



AUDIT COMMITTEE INSTITUTE

Highlights from the 7th Annual Audit Committee Issues Conference

Planning the 2011 Agenda

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About the Audit Committee Issues Conference

Now in its seventh year, the Annual Audit Committee Issues Conference brings together audit committee members from around the country to discuss the challenges, practices, and priorities shaping audit committee and board agendas. Designed exclusively for audit committee members, the conference is hosted by KPMG's Audit Committee Institute (ACI), and cosponsored by the National Association of Corporate Directors, the University of Miami School of Business Administration, and Weil Gotshal & Manges LLP.

For more information about the conference, visit auditcommitteeinstitute.com, or contact KPMG's ACI at 1-877-KPMG-ACI (576-4224).

It should come as no surprise to find risk management at the top of the audit committee agenda in 2011: Events and developments of the past 18 months—business crises, product recalls, WikiLeaks, mounting public debt, geopolitical unrest, and more—point to the ongoing challenges that companies face in managing risk globally in a complex, volatile environment. Among the other “top concerns” for audit committees in the year ahead: financial communications/disclosures and new accounting standards, legal and regulatory compliance, uncertainties posed by the economy and government regulation, IT risk and emerging technologies, and leadership/culture/tone at the top.



Top Concerns for 2011

What issues will pose the greatest concern for your audit committee in 2011?

1. Risk management and crisis response
2. Financial communications/disclosures and new accounting standards/convergence*
3. Legal/regulatory compliance
4. Uncertainty: economy and government regulation
5. Leadership/culture/tone at the top
6. IT/emerging technologies (cloud computing)
7. Audit committee effectiveness (composition/self-evaluation)
8. Globalization (off-shoring and supply chain)

* Reflects combined votes for “Financial communications/disclosures” and “new accounting standards/convergence,” which are closely related but were offered as two possible survey responses.

Based on the dialogue and polling at our 7th Annual Audit Committee Issues Conference, this line-up of issues—with risk, compliance, and financial reporting integrity front-and-center—is not only shaping what is on audit committee agendas, but *how* those agendas are being carried out: “*Crossing the T’s and dotting the I’s is necessary – but it’s not a substitute for truly understanding the business and its risks.*” “*The risk culture of the organization trumps everything—including process.*” “*Are dissenting views being heard?*”

From linking strategy and risk—and tying it to the board’s self-evaluation—to defining their information needs, challenging management, and ensuring the company is ready to respond to a crisis, leading boards and audit committees are focused squarely on raising their game. “*The best boards,*” noted one speaker, “*have moved from governance to leadership*”—and audit committees, often viewed as a board within a board, are playing a pivotal role.

In the following pages, we highlight key issues and practices that are shaping audit committee agendas in 2011, as discussed by 120 audit committee members and business leaders attending this year’s “Issues Conference.”

Key Risks Shaping Audit Committee Agendas in 2011

In addition to financial reporting and related internal control risks, a number of new or emerging risks will be front-and-center for audit committees in the months ahead, and much of the Issues Conference dialogue focused on how audit committees will be dealing with these risks.

Emerging Issues in IT Risk and Governance

Cloud Computing

As the demands on business IT infrastructures have increased dramatically in recent years—with companies generating huge amounts of data, sharing it among multiple users, and transmitting it across the globe—more and more companies are turning to cloud computing and similar technologies (such as mobile computing and the use of “virtual” hardware platforms, operating systems, storage devices, and network resources), to meet these IT demands in a cost-effective and scalable way. One panel member cited recent surveys indicating that nearly two-thirds of business executives say their companies are using cloud computing now or have plans to do so within the next 24 months.



At the same time, of course, cloud computing poses significant regulatory and operational risks—including critical data security risks—as companies transfer their data to third-parties for storage, processing, or support. Protecting intellectual property and safeguarding employee, customer, and third party information is a critical challenge for every company.

As panelists emphasized, however, another important and often overlooked risk for many companies is the risk that individual business units or departments may move to the cloud without an overall company-wide cloud adoption strategy. Because of the ease of purchasing cloud IT services, company executives may opt to purchase services directly through the cloud rather than obtain those services (e.g., sales force support and HR applications) through the company's IT organization, particularly when it means additional delay or expense.

- *“You may lose control of your supply chain of IT providers.”*
- *“Who is managing the company’s cloud adoption strategy? What is the role of the CIO?”*

While only 19 percent of audit committee members said their audit committee receives briefings on the company's plans to use the cloud, panel members suggested that audit committee members may want to probe more deeply about the company's cloud computing plans as well as its overall “data policy”:

- *“What information will be stored in the cloud? Where?”*
- *“Who owns the data and applications? Who can access, delete, or change the data?”*

Panelists offered a number of “takeaways” for audit committee members:

- Do we have a clearly articulated cloud adoption strategy—including a road map and timeline for cloud adoption?
- Are the company's policies and procedures “cloud ready” prior to adopting cloud solutions?
- Are the CIO and CRO involved in selecting cloud service providers?
- Do we have an information security governance policy?

