements (e.g. Q1 2010).

"Engage your auditor sooner rather than later to perform an interim review of the first IFRS interim financial statements, as interim review procedures will add to the time required to meet filing deadlines."

The first interim IFRS report should help stakeholders understand how the transition to IFRS affected previously reported results. In this vein, the OSC has provided suggested note disclosures, including significant policies; a summary of IFRS 1 exemptions and elections; the level of detail in financial statements; explanatory notes; and comparative information. It is also important that companies communicate actively with the investor/analyst community about their IFRS transition as a matter of governance and transparency and to help investors make better decisions.

"We ignore analysts and raters at our peril. You owe it to your organization to share this info. Capital providers need to understand where you're coming from, so there are no surprises. Otherwise, access to liquidity can become problematic."

There are a number of IFRS conversion messages to keep front of mind:

- Quick fixes to meet IFRS deadlines need to be replaced by more thought-out and sustainable long-term plans.
- Monitor and compare with peers/leaders.
- It's critical to prepare a full and meaningful MD&A (management discussion and analysis).
- Continue to provide tailored training to internal and external stakeholders.
- IFRS will continue to change through 2013, so retaining key members of your conversion team and continuing staff education are important.
- Pay attention to the FASB-IASB alignment process.

"The deadlines aren't changing, Canadian GAAP no longer exists, and a false statement will have serious legal repercussions."

For more information about the Audit Committee Institute, please visit www.kpmg.ca/auditcommittee.