Re-Thinking Risk

Audit committees in the wake of the financial crisis

ODGERS BERNDTSON

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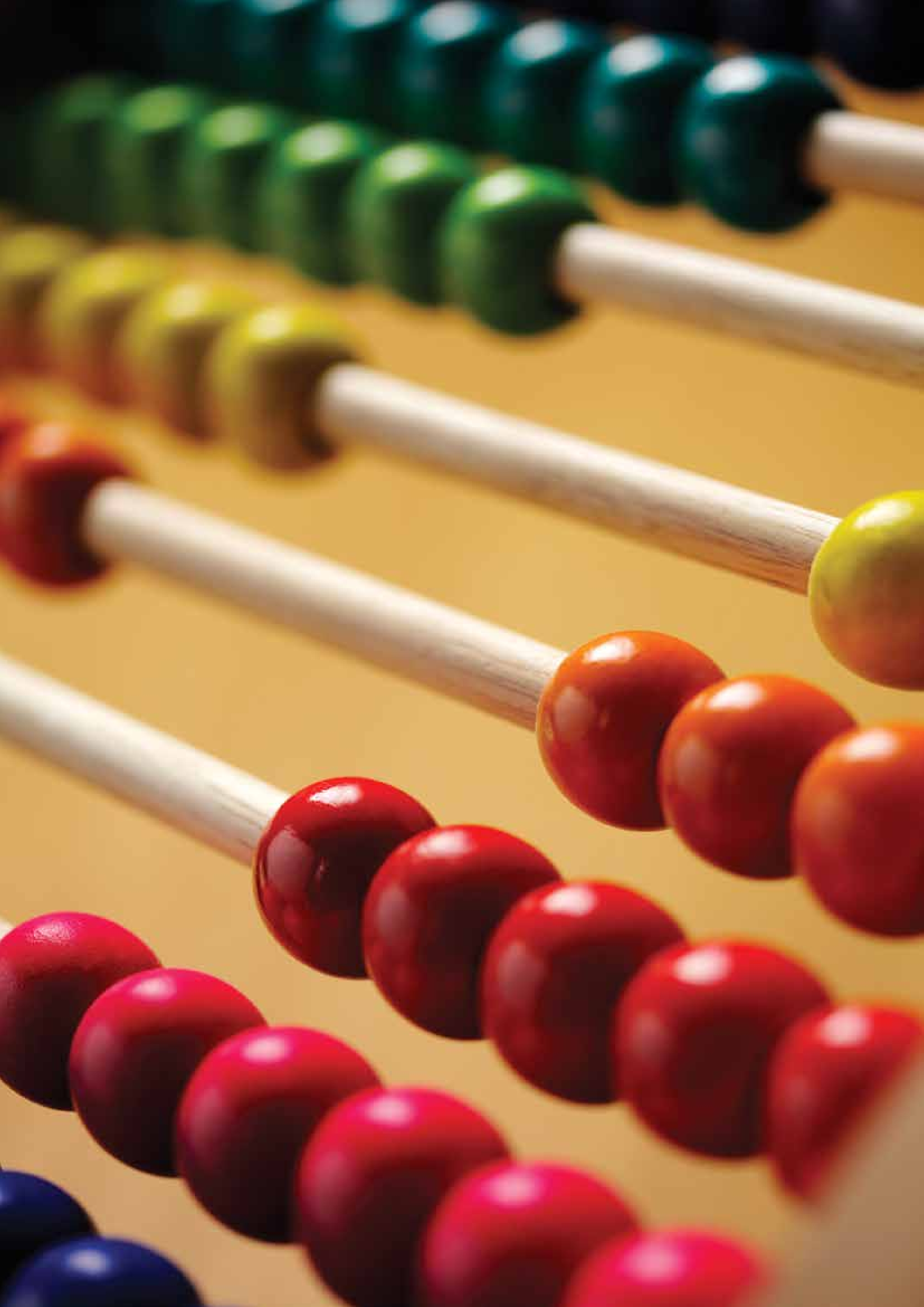

Executive Summary

It is a tough time for audit committees.

