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Audit Committee Institute
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Non executive directors – are you getting the right information to govern?

Despite being vigorously independent, diligent and knowledgeable, non-executive board members will never be fully effective unless they have both access to, and an understanding of, all the relevant information.

The relationship between external auditors and audit committees is very much under the spotlight at the current time, but little has been written about what audit committees (and non-executives more generally) should expect to see from management, when they should see it and how it might best be communicated.

Non-executive directors should insist on receiving high-quality information sufficiently in advance so that there can be thorough consideration of the issues prior to, and informed debate and challenge at, board and committee meetings. High-quality information is that which is appropriate for making decisions on the issue at hand – it should be accurate, clear, comprehensive, up-to-date and timely; contain a summary of the contents of any paper; and inform the director of what is expected of him or her on that issue.

Ultimately the chairman of the board, or committee chairman where appropriate, is responsible for ensuring that non-executive directors receive accurate, timely and clear information. As such they must have open and candid conversations with management regarding the specific types of information the non-executives require to perform their duties, with the understanding that this information needs constant refinement. Directors and management also need to be cognisant that too much information can be as bad as too little information.

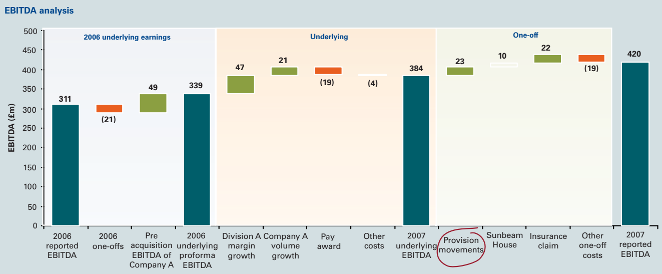
The following pages address in a little more detail the types of information non-executive directors might receive and what it might look like in practice.

Performance

Do you have a clear view of underlying performance in each part of the business?

- *Are reported operational achievements backed up by financial performance?*
- *Are results and issues being communicated to investors with sufficient transparency?*

Key components of earnings



Source: KPMG LLP (UK) 2011

You should be getting clear financial analysis that:

- matches the current operating structure of the business
- distinguishes between core business performance and one-off events/distortions including the effect of judgements and estimates
- adapts to address new issues as they develop
- is consistent with the view presented in the published accounts.

Are the operating implications of the financial performance clear?

- *Does current performance have implications for overall strategy?*
- *Are the key operational challenges being recognised and addressed?*

Are you getting information that is:

- **Relevant** – A balanced set of measures that address the **strategic** objectives and are directly **aligned** with operational structures and responsibilities
- **Forward looking** – Rolling forecasts that provide **continuous insight** and direct comparison to actual performance on a consistent basis
- **Focused** – Trend and run rate analysis with commentaries addressing both internal and external issues with **direct actions**

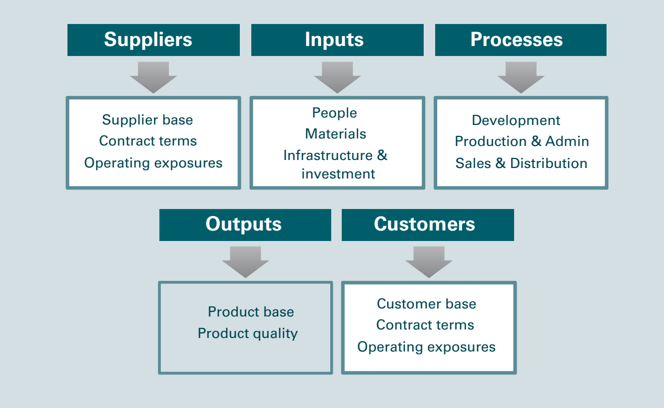
Both the narrative and numeric reporting you receive should reflect management's best view of past and future performance. Key ongoing and potential challenges for management should be clear.

Analysis should be consistent but flexible enough to anticipate your questions and provide you with the understanding you need to challenge developments as they arise.

Are you equipped to challenge strategic decisions?

