



Risk just got riskier

**Insights from KPMG's audit
committee peer exchanges**

2017 Audit Committee Issues Conference

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Risk just got riskier

Risk management has been high on audit committee and board agendas in recent years, and many directors say their companies have made progress putting in place robust risk management processes. In the months ahead, however, even the most sophisticated approaches to managing and overseeing risk will be put to the test as companies find their way forward in a significantly more volatile and opaque business environment.

“Few business leaders today have experienced the mix of risk and uncertainty, opportunity, and complexity that we’re seeing today,” notes Jose Rodriguez, partner in charge and executive director of KPMG’s Audit Committee Institute. “Discussions about risk are taking on an added sense of urgency in the boardroom, and audit committees continue to be a catalyst for those conversations.”

In a series of candid peer exchanges hosted by KPMG’s Audit Committee Institute and Board Leadership Center,¹ audit committee members highlighted a number of critical challenges and concerns driving their audit committee and board agendas in the months ahead, such as:

- Risk oversight, including internal audit’s role and assessing corporate culture
- Cybersecurity
- Financial reporting matters, including non-GAAP metrics, new accounting standards, and CFO succession
- Audit committee effectiveness

From your perspective as an audit committee member, which of the following issues pose the greatest challenges to your company? (select up to three)

45%

Effectiveness of risk management program

34%

Legal/regulatory compliance

28%

Managing cybersecurity risk

28%

Maintaining the control environment in the company’s extended organization

24%

Tone at the top and culture of the organization

22%

Maintaining internal controls over financial reporting

21%

Ensuring that internal audit is maximizing its value

19%

Pressures of short-termism and aligning the company’s long-term and short-term priorities

Multiple responses allowed

Source: KPMG 2017 Global Audit Committee Pulse Survey

¹ KPMG’s 2017 Audit Committee Issues Conference, January 9–10, 2017 in Boca Raton



Risk oversight: "How do I know what I don't know?"

Risk management remains top of mind for audit committees (and boards) given the expectations for slow growth and economic uncertainty, mounting cyber risk, unrelenting technology innovation and business model disruption, and the dramatic, if uncertain, policy shifts of the Trump administration and Republican-controlled Congress.

"How do I know what I don't know? There's simply no way to predict and prepare for every scenario," said one audit committee member, noting that, "just about everyone missed the Trump win. This just emphasizes the need to have a good risk process in place, both at the management and the board level. Risk just got a lot riskier."

More than 40 percent of respondents to KPMG's 2017 Global Audit Committee Pulse Survey said their company's risk management program "requires substantial work," and a similar percentage said it is "increasingly difficult to oversee major risks" on the audit committee's agenda (in addition to core financial reporting matters).

"We still rely on the three lines of defense—compliance, risk management, and internal audit," noted one attendee. "But we've shifted the emphasis to the first line—compliance. You can't just expect quality and integrity at the end of the process. You have to get it right the first time, before it comes downstream."



Assessing corporate culture

“For us, it’s all about spotting yellow flags and warning signs—detecting patterns of noncompliance,” noted one participant. “When I think about the systems we have in place to capture data and analyze trends—employee surveys, customer complaints, a whistle-blower hotline—they’re all essentially detective controls. The real challenge is to prevent problems in the first place.”

Discussions highlighted the increasing focus on compensation and incentives. “Our compensation committee asks the audit committee to look at the potential risks that our incentives program might create. That’s helpful, but the question is, are we going deep enough? We are doing it at the management and senior levels (of compensation) but not down in the trenches. Is culture the root cause of the problem? Is it compensation? Is it how we hire?”

Most companies today have a whistle-blower mechanism in place, but as one director noted, “You need to periodically ask the basic question—is it working as intended? Is the right information getting up to the audit committee?” Another participant warned of the false sense of security that whistle-blower programs can create. “You can get lulled into thinking most issues will bubble up through a formal hotline system but it may not catch those weak signals. Is there a smoldering ash or common thread in the data around those dismissed for performance issues that might have keyed the board into larger operating issues? Does the board have effective aggregate information on dismissals?”

Discussions indicated that most audit committees and internal audit departments are in the relatively early stages of determining how to audit culture. “We’re starting to see some frameworks and criteria for culture audits,” said one participant, suggesting that many companies are “already doing some of this work, just not in a systematic way.”

Heavy risk agendas

Audit committee members continue to say it is getting more difficult to oversee the major risks on the audit committee’s agenda in addition to its core responsibilities. “We’re fine owning the oversight of the company’s risk process, but the audit committee’s job, first and foremost, is financial reporting and internal controls, and oversight of the auditors. We’re very cognizant of risk topics crowding out the committee agenda and diluting our main focus.”

One attendee, however, noted that audit committees often end up with additional risk oversight responsibilities—mission creep—“because if the audit committee doesn’t do it, it frankly doesn’t get done properly. At the board level, discussions can be very superficial.”

One director emphasized that the audit committee’s agenda can quickly become unmanageable even in the absence of new risks on the agenda. “Cybersecurity has been on our audit committee’s agenda for years, but it’s taking up more and more agenda time because of the complexity and impact a cyber breach could have. At some point, certain risks may need to be off-loaded to the full board or a separate committee.”

While risk oversight from a defensive perspective—e.g., regulatory compliance, cybersecurity, internal controls—may be appropriate for the audit committee, most attendees emphasized that the full board has responsibility for connecting risk and strategy. “Assessing the types of risks we’re taking and how that aligns with the strategy is clearly a full board discussion.”

“It takes strong leadership to keep control of the audit committee’s agenda,” noted one attendee. “It’s up to the chair to set the agenda and keep the committee focused. If it isn’t in the committee’s charter, the chair has to push back. Say no—and talk to the nominating and governance chair.”



Cybersecurity: Does the board have a clear picture?

As one committee member put it, “I think it’s finally sunk in that we simply can’t wall off the company from cyber risk. It’s now a matter of internal awareness, mindset, and readiness for a breach.” Attendees generally agreed with this assessment of how companies and boards are evolving their approach to cybersecurity. “I see cyber discussions generally shifting from prevention toward detection and containment.”

Efforts are increasingly focused on raising awareness among employees and board members about vulnerabilities to hacking. “We have a pretty rigorous cyber awareness program, but to test and reinforce, we hired a white hat vendor to routinely phish our employees to see who they can lure into clicking on a bad email.”

Companies are also focusing more on vulnerabilities posed by third-party vendors and adjacencies that can serve as entry points for hackers. “You really need to look at cyber risk at an enterprisewide level—product development, mergers and acquisitions, the supply chain. The Internet of Things has created a whole new set of access points for hackers.” A number of participants noted increasing involvement by internal audit in assessing cyber risks associated with vendors, including law firms, that may have access to clients’ systems or have client data on their systems.

In KPMG’s 2017 Global Audit Committee Pulse Survey, respondents ranked cybersecurity risk as a top challenge, after risk management generally and legal/regulatory compliance.

Cutting through cyber-speak

Getting a clear picture of the company’s cyber-risk profile—key threats, risk mitigation, and response plans—continues to be a challenge at the board level. “Our CIO’s presentations were so technical and filled with jargon that we debated bringing someone

onto the board with technology expertise just to help translate,” noted one director. “But the more we explored the issue, it became apparent that the problem wasn’t with us, it was that our CIO wasn’t equipped to translate technology issues into a business conversation. We now have someone who can do that, and it’s been a game changer for us.”

Another attendee observed that “a CIO’s inclination is to see the glass as half full—by nature, they want to tell you how effective security systems are. But a chief risk officer tends to be the pessimist—seeing the glass as half empty. So we’ve assigned cyber risk to our ERM group as a risk management issue, with the CIO working closely with that group.”

The frequency of communications with the board is also important. “We went from getting one major cyber update a year to doing about 20 minutes at every board meeting,” one director noted. “It’s a much better rhythm.”

In terms of readiness to respond to a major breach, one participant emphasized the importance of establishing a rapport with law enforcement—including the Federal Bureau of Investigation (FBI)—before something happens. “In one situation, we had a visit from the FBI to tell us we’d been hacked and to advise us to let the hackers stay in the system so they could watch what they did. It’s a little unnerving, but law enforcement sees so many of these cases; they have great insights.”

Should the board have a designated member with cyber expertise? “It depends on the business. If the company is all about data, you should think about it. Otherwise, it’s easy enough to bring in expertise from the outside,” one director said. Another cautioned against using a board seat for such a narrow skill set, noting that, “A board member needs to be able to contribute in many ways, not just in their area of expertise.”



Financial reporting matters

Non-GAAP

With the transition to a Trump administration, changes are underway at the SEC, including a new chair who will set the agency's rulemaking agenda, as well as new heads of the Corporation Finance and Enforcement divisions, among others. Nevertheless, peer exchange participants anticipate a continued SEC focus on the quality and consistency of disclosures, particularly around the use of non-GAAP information.

"Non-GAAP information [both non-GAAP financial measures and other non-GAAP information] is more important than it ever was—particularly when you're trying to give the investment community metrics that support your long-term strategy. But it also means that non-GAAP will be under more scrutiny," said one participant. "I think most companies are spending much more time on what those numbers are and how they were generated."

"We try to stand in both the investors' and the SEC's shoes to assess the value and reasonableness of the non-GAAP information we're considering," said one participant. "It's also helpful to get feedback from your investors on how they perceive the company's use of non-GAAP—whether it's through your investor relations department or as part of your direct engagement with shareholders. Ultimately, it's your investors who need to understand the company's story."

Several attendees said their companies' approach to developing non-GAAP financial measures is to use GAAP as the starting point, "rather than starting with the non-GAAP number and searching for the GAAP equivalent. It helps keep our disclosures on solid footing."

"My biggest concerns are the adequacy of controls over non-GAAP information and the fact that information is not audited," said one attendee. "I want to know what work is being done to ensure that the non-GAAP information is accurate and consistent," observed one attendee. Another director suggested that a certification process for non-GAAP information, similar to the one required by Sarbanes-Oxley for ICOFR, "could be useful to help audit committees understand where that information comes from."

Revenue recognition and lease accounting standards

The impact of the FASB's new revenue recognition standard (effective January 1, 2018 for calendar year-end public companies) and the new lease accounting standard (effective January 1, 2019 for calendar year-end public companies) will vary across industries; yet, both represent major changes to accounting practices and disclosures and have significant implications for financial reporting processes and resources.

"This is much more than an accounting exercise," said one participant. "It involves technology systems, people and training, and organizational change. I think a lot of companies are in for a big surprise if they're not already well into the implementation of these new standards." KPMG's 2017 Global Audit Committee Pulse Survey found that only 13 percent of U.S. respondents said their company had a "clear plan" for implementing the new revenue recognition standard, and even fewer for the lease accounting standard (9 percent).

Talent and CFO succession

CFO succession planning continues to be a key area of concern for many audit committees. "The CFO's role is so strategic today; you need to be thinking about bench strength and who could fill that person's shoes. Think of CFO succession like you do CEO succession." For mid-cap companies that often do not have the luxury of deep bench strength and a few potential CFO successors to pick from, one director noted, "It's even more important to think ahead and have a recruiting plan in place. Nothing is stopping you from keeping your eye on talent in the industry."

Understanding the depth of talent in the finance organization—including the controller, treasurer, and chief accounting officer—is also important as these roles take on responsibility for finance activities that were traditionally done by the CFO. One attendee said, "We're spending more time with members of the finance team—sometimes unannounced—just to see what they're focused on, what they're concerned about." Another noted that, "Internal audit is an incredible source of insight and unvarnished views about the company's talent and culture and blind spots."



Audit quality, relevance, and transparency

While audit committees continue to express confidence in audit quality, the value and relevance of the audit are generating more discussion as investors, regulators, and the audit profession consider the potential for technology and data and analytics to provide greater insight into a company's performance, prospects, and key risks.

Discussions also touched on PCAOB and SEC efforts aimed at enhancing audit-related transparency—expanding the audit committee's and the external auditor's report—to provide greater insight into their work. While many attendees recognized the intent of these initiatives, some suggested that they could have the reverse effect of stifling communications between the audit committee and auditor. "Our conversations with the auditors have gotten much better in recent years. I would be concerned that more disclosure requirements would hamper those discussions and result in boilerplate disclosures. That would be a step backward."

When asked in a conference survey what aspect of the audit would deliver the greatest value to the audit committee in the year ahead, most audit committee members cited "candid feedback and insights relating to business processes, controls, company resources, and other important areas that are addressed by the scope of the audit."

"It's going to be interesting to see how technology and data analytics impact the audit," noted one attendee. "Today, I think we're all getting high-quality audits. But there are probably plenty of patterns and business insights inside all of the information that audit firms are looking at. When you can fully harness that, it'll be a game changer."





Audit committee effectiveness

To address heavy agendas, many audit committees are focusing on ways to improve their efficiency and effectiveness—refining their agendas and oversight processes, reassessing their skills and composition, and deepening their knowledge of the business.

Echoing the findings of KPMG's 2017 Global Audit Committee Pulse Survey, many peer exchange participants said a better understanding of the business—how it makes money, top risks, and the strategy going forward—would most improve the audit committee's oversight effectiveness. "It's important to spend time outside of the corporate headquarters, visiting facilities, talking to employees, customers, and vendors. It's how you develop your understanding of the culture and what makes the organization tick."

Risk oversight continues to contribute to the agenda overload that many audit committees report today. "Time and agenda management has been a big focus for us," noted one attendee. "We've found that using a consent agenda to take care of must-do items that we're all comfortable with has opened up a considerable amount of time for good discussions."

Among other practices for improving the committee's time management and effectiveness, attendees suggested inviting the entire board to audit committee meetings to keep the board up to speed on key risk issues, therefore streamlining full board meetings/discussions; sharing the committee's agenda and meeting materials with all directors; increasing the number of audit committee meetings ("doing whatever it takes to get the job done"); holding unprepared directors accountable ("everyone knows who the chronically unprepared directors are"); holding a 30-minute pre-meeting prep call "to tighten up the agenda and prioritize discussion topics."

Commenting on the growing time commitment and deepening level of board engagement, one director observed that, "The line between governance and management isn't a bright line anymore. It's blurred, and I think directors are more into the management side than we ever expected to be." But, another noted, "Doing the job well requires deeper engagement. Frankly, investors don't want to hear the excuse that it's a part-time role. The board needs to take a hard look at itself and its members to make sure sufficient time and effort are being devoted to the job."



For insights from the full conference, see
Going the distance: Insights from the 2017 Audit
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Audit committee peer exchanges were facilitated
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