The financial crisis and recession have raised acute challenges, ranging from relations with the auditor to going concern statements, accounting treatment and financial reporting.

In particular, the crisis has focused the attention of boards and audit committees on how the company assesses and manages risk. The pressures of serving on an audit committee have increased; so has the time commitment. Fellow directors, the media and shareholders are all looking to the audit committee for reassurance that any looming risks to the business will be spotted and avoided.

New regulations have been introduced. The Walker review of the governance of banks and other financial institutions called for the introduction of risk committees to complement audit committees.

Meanwhile, the Financial Reporting Council has toughened up its guidance on the board's responsibility for overseeing risk management.

In this environment, boards must take extra care to ensure that their audit committee is properly constituted and has the right objectives.

This paper, based on Odgers Berndtson's extensive experience in helping boards recruit the best finance teams and audit committee members, looks at how the role and remit of the audit committee is changing in the wake of the financial crisis.

In particular, it asks how boards should implement new regulations in relation to the oversight of risk.

It concludes that, in uncertain economic times, the contribution of a strong audit committee is more important than ever and lies at the heart of an effective board.

The governance context

The responsibilities of board audit committees are well defined in the UK Corporate Governance code.

These responsibilities were drawn up in the wake of the last corporate crisis – namely the failure of US companies like Enron and WorldCom – and have proved resilient in the course of the more recent financial crisis.

According to the code, the audit committee's remit is to:

- Monitor the integrity of financial statements and announcements on financial performance, reviewing significant financial reporting judgments;
- Review internal financial controls and risk management systems, unless the board has a separate risk committee or deals with risk itself;
- Monitor and review the effectiveness of internal audit;
- Make recommendations to the board on the appointment, removal, remuneration and terms of engagement of the external auditor;
- Review and monitor the external auditor's independence, objectivity and the effectiveness of the audit process;
- Develop and implement policy on the extent to which the external auditor supplies non-audit services, such as management consultancy, keeping an eye on ethical principles;
- Report and make recommendations to the board on any matters on which action or improvement is required.

Put simply, the audit committee's job is to be the board's eyes and ears on financial matters. The objective should be a culture of 'no surprises' for the full board, so that problems are identified and tackled early. At the same time, a strong audit committee will both support and mentor the finance team – especially important if the finance director is relatively new to the role – while also providing the right degree of challenge.

A strong audit committee will both support and mentor the finance team

But while the governance framework for audit committees remains largely untouched, the climate in which they are carrying out their role has changed greatly. The global financial crisis put severe strain on the finances of virtually every company, placing additional burdens on the audit committee and creating a need to treat formerly improbable risks as a real possibility.

In good times, few audit committees spend much time worrying about the validity of their going concern statement. Over the past two years, as sources of financing disappeared, a debate over going concern will have been a topic of discussion for an unprecedented number of audit committees.

A tougher job

The impact of the crisis has been to make the job of audit committee chair or member more demanding. The committee has faced the unenviable task of giving the board rigorous guidance on the company's financial footing at a time of extreme volatility.

One noticeable implication is that the role has become more time consuming. Audit committee meetings take longer, and the preparation is more intense. Items for debate that have never emerged before – for example, whether financing is available

For many companies, the audit committee is more active and engaged than ever

– have to be confronted for the first time. Audit committee members also report that they are spending more time with the company's lawyers, as difficult issues of responsibility emerge, and of course with the auditors.

For those directors who serve on the board of a financial services company, the pressures are even greater and include interviews with the Financial Services Authority to establish whether the director is up to the task of challenging management. The FSA will also study committee minutes as part of regulatory visits.

As well as spending more time on the job, audit committee members are reacting to the tough financial climate in other ways. The members of the committee are speaking up more, asking more questions and probing to ensure they receive full answers.

More aware of the responsibilities of the role – and liabilities – non-executives are ensuring that their questions or objections on specific topics are minuted. For many companies, the audit committee is more active and engaged than ever.