Cloud Computing

Does your board or audit committee receive briefings on the company's plans to use cloud computing?

19%

Yes

64%

No

17%

No plans to use cloud

WikiLeaks

In light of the WikiLeaks issue, which of the following pose the greatest concern for your company regarding employee access to sensitive information? (select two)

62%

Employee with access may unintentionally expose sensitive information

56%

Company's crisis response plan may be inadequate

48%

Access not effectively limited to employees with a "need to know"

34%

Employee with access may intentionally expose sensitive information

Impact of Regulations

What aspect of the audit committee's oversight role do you expect to be most affected by the new regulatory environment?

44%

Risk management

37%

Compliance & ethics

12%

Financial reporting

7%

Internal controls

0%

Auditor relationship



- Have we classified information according to its sensitivity and criticality to the business?
- Is internal audit focused on key cloud-related risks?
- Do we meet regularly with the CIO—and are these discussions in business context and plain English?

WikiLeaks

In discussing possible lessons learned from WikiLeaks, panel members emphasized that *"this was not a case of a third party accessing sensitive information; rather, it was a disgruntled employee, who had access to confidential information, and who was able to use social media to cause severe damage."*

Conference attendees cited a number of concerns stemming from the WikiLeaks development, including the risk that employees with access to confidential information may unintentionally—or worse, *intentionally*—expose sensitive information; the company's crisis response plan may be inadequate; and access to confidential information may not be effectively limited to employees with a need to know.

- *"The combination of access to sensitive information and access to social media poses a serious risk for every company."*

- *"Take a look at your policies regarding employee access to information and the use of social media. And make sure you have a crisis response plan."*
- *"Information can go viral in an instant. To protect your brand, it's critical to have a communications plan ready to take off the shelf."*

Compliance Oversight: Dodd-Frank, FCPA, Federal Sentencing Guidelines

As one attorney suggested, three converging trends—heightened FCPA enforcement, new Dodd-Frank Act whistleblower bounties, and recent amendments to the Federal Sentencing Guidelines—should put oversight of corporate compliance very high on the current agenda of all audit committees.

Indeed, nearly 75 percent of conference attendees said that, in the aftermath of Dodd-Frank, they expect to spend more time on compliance than in the past several years—with legal/regulatory compliance being one of their top-three concerns for 2011. Dodd-Frank whistleblower provisions, said attendees, are particularly troublesome.

The whistleblower provisions provide incentives for whistleblowers to report suspected wrongdoing directly to the SEC in exchange for cash rewards of 10 percent to 30 percent of amounts recovered by the SEC in excess of \$1 million. A key focus of discussion was how this bounty program will

impact existing compliance programs—including whistleblower processes—that companies have spent considerable time and resources developing. In particular, panel members expressed concern that the Act's bounty program provides tremendous incentives for employees to bypass internal corporate processes for reporting suspected wrongdoing, and thereby reduce the effectiveness of the company's compliance programs.

A good example of these incentives is in the area of FCPA enforcement. In recent years, the DOJ and SEC have made FCPA enforcement a priority, stepping up their efforts dramatically. Importantly, the Dodd-Frank whistleblower bounty program applies in the case of FCPA violations. To put this in context, in recent FCPA enforcement cases the financial sanctions have been quite large—\$800 million in one case, \$575 million in another. Since 2003, 23 companies have paid monetary sanctions of more than \$10 million. As panel members emphasized, *"the incentives for corporate insiders to become FCPA whistleblowers are huge."*

- *"As directors, we all understand the challenge of maintaining effective compliance programs in this highly complex and global business environment—and we need the commitment of our people—all our people—to meet that challenge."*
- *"I hope the SEC can address these concerns in its rulemaking proceeding. In the meantime, the best we can do is to redouble our efforts on compliance and address employee concerns."*

Among the questions audit committees might consider:

- Do we understand the risks the company faces with respect to bribery and corruption?
- Do we understand the cultural sensitivities?
- Do we have a strong FCPA compliance program specifically tailored to our risk profile?
- Do we receive risk reports from the chief compliance officer (CCO) about the status of the compliance program

generally, as well as specific and timely reports about issues that may arise?

Attorneys on the panel also highlighted recent amendments to the Federal Sentencing Guidelines: These changes increase the opportunity for a reduction in organizational sentences when the company has an effective ethics/ compliance program in place at the time of the offense, and, as stated in the amendments, "the individual or individuals with operational responsibility for the compliance and ethics program... have direct reporting obligations to" the board or a board committee, such as the audit committee.

In light of these amendments, audit committees and boards will want to review with counsel the nature and frequency of the reports they receive directly from the company's CCO—including the access the CCO has to the board or audit committee.