- *Do you have a clear enough picture of operations to challenge management effectively?*
- *Do you have the information to relate operational exposures to financial consequences?*

Operational understanding



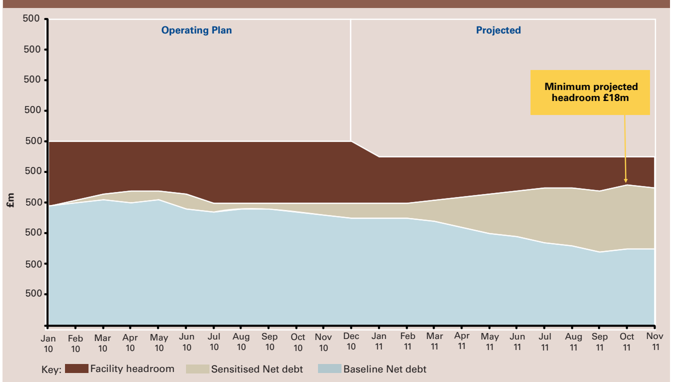
Management reporting is often not sufficient on its own to provide the full context in which strategic decisions are proposed. You should also be getting a clear understanding of the current and expected impact on operational processes that can be related to the anticipated financial consequences.

Financial management

Is sufficient funding available to the business?

- *Is sufficient funding in place to meet the business's requirements?*
- *Does this cover a realistic downside risk?*

Funding headroom



Source: KPMG LLP (UK) 2011

You should be getting:

- Up-to-date analysis of future cash requirements, committed funding arrangements and projected debt covenant compliance
- Realistic downside sensitivities on cash needs covering at least the next eighteen months
- A contingency plan that demonstrates mitigating actions can be implemented in time to generate required savings in a downside situation

Are profits being converted into cash effectively?

- *Is cash generation given sufficient operational priority?*

Cash management – questions to consider:

- Does the **business culture** focus solely on profit? Do remuneration structures and management reporting reflect this?
- Is the approach to cash management limited to **reactive** squeezes of supplier / customer terms to meet targets?
- Are **unduly complex systems** and weak links between finance and operations frustrating efforts to manage collections, payments, and inventory?

PE investors have an excellent track record in extracting cash from established businesses. Are you providing the same challenge to management?

- Could more be done by both finance and operations to manage the funding requirement?
- Are there non-core assets that could be converted to cash?

Is failure to convert profits into cash indicative of underlying operational problems?

Is the strategy for managing financial risks appropriate?

- *Does the strategy as implemented meet business and investors' needs?*
- *Are you satisfied with the operational controls over cash and treasury instruments?*

Does your organisation have:

- A clearly defined, **board approved hedging policy** that covers interest rate, exchange, and commodity exposures
- A **group cash management** structure
- Realistic short and medium term **cash forecasts**

You should be getting sufficient analysis of financial risks and exposures to challenge current hedging strategies.

Treasury governance including the use of financial instruments, cash management, and cash forecasting is an important but technically challenging activity that will require support from within the business – typically Internal Audit

Liability management

Are commitments and contingent obligations under control?

- *Is management tracking and controlling the major commitments made by the business?*
- *Is management getting the balance right between risks and benefits?*

How much visibility do you have over:

Contractual arrangements

- Internal audit should be providing a clear view of how well the business manages contractual commitments, indemnities, and exposures

Existing exposures

- Where exposures are likely to crystallise, management reporting should be flexible enough to highlight the potential issue in advance and anticipate key questions

Tone at the top is key in setting attitudes to downside risk across the business. You should be looking beyond the existing strategy to assess whether management has the right balance between risks & commitments and delivery against targets.

You need to be satisfied that major obligations which have or are likely to crystallise are being managed in the best interests of investors.

Are tax obligations being managed effectively?

- *Are you satisfied with the underlying tax rate?*
- *Are all taxes being managed effectively?*

Are you getting a clear picture of:

- The long term underlying tax rate and how it is being managed across the group
- How the effective tax rate translates to cash tax payable
- How one-off tax costs and disputes are being managed, including the level of balance sheet uncertainty
- You should expect clear lines of responsibility for all taxes across the group

Boards have a significant role to play in agreeing overall tax strategy. This includes scrutiny over the location of profits, effective tax rates and actual cash tax paid, and the approach to managing relationships with local tax authorities.

You should be getting analysis that enables you to challenge these areas at a strategic level without requiring a specialist understanding.

Are pension obligations being managed in investors' interests?

- *Are existing obligations being managed effectively?*
- *Do ongoing pension arrangements fit with business objectives?*

Is the pension funding position being clearly explained?

- Is it clear how the effect of decisions and external events has affected the position?
- Is the potential impact of future exposures clear?
- Are available options being constantly assessed?

Pension funding obligations have a major impact on shareholder value for groups operating defined benefit schemes.

You need sufficient information to understand the funding situation in overview, how it has moved, and the future exposures and available options for managing these.

Financial systems

Financial governance & control

- *Are you able to challenge the approach to risk management and oversight effectively?*
- *Is financial control more than just a tick-box exercise?*

Are you getting a clear view of where controls are stronger/weaker?

- Is the view consistent between internal and external audit and your own experience?

Is finance fulfilling the right role?

- Does it work with the business or apart from it?
- Is it providing constructive challenge?
- Does it have global visibility and exercise control accordingly?
- Does it have the right resources?

Are your assurance providers addressing issues that are relevant to you?

- Do they cover all the areas where you need clarity?
- Are you satisfied with their scope, resourcing, and independence?

In your experience, is finance providing consistent and reliable information? Is it able to respond to your questions quickly and effectively?

Does the financial reporting provide a fair view of business performance?

- *Are investors being told what they need to know?*

Does your narrative reporting explain:

1) The nature of the business – including its market environment and key challenges
2) Objectives and strategies as recognised by the board
3) Reliance on and adequacy of resources together with the associated risks
4) Results and prospects including the link between underlying and future earnings
5) KPIs as used by management

You have a key role in ensuring that investors are getting the information they need.

Scrutiny of external reporting should go beyond the key accounting judgements. Note disclosures and management commentary play a central role in investors' understanding. If these are inadequate investors may have to fill gaps from less reliable sources of information.

IT strategy

- *Does the IT structure match the business needs?*
- *Are business critical IT risks being managed effectively?*

Five challenges on IT:

- Is your CIO in control of the whole IT estate or just part of it?
- Is management getting the information they need to run the business?
- Is finance getting clean error-free transaction processing?
- Who's in control of your outsourced processes?
- How will current IT projects affect these answers?

IT is often considered too technical to be debated at board level but the strategic decisions taken can have far reaching implications for the business. Is the board being given the opportunity to consider these?

Where IT is discussed, it is often as a cost. Governance of IT should understand the business value it can deliver and measure performance by reference to outputs/deliverables as well.

Major IT projects can require the same level of investment as some corporate acquisitions – yet rarely receive the same degree of scrutiny.

Governance

Corporate governance

- *Are you satisfied with the effectiveness of the company's governance?*

How active is the board in exercising leadership? Including:

setting strategic aims; assessing resourcing; monitoring management performance; setting values; meeting obligations to shareholders

What role does the board play in ensuring accountability? Including:

financial and business reporting; risk management and internal control; audit relationships

Does the board have the resources it needs to exercise leadership and maintain accountability?

Is the board playing a genuine role in each of these areas or just following management's lead?

Fraud and illegal acts

- *Are all aspects of fraud and ethics policy addressed?*
- *Is the intent of the policy being implemented in practice?*

Responsibility

Is the right person responsible for anti-fraud measures? When was the last time that the scope and operation of anti-fraud controls was assessed?

Culture

Is the culture of the whole organisation consistent with these? Would whistle blowing facilities be used in practice?

Are all aspects of fraud risk being addressed? You need to consider: misappropriation; financial reporting; market abuse; money laundering; corrupt practices.

Are you getting assessments of the appropriateness of policies including?

- Governance and tone
- Risk assessment, detection, and investigation
- Training and awareness
- Monitoring and oversight

Contact us

If you would like further information on any of the matters discussed above, please talk to your usual KPMG contact or contact:

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