Information flow

If audit committees are also working harder, they are also working smarter. As one finance director told us: "There are two ways to confound a non-executive director – you either give them no board papers or you give them a huge volume of material." Over the past two years, as finance teams and audit committees have sought to navigate unpredictable and high-risk economic waters, there has been a natural tendency to overburden the committee with too much information. In a bid to be comprehensive, audit committees run the risk of getting bogged down in detail and missing the big picture.

Since the crisis broke, the best audit committees have been clear about those topics that they should – and should not – tackle. This puts considerable onus on the chair of the audit committee to ensure that the board papers are of the appropriate length and level of detail. The judgement of the audit committee chair in terms of setting the agenda and ensuring an appropriate information flow has been at a premium.

Composition

The governance code advises that all audit committees include one member with 'recent and relevant financial experience.' In practice, this has come to mean those who have been a finance director, a qualified auditor, an investment banker, or the chair of an audit committee within the last two years.

Given the financial origins of the crash, financial skills have understandably been vital. But the non-financial members of the committee may, paradoxically, have also grown in influence. It is these directors who can question assumptions, create clarity by insisting that difficult issues are discussed in non-technical language, and ask 'why?' They are less likely to get mired in the complexities of accounting treatment, and hence provide a more strategic contribution.

The need for the audit committee to work as a team has been amply borne out by the crisis, with a mixture of financial experts and other directors providing a balanced mix of skills capable of both supporting and challenging the finance team, internal audit department and outside auditor.

Risk management

In 2009, the Financial Reporting Council, the UK's corporate governance regulator, reviewed the code to see if its structure and content were still fit for purpose in light of the financial crisis.

A key conclusion was that the board's responsibility for overseeing risk management should be greatly strengthened. The Council said: "One of the strongest themes to emerge from the review was the need for boards to take responsibility for assessing the major risks facing the company, agreeing the company's risk profile and tolerance of risk and overseeing the risk management systems. There was a view that not all boards had carried out this role adequately."

The review introduced new language to emphasise the board's responsibility in relation to risk. The Council said the lack of such a principle in the previous versions of the code was "a significant omission."

The revised code now reads that: "The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems."

This principle makes clear that it is not the board's role to manage risk, which is properly the remit of management. But the board should have a clear view on how much risk it is willing for the company to assume and ensure that management understands and implements this policy.

A further new provision in the revised code states that: "The board should satisfy itself that appropriate systems are in place to identify, evaluate and manage the significant risks faced by the company." This wording is drawn from the Turnbull guidance on internal controls and hence is already part of current best practice guidance. But the elevation of this provision to the main code lends extra emphasis to this vital board responsibility.

This reform has implications for the audit committee. Before the crisis, many boards let the audit committee take the lead in reviewing the effectiveness of internal controls and other risk management systems, especially in relation to financial risks and controls. Directors now report that that trend has reversed as boards become much more assertive in their oversight of risk management.

Setting clear policies on risk appetite and tolerance, and ensuring a sound system of internal controls, lie at the heart of the board's role. An audit committee (or risk committee, as discussed below) exists only to enable the full board to make better decisions, not to reach final judgements itself. The financial crisis has reinforced this critical principle.

Finally, the new code contains the provision that "remuneration incentives should be compatible with risk policies and systems." This is eminently sensible – incentives are designed to ensure that management strives to achieve specific objectives, and the board should be clear that the pursuit of these objectives does not imperil the business. Efforts to ensure that remuneration policies and risk controls are closely aligned can only be welcomed.

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Reporting of risk

The Financial Reporting Council concluded that board reporting of risk issues is unsatisfactory. The code review cited a report by the Accounting Standards Board which found that only 6% of sampled companies met best practice on risk reporting. The standards board concluded that there were "significant opportunities for improvement in the reporting of principal risks."

The revised code seeks both to strengthen reporting in this area and encourage the board to engage in some 'big picture' thinking about the company's long-term prospects and the potential threats to the business. The code now calls for the company to include in the annual report: "An explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company."

This description should be linked to the discussion on risk and uncertainties in the Business Review so that, according to the code review, "shareholders and potential investors have a better understanding of what those risks and uncertainties threaten."

The Financial Reporting Council added: "Preparation of such a statement may also serve to prompt discussion in the boardroom as to the long-term robustness of the business model."

This statement, intended to accompany the Business Review, revives the debate over how to incorporate more forward-looking information within financial reporting. The Operating and Financial Review, which encouraged companies to report on strategy, intangible assets and the prospects for the business, as well as the principal risks, was abandoned five years ago.

But the pressure on companies to include reporting that reflects future opportunities as well as historical performance remains strong, and is now formally encouraged by the governance code.

Risk Committees – the way forward?

In the financial services sector, the formation of a dedicated risk committee is set to become established best practice, thanks to the recommendations of Sir David Walker, author of a government-sponsored review of the governance of banks and other financial institutions.

Walker recommended that the risk committee "should have responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy." He argued that audit committees of financial services companies already bear a heavy load in terms of overseeing financial reporting and internal controls, and that a considered analysis of the strategic risks facing the business can therefore be squeezed out for lack of time.

His report continued: "A risk committee should focus as much as possible on the 'fundamental' prudential risks of the institution." He acknowledged that financial services companies face a wide range of significant risks, but argued that the risk committee should focus on high-level risk matters," namely those key risks that have the potential to sink the business.

Walker further recommended that there be appropriate overlap between the risk committee and the audit committee, and that the chair of the audit committee should always participate in the risk committee's deliberations even if they are not a member.

Given the pressure on boards in all sectors to devote substantially more time and energy to overseeing risk management, can we expect to risk committees to become a default addition to company boards outside the financial services sector?

There are advantages to such a move. A dedicated risk committee ensures there is a group responsible for overseeing aspects of risk management and reporting back to the board. The danger that the audit committee is overburdened, and hence that risk-related considerations receive insufficient attention, is thus minimized.

But creating a risk committee also creates the need for a further committee chairman, and perhaps additional non-executive directors with specialist skills. Many companies, particularly those operating in relatively low risk environments, will consider that the costs outweigh the benefits.

In such companies, the audit committee will continue to play a role in reviewing controls, subject to the principle expressed above that risk oversight, appetite and tolerance is a board-level responsibility.

Conclusion

Whenever poor governance plays a role in destroying shareholder value, the spotlight tends to fall on the audit committee.

The financial crisis placed audit committees under even greater scrutiny as the board, investors and other stakeholders sought assurance that the company was on a sound footing. In the wake of the crisis, the committee's role in keeping the board informed on financial matters and providing early warning of potential future trouble spots will remain to the fore.

The governance code has been revised to reinforce the principle that the oversight of risk is an issue for the full board. The code's language has been strengthened to emphasise that it is the board's responsibility to define the company's appetite and tolerance for risk. It is then for the management team to put this policy into effect.

The code also obliges boards to report more fully on the company's business model, strategy, and the principal risks facing the business.

Strong audit committees have an important role to play in supporting the board in both these areas. The audit committee is likely to have specific expertise on the subject of financial risk and will in most companies take the lead in reviewing the effectiveness of internal controls.

Members of the audit committee will also be expected to make a valuable contribution to the debate over more textured, forward-looking financial reporting.

The result is that, as recession gives way to recovery, audit committees are set to become an even more important and influential part of strong, effective boards.

A risk committee should focus as much as possible on the 'fundamental' prudential risks of the institution

About Odgers Berndtson

Odgers Berndtson is one of the leading international executive search firms and the largest in the UK. Our reputation for excellence and integrity has been established over 40 years. We act as trusted advisors to clients who need help recruiting for important positions.

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As part of a truly global firm, the Board Practice spans all major markets. We work with a wide range of FTSE and AIM-listed companies, international groups, private equity-backed businesses, family-owned organisations, and small and medium sized enterprises.

We have a thorough understanding of board and committee structures, and board dynamics. Our team includes experienced directors of publicly quoted and privately held companies. In short, we know how boards work.

Odgers Berndtson has been an influential voice in the corporate governance debate. We understand how the principles of good governance, applied practically and not by rote, can help create strong, effective boards that add real value to an organisation.

Our wide experience and deep knowledge is brought to bear on every board appointment we undertake.

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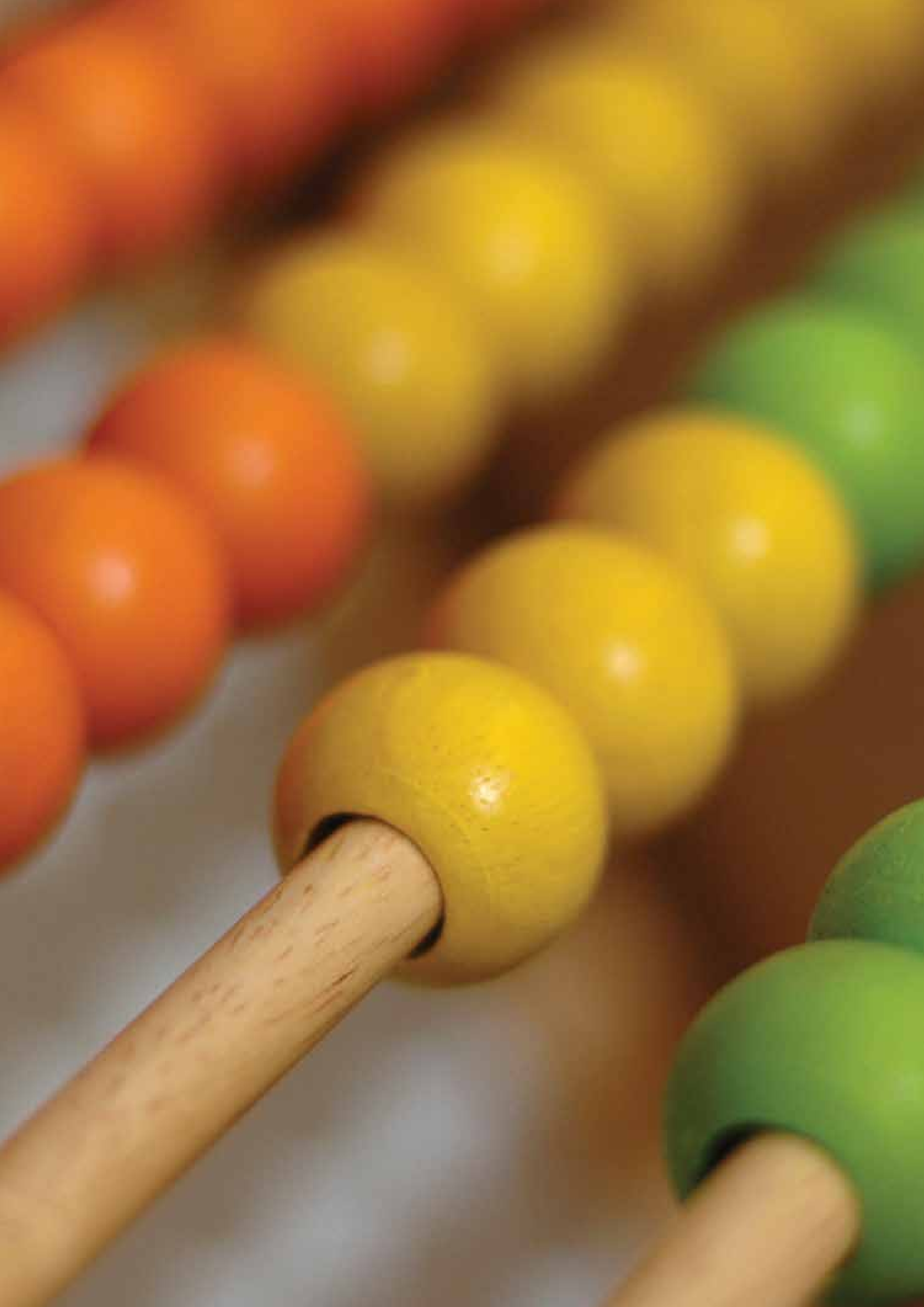

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