Recent Lessons Learned (or Relearned) about Risk

Given the events of the past 18 months—the oil spill in the gulf, mining disasters, product recalls, geopolitical unrest, and more—conference participants identified a number of lessons learned, or relearned, about risk. Chief among them, the need to focus on:

- The adequacy of business controls around significant operational risks
- Tail risks, or low-probability/high-impact risks
- Risks posed by the extended (global) organization
- Early-warning signs regarding important safety, product quality, and compliance risks
- The adequacy of disaster response plans
- The importance of what-if scenarios and "war-gaming."

Perhaps one of the most important lessons learned, however, is about the critical role of risk culture—not only at the senior management and boardroom levels, but throughout the organization.

Dodd-Frank Compliance

How much attention do you expect compliance issues will require from your audit committee in the aftermath of Dodd-Frank?

73%

More attention than in the past several years

27%

Same attention as in the past several years

0%

Less attention than in the past several years

Whistleblower Bounty

How concerned are you about the impact of the expanded bounty program on the ability of the company to discover and address compliance issues?

45%

Very concerned

31%

Moderately concerned

16%

A little concerned

8%

Not at all concerned

Product Liability

How satisfied are you with the briefings your audit committee receives about the company's product liability risks?

51%

Satisfied

34%

Somewhat satisfied

15%

Not satisfied

MD&A and Risk Environment

Given today's risk environment, how satisfied are you that your company's MD&A adequately communicates the sensitivity and risks inherent in the company's accounting judgments and estimates?

53%

Satisfied

37%

Somewhat satisfied

10%

Not satisfied

- *"The risk culture of the organization trumps everything—including process."*
- *"Audit committees and boards need to hear dissenting views—including the views of those "down the line"—on what and where the risks are."*
- *"Is there real internal transparency about risk? Are we getting the views of those in the middle?"*
- *"Seek to understand the economic purpose of business transactions. Ask whether there are dissenting views regarding the proposed accounting."*
- *"Recognize that the culture of the board may be very different from the actual culture of the company."*
- *"Keep contrarian voices in the boardroom, and ask questions, and probe."*
- *"Understand the perspectives you're getting. Some will view risk primarily as a strategic business opportunity. Others will view risk as risk—with an eye to putting the brakes on at the right time."*

How Informative is the Board's Information?

An ongoing challenge for directors and boards is the quality—versus the volume—of data and information they receive from management, with one conference attendee quoting Nobel Prize-winning economist Herbert Simon: "Information consumes the attention of its recipients. Hence a wealth of information creates a poverty of attention."

Panelists emphasized the need for boards to work with management—particularly the CIO—to more-clearly define the board's information needs:

- *What is the information you really need—to assimilate, analyze, and draw business conclusions?*
- *What is the right level of depth and detail?*
- *Can the format and presentation better show what's most important—and what's actually happening? What has changed or is changing?*

The problem of "data deluge," noted one panelist, is likely to get worse given that "we will produce more data in the next two years than mankind has produced in its entire history."

Linking Board/Audit Committee Oversight of Risk and Strategy with a Rigorous Self-Evaluation Process

An important lesson learned about risk—highlighted by a prominent audit committee chair—is that the risk environment is constantly changing, and audit committee members and directors need to assess whether their board, their audit committee, and they themselves are in a position to understand the implications of these changes for the company.

- *"This is an opportunity to take a step back and look at the composition of the board in the context of the company's strategy and risk profile today and for the next several years."*
- *"When the changes in technology reached the point where I didn't fully understand the implications to the business, it was time for me to step off the board."*
- *"Does the board understand the company's strategy and where the big bets are? As growth comes, how are we taking advantage of it?"*

How is the company doing in developing and executing its strategy and managing risk? Is the board adding real value in these areas? Does the board/audit committee have the right composition to meet the challenges of today and tomorrow, versus yesterday?

- *"Good governance processes are no substitute for engaged, informed, knowledgeable, and experienced directors."*
- *"We spend a lot of time mentoring and counseling management—and to do that you need a real understanding of the business and the risks it faces."*
- *"Why do boards whose governance structures are considered to be 'top notch' fail? Ultimately, it comes down to leadership."*

As a keynote speaker emphasized, *“the main task for boards is not governance, but leadership.”* He suggested that each board and board committee evaluate itself by asking the following questions:

- Over the past two years, what was the net output (versus inputs) of the board/committee?
- What two things could the board/committee have done better?
- What two things does the board/committee need to accomplish in the next year?

Financial Reporting/Accounting Developments and Hot Topics

Financial communications and disclosures, together with convergence and new accounting standards, continue to be key areas of focus for audit committees, and were cited by conference attendees as being among their top oversight concerns for 2011.

Convergence and FASB Standards

While there is continued uncertainty about the role IFRS might play in U.S. financial reporting—with some suggesting that the SEC will likely opt for the “incorporation” of IFRS standards into U.S. GAAP (over time, on a case-by-case basis) rather than an “adoption” of IFRS—it is clear that significant change to U.S. accounting is on the way as a result of joint activity of the FASB and IASB.

FASB currently is scheduled to issