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Across the Board August 2016

How is Australia addressing its looming productivity crisis? In this issue we explore the challenges and opportunities ahead.

We also look at how companies and boards can prepare for the new auditor reporting requirements, and bring you the latest from KPMG’s Global Audit Committee Institute survey on building a great board. Plus, we explore corporate debt alternatives beyond traditional avenues and ways in which the board can guide the company through a customer-centric transformation.

If you would like to discuss any articles in more detail, please contact me or your local KPMG partner.

We hope you find this issue of Across the Board interesting and insightful.

Peter Nash
National Chairman
KPMG Australia

For feedback on Across the Board please contact us.
Confronting Australia’s looming productivity crisis

Understanding the challenges and opportunities ahead

It’s time for corporate Australia to understand the challenges and opportunities ahead when it comes to national productivity and make sure they’re prepared to advocate for and embrace change – particularly with regard to innovation and workplace relations.

Here’s a confronting reality. In the world’s advanced countries, productivity growth has slowed to such an extent over the last decade and a half that genuine fears are being held that the developed world has entered an era of long-term economic stagnation.

The ageing of these countries’ populations and the absence of breakthrough innovations of the magnitude experienced since the Industrial Revolution – such as sewerage, railways, highways, airlines and electrification – might be consigning them to slow growth in incomes for the foreseeable future.

Australia may be facing the same economic disease.

The best measure of productivity – multifactor productivity – which reflects the skill and cleverness with which inputs of capital and labour are combined to produce a given amount of output, is lower now than it was more than 15 years ago.

So it’s difficult to escape the conclusion that, as a nation, we are not as clever as we were a decade ago.

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It’s difficult to escape the conclusion that, as a nation, we are not as clever as we were a decade ago.

There are eight key government agenda areas that could help us resolve our looming productivity crisis – and board members need to both buy in and prepare for change.

A clarion call to corporate Australia

For corporate Australia, there are clearly some major challenges and opportunities ahead. Boards need to be aware of how the productivity problems besetting our nation can have major flow-on effects in their own organisations.

In a market-based economy, it is the private sector, particularly that part exposed to global markets, which drives productivity growth because it has a strong incentive – the profit motive – to seek ways of improving productivity.

Capital is now highly mobile, both nationally and internationally, and investors will seek out opportunities that maximise risk-adjusted returns. Skilled workers and entrepreneurs are also becoming increasingly internationally mobile.

Corporates need to be highly attuned to these changing dynamics and how they affect their funding, workforce and future plans. They also need to be aware of how the government’s approach to solving the productivity problem could impact them.

We believe there are eight key government agenda areas that could help us resolve our looming productivity crisis – and that board members need to both buy in and prepare for change. These agenda areas include:

1. exploring innovative ways of encouraging the development of infrastructure policy that facilitates change where needed
2. reducing complexity, duplication and compliance costs to free up resources that can be used for more productive purposes
3. reforming Competition Policy in light of the Harper Review
4. disseminating information on new technologies to businesses and how they could be adopted and applied for the productivity benefit of the economy
5. implementing reforms to insolvent laws to encourage risk-taking without compromising protections
6. allowing individual companies, and even whole industries, to cease operating if they are structurally unprofitable. This implies a more flexible labour force policy that facilitates change where needed
7. supporting higher education outcomes beyond just finding university places
8. ensuring tax policy settings assist rather than hinder innovation

Some of these are an immediate win for corporates – improving infrastructure, removing ‘red tape’ that stifles innovation and a focus on technology are all exciting positives.

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Australia’s well-known problems in cooperation in labour-employer relations is one factor that is most inhibiting our productivity reforms.

In the World Economic Forum’s competitiveness rankings, Australia comes in 109/144 in terms of cooperation levels. Australia should not be left behind in the productivity stakes.

If we really want a nimble economy and the courage to let unproductive industries fail, we must recognise our negative culture around how the loss of employment drives a very reasonable desire to cling to unproductive jobs. Creating an economy-wide safe to fail culture would mean a general acceptance of stints of unemployment as an unremarkable element of a normal working life.

While much of this change would be cultural, a meaningful commitment to the principle would also require investment from government. Unemployment would have to be made less punitive. This would necessitate significant public funding, primarily in resourcing quality education and training opportunities.

Implementing productivity reforms will be challenging but in their absence it’s difficult to see any major new sources of productivity growth on the horizon given our ageing population, and with no new mining boom in prospect. It’s not too late – Australia should not be left behind in the productivity stakes. We have the great ideas, talented people and motivation to surge ahead. But our corporate culture as well as government policy settings may need to shift to help us get there.
Leading the way to a customer-centric future

With new technology, regulatory policies, customer behaviour and globalisation all impacting businesses, boards have an opportunity to guide transformation, ensuring customer value is at the core.

Phil Barfield
Partner,
Transformation Program Management

Customers in Australia and internationally are increasingly expecting businesses to be at the forefront of product and service delivery. Thanks to emerging technologies, disruption and social media, they are aware of the best and want an optimum experience from every organisation they deal with. Customer centricity is a driver in both the private and government sectors. This is triggering a raft of transformation projects which place customer needs and value at the core of strategy and decision making.

Transformation represents a fundamental change in an operating model which could be strategic and long-term, or reactive to unexpected movement in the marketplace. KPMG’s Global Transformation Study 2016 revealed 28 percent of Australian organisations have completed at least one major change project, and 25 percent have started a transformation initiative within the past 2 years.

Boards can help steer a company through a customer-centric transformation, but to do so effectively, they need to ask some pertinent questions of the company’s leadership team.

To begin, boards need to find out if there is sufficient clarity on the objective of the transformation and the business outcomes that it will deliver. It is important to establish common goals across the organisation’s stakeholders.

Boards should also consider if the leadership team has allowed sufficient time to build organisation-wide consensus on the transformation, and to encourage commitment to the process before it begins. A very, very strong governance framework is needed to make decisions early and to stick with those decisions, rather than let them be re-litigated.

A leadership framework for change

Board members are in the ideal position to improve leadership and culture to support and sustain transformation. They need to ask if they are delivering the right tone from the top to drive the change.

It is also important to ensure management is committed to a pragmatic approach that recognises the high levels of ambiguity that will be involved in a transformation of scale and complexity.

To ensure transformation is supported, boards should consider appointing a dedicated program director who is accountable for finding resolutions to challenges, and ensuring momentum is built into the process. If working with external consultants, appointing an internal lead sponsor of the program to engage with the consultants can aid efficiency. A transformation program steering committee could provide additional support.

Boards can also ask if all parts of a business are well informed on the reasons for transformation, and if they understand how it will impact the organisation’s future.

Transformation is, by definition, a massive change. One of the techniques we use very successfully is to have events where we get key stakeholders together for 3 days to work on the big challenges, and do the first level design of the solution. If team members are involved from the outset, the result is far greater buy-in.

While this can be a substantial investment, in our experience it pays off by accelerating the program and driving the change, rather than allowing the program to slip into the big program malaise.

If organisations have an ingrained focus on innovation, boards need to support this and be open to ideas that may not be fully formed.

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Outcomes and risk

In KPMG’s Transformation study, just 37 percent of Australian respondents rated their ability to track transformation progress as ‘somewhat capable’. To overcome this challenge, it is perhaps important to focus on just three or four key measurements that are designed to measure improvement in the key metrics, otherwise it is easy to become overwhelmed by data.

Another area that boards can offer strategic guidance on is risk, giving perspective on the pitfalls that could bring a transformation undone.

Boards need to ask, ‘have we built the risks into our planning and budget estimates? Is there budget for time and cost overruns? Do we have contingency built into our program?’

Gaining value from transformation

Ultimately, any transformation project needs to deliver value to the business. Yet just 55 percent of Australian organisations in KPMG’s Transformation study reported that the realised value of their transformation project was ‘about equal’ to the anticipated value.

Boards can assist with building value by ensuring each transformation has intensity and momentum inherent in the strategy. Finally, they can keep revisiting the purpose of the transformation, and ensure that every decision along the way stays on track, with the end goals of the project remaining in clear view.

The KPMG Global Transformation Survey 2016 surveyed 1600 executives across 16 countries, including 102 from Australia about their status on transformation activities. Find out more in our report: Succeeding in disruptive times – Three critical factors for business transformation success.
Building a great board

Aligning board talent with strategy: a key challenge

Chris Hall & Paul McDonald
KPMG’s Audit Committee Institute

Aligning boardroom talent with the company’s strategy is a key driver of many boards’ increasing focus on board composition and succession planning today. Talent in the boardroom is also front and centre for investors, regulators and the media.

To better understand how directors are thinking about the mix of skills, backgrounds, experiences and perspectives in the boardroom – and tools and approaches to achieve the right mix – KPMG surveyed more than 2,300 directors and senior executives across 46 countries, including Australia.

The Building a great board survey findings show that aligning board talent with strategy is a key challenge – three quarters of directors say the alignment of board talent with the company’s long-term strategy is a critical challenge for their board, and three in five cite a need for greater diversity of background and viewpoints on the board. As one board member noted, “Real diversity of thought requires diversity of experience...so diversity is as much a larger issue than just gender or age. There’s a broader strategic context and importance to diversity that boards need to consider.”

Many boards are reassessing how they approach board composition from start to finish – from recruiting and onboarding to board evaluation and succession. Directors see significant room to refresh or refine the board’s makeup: only 36 percent said they are “satisfied” and 49 percent “somewhat satisfied” that their board has the right combination of skills, background, and experience to probe management’s strategic assumptions, although Australian directors appear to be a little more positive on this score.

The survey also identifies key challenges or barriers to building high-performing boards, as well as steps boards are taking to overcome these hurdles and position themselves as strategic assets for their companies.

While the views and practices relating to board composition can vary by country, key global trends from the survey include:

Board composition – and alignment with strategy – is a key priority. Survey respondents identified several reasons for the intense focus on board composition, including the need for directors with an understanding of the competitive environment, greater diversity of viewpoints and backgrounds, and understanding the pace of technology change and the potential disruptors of the company’s business model.

For Australian directors, the alignment of board talent with the company’s 3-to-5-year strategy is of particular concern. As one director noted, “Strategy is the number one reason that boards are looking at their skill sets and composition. Where are the board’s gaps in relation to the company’s strategy?”

Significant barriers exist to building a high-performing board. The barrier most frequently cited by survey respondents was “finding directors with both general business experience and specific expertise needed by the company” (69 percent). Identifying the board’s future talent needs ranked second (55 percent), followed by resistance to change due to “status quo” thinking (43 percent), although the latter is less of a concern for Australian directors.

Does the board have the skills and expertise as well as the diversity and variety of perspectives that are essential to being effective?
Despite wide recognition of the importance of succession planning in achieving optimal board composition, many boards lack a formal succession plan. While the vast majority of survey respondents said that a formal board succession plan is a key mechanism to achieving the right board composition, only 31 percent reported having either a “formal succession plan in place that aligned with the company’s future needs”, or “robust discussions and succession planning in process”. In Australia, directors suggest the incidence of robust board discussions on succession planning is higher than the global average. There are important mechanisms to help maintain optimal board composition – but they are often underutilised. Respondents overwhelmingly cited robust board evaluations (87 percent) and formal succession plans (77 percent) as the most effective mechanisms to achieve the right board composition, however, as noted few boards have formal succession plans in place.

Generating the necessary change and turnover to achieve the ‘right’ board composition requires an active approach. The survey findings point to the need for a strategic, integrated approach to board succession planning, composition and diversity, which should be part of discussions by the full board about long-term strategy. Robust board and individual director evaluations are also critical – and a key area that requires attention by many boards. The findings from KPMG’s Audit Committee Institute survey provide key insights into directors’ views on board composition and succession planning around the globe. In our experience, the views and challenges faced by Australian directors are generally consistent with their global counterparts, although in some areas, such as succession planning, Australian boards would seem to be ahead of the curve. Find out more in our report: Building a great board.

The survey findings point to the need for a strategic, integrated approach to board succession planning, composition and diversity

Is everything under control?

Share your views in the global pulse survey of audit committee challenges and priorities

KPMG’s Audit Committee Institute (ACI) invites audit committee members to participate in a brief global survey to better understand which issues pose the greatest challenges and concerns to audit committees — from efforts to implement major new accounting standards and overseeing the internal control environment to helping address cyber risk and continually improving the audit committee’s effectiveness.

Your participation in this survey is strictly anonymous. Your views will help us shed light on key audit committee challenges and priorities in the current environment.

Take the survey

Q. What challenges or concerns are most influencing how your board is thinking about its current and future composition — skill sets, backgrounds, experiences, and perspectives?

75% Alignment of board talent with the company’s 5- to 5-year strategy
61% Need for greater diversity of viewpoints/ backgrounds
54% Business model disruption and other competitive threats
49% Need for greater skills
41% Need for greater experiences
36% Need for greater specific expertise/skills/
33% Resistance to change due to “status quo” thinking

Q. What factors are the greatest barriers to building – and maintaining – a high-performing board?

69% Finding directors with both general business experience and specific expertise
55% Identifying the talent the board will need in 3-5 years
43% Resistance to change due to “status quo” thinking
38% Need for greater diversity of viewpoints/ backgrounds
36% Need for greater experiences
33% Need for greater skills
33% Need for greater specific expertise/skills/
31% Resistance to change due to “status quo” thinking

Q. How satisfied are you that your board has the right combination of skill sets, backgrounds, experiences and perspectives to probe management’s strategic assumptions and help the company navigate an increasingly volatile and fast-paced global environment?

75% Satisfied
61% Somewhat satisfied
54% Neutral
49% Somewhat dissatisfied
36% Dissatisfied
21% Not satisfied

Q. In your view, what are the most effective mechanisms to achieving the right mix of skills, backgrounds, experiences, and perspectives on the board?

87% Robust board evaluations
77% Formal board succession plans
69% Improving board and individual evaluations to identify gaps
66% Currently assessing board’s future needs
66% Tenure limit (years or terms) for individual directors
64% Actively recruiting for specific expertise/skills/ perspectives
61% Finding directors with both general business experience and specific expertise
55% Identifying the talent the board will need in 3-5 years
43% Resistance to change due to “status quo” thinking
38% Need for greater diversity of viewpoints/ backgrounds
36% Need for greater experiences
33% Need for greater skills
33% Need for greater specific expertise/skills/
31% Resistance to change due to “status quo” thinking

Q. To what extent has your board addressed board succession planning?

87% Currently assessing board’s future needs
77% Actively recruiting for specific expertise/skills/ perspectives
69% Improving board and individual evaluations to identify gaps
66% Tenure limit (years or terms) for individual directors
55% Identifying the talent the board will need in 3-5 years
43% Resistance to change due to “status quo” thinking
38% Need for greater diversity of viewpoints/ backgrounds
36% Need for greater experiences
33% Need for greater skills
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38% Need for greater diversity of viewpoints/ backgrounds
36% Need for greater experiences
33% Need for greater skills
33% Need for greater specific expertise/skills/
31% Resistance to change due to “status quo” thinking

Q. What steps are your board taking to position itself for the future?

47% Currently assessing board’s future needs
45% Actively recruiting for specific expertise/skills/ perspectives
31% Improving board and individual evaluations to identify gaps
31% Finding directors with both general business experience and specific expertise
27% Tenure limit (years or terms) for individual directors
25% Identifying the talent the board will need in 3-5 years
24% Resistance to change due to “status quo” thinking
23% Need for greater diversity of viewpoints/ backgrounds
22% Need for greater experiences
22% Need for greater skills
22% Need for greater specific expertise/skills/
Opening up to corporate debt financing alternatives

Looking beyond traditional debt financing avenues

Private, unrated wholesale markets can offer attractive pricing, as well as provide issuers with a diversity of funding and extended tenor that is typically unavailable from traditional bank financiers.

It is not only the financing market that has struggled with a rise in debt financing costs. Bank loans in the Australian market have also seen an increase in margins. Causes include the increased cost of debt raisings by the banks; requirements from the regulator (APRA) on regulatory capital being retained to cover unforeseen events and credit risk; the increased loan loss provisions, particularly from exposures in certain industries (such as mining, oil and gas); and servicing recent significant equity capital raisings completed to meet regulatory capital requirements.

The ability of the banks to pass on these pricing pressures is dependent on relationship factors including the borrower’s credit. These have been exemplified in recent transactions where both increases and decreases in margins were evident among different borrowers. Woolworths’ 5-year transaction, for instance, was 50bps higher than its October 2014 financing (albeit at a 5.5 year tenor). On the other hand, Asciano’s 3-year transaction was 10bps lower than its February 2014 transaction.

As volatility stabilises and competition moves back into the market, some of the extreme pricing pressures earlier this year are starting to dissipate. However banks are still likely to push their higher funding costs to borrowers, and will continue to pull back from sectors directly or indirectly exposed to the commodity markets. Ultimately, it will not dull their appetite for good quality borrowers, but there is no question that keeping an open mind to alternate solutions is likely to be useful.

Australian corporates are facing global uncertainty, fluctuating volatility and higher prices, creating a challenging environment for finding appropriate sources of capital. The Big 4 banks are treading cautiously, while concurrently there was no corporate issuance in the domestic public bond market in early 2016.

As leaders of organisations in this disruptive time, it is important to think differently about where capital could come from. While corporates of sufficient size and credit rating are able to source funds through issuance in international markets, alternative debt markets, catering to unrated corporate borrowers, are likely to play an increasing role. In particular, the mid-market mining, oil and gas services sectors have already realised the need to be open to new avenues due to their challenging market conditions.

Private, unrated wholesale markets are common in the United States, and their prevalence is increasing in Australia. They can offer attractive pricing, as well as provide issuers with a diversity of funding and extended tenor that is typically unavailable from traditional bank financiers.

The last 12-18 months have seen a good number of transactions announced and completed with financing provided from non-traditional sources such as institutional money, loan specific funds, niche asset financiers, and export credit agencies. However while many alternative financiers have money available, they are able to be selective.

In 2015, Australian borrowers were the largest foreign players in the US Private Placement (USPP) market, with more than 16 percent of market share, and Australian issuers borrowing US$7.2 billion. This market continues to have decent liquidity for investment grade Australian borrowers in the US$120 million to US$500 million range, seeking 7 year plus money.

The Australian private placement market, led to date by FiIG Securities and NAB, appears to be reaching a level of maturity. For the most part, these bond-like transactions are being placed with wholesale investors, although individual sophisticated investors can participate through self-managed super funds, providing access to a fixed income investment profile that was previously inaccessible.

The last 3 years in this market has seen compounding growth in both volume and deal count. There has been a slower start to 2016 but this can be attributed to volatility in the markets generally, and is not considered to have demonstrated a reduced lack of appeal.

While there are attractions to alternative debt options, unrated markets are not immune to global pressures. The USPP market has experienced a jump in pricing across all credit rating ranges over the first 6 months of 2016. Australian transactions in the USPP market have been muted as a result, with only two priced for a collective issuance volume of US$425 million in 2016’s first quarter, and another two in the second quarter with volume of US$845 million (as at 31 May 2016).

When alternative debt sources could be considered:

• Is your company over-reliant on the Big 4 Banks for funding?
• Is your company under pressure from its banks?
• Could raising finance from alternative sources help to diversify your financing arrangements?
• Are banks putting pressure on your company for ancillary revenue and passing on increased cost of capital?
• Do you have a debt that requires refinancing?
• Should a competitive financing process be run?

Scott Mesley
Head of Debt Advisory Services

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Corporate Debt alternatives

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05 / Leading the way to a customer-centric future
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10 / Enhanced auditor reporting – a new way forward
An overhaul of auditor reporting is set to be implemented in Australia, giving greater transparency of the auditor’s responsibilities and key focus areas. For as long as we can remember, auditors would only offer a pass/fail sign-off on a company’s financial information, but these new rules now require the auditor to set out the areas they gave significant attention to, and what action they took in those areas.

The new standards, approved by the Australian Auditing and Assurance Standards Board (AUASB) and international equivalents, (International Auditing and Assurance Standards Board), become mandatory for audits with financial years ending on or after 15 December 2016. They can be adopted earlier.

In the UK, new auditor reporting standards of this manner are already in place, while the EU will launch new regulations from December 2017 year-end reports. Overall, the obligations for transparency and insight will be similar, but each jurisdiction will have specific requirements.

Ahead of the Australian implementation, it’s a good time to look at what the changes are and how audit committees, management and shareholders can prepare.

Changes for each interest group
Auditors have primary responsibility for implementing the new requirements, but the changes impact other stakeholders including shareholders, audit committee members and management.

Auditors will now be responsible for identifying key audit matters (KAMs) and communicating these in the enhanced external audit report. They need to describe why these matters were considered important, how the matter was addressed in the audit, and refer to relevant financial statement disclosures.
KAMs are written by the auditor based on their own judgement and should be tailored to be company specific. Each KAM description should be concise, free from technical jargon and with sufficient detail to show how the matter was addressed. This will help shareholders clearly understand the focus of the audit.

Other changes for auditors are the placement of the opinion at the top of the audit report and inclusion of the basis for that opinion, a revised description of the responsibility of management and those charged with governance, and auditor’s responsibilities. Audit committee members can expect to explicitly discuss key audit matters with the auditor, including earlier review of drafts of the audit opinion.

As a result, shareholders will gain access to information about the audit that was previously not available.

Getting prepared

Many, but far from all, auditors and companies have commenced preparation for enhanced auditor reporting. A good ‘preparation path’ for audit committees to follow includes:

• understanding the requirements
• discussing the auditor’s implementation plan with the auditor
• discussing how the new audit report will look
• discussing the implications on timelines and accounts preparation logistics with the auditor and management.

In the UK, feedback on the expanded auditor’s reports has been positive. Shareholders have found value in the deeper insight provided. The success is due to engagement from key stakeholders, along with regulator support and encouragement.

Key elements that could help replicate this success in Australia are reporting that is written in plain English and engaging, with specific descriptions relevant to the audit of that company, and insights for shareholders. Auditors should have open communication with the audit committee and management and be specific about the KAMs they are referring to. They should put themselves in the viewpoint of shareholders to consider how the new audit report elements meet their requirements.

If Australian auditors, businesses and shareholders take on the new auditor reporting approach with a shared sense of direction, a positive view of the changes and a willingness to advance, then expanded auditor reporting could benefit all stakeholders.

Read more details on the new Enhanced Auditor Reporting approach here.

As a result, shareholders will gain access to information about the audit that was previously not available.
To support directors in their challenging role, KPMG has launched the third edition of The Directors’ Toolkit. The toolkit provides company directors with a unique experience where they can easily navigate through a series of questions that they should ask, alongside a list of ‘red flag’ responses, that may impact their organisation’s performance.

Three new on-the-pulse chapters
Three new chapters have been included in the 2016 edition – one exploring the unique factors involved in being on the board of a not-for-profit organisation, the second looking at governance oversight of social media, and the third looking at the unique role and responsibilities of those on Investment Committees.

1. Not-for-profit entities
For directors in the not-for-profit space, many factors are the same as corporate or government counterparts, but there are some distinctive elements. The Directors’ Toolkit highlights the unique aspects of not-for-profits when it comes to legal compliance, tax obligations, strategic and operational areas of focus and accountability of members. It reviews the importance of the entity’s constitution, how to structure an effective board, and approaches to strategy and risk.

2. Social media
The prevalence of social media needs no introduction, but perhaps it is less commonly associated with the roles and responsibilities of boards. However, with the opportunities of social media there are also huge reputational risks posed to businesses. This new section looks at where boards fit in, exploring how directors of all organisations must keep pace with the social media platforms used and the behaviours they create, in order to fulfil their fiduciary duties and manage risk.

3. Investment committees
While boards are generally involved in investment decisions, Investment Committees are often established by organisations that rely on the investment of funds to meet their strategic investments – such as asset and wealth managers, insurers and health funds. This new section outlines issues for directors in this position – for example the unique risk appetite considerations, investment strategies and issues around asset allocation.

Other key areas
In addition to the three new chapters, The Directors’ Toolkit explores fundamental topics including the legal duties of directors, the different governance roles, accountability to shareholders and stakeholder engagement. It delves into helpful advice for establishing a new board, company leadership and conducting productive board meetings. Important areas of governance oversight are explored, including ethical culture, general risk management, private equity and receiving assurance. For more information on the new Directors’ Toolkit or to request a copy, visit: KPMG.com.au/directors.

KPMG has established an Audit Committee Institute (ACI) to help committee members keep up with relevant business issues and generally enhance audit committee practices and processes. The Institute:
- conducts regular ACI Roundtables that function as a forum and ideas exchange for audit committee members
- publishes the findings of local and overseas surveys of audit committee practices
- produces the Across the Board newsletter for audit committee members and other directors
- hosts special interest workshops (e.g. financial reporting requirements)

Contact KPMG’s Audit Committee Institute for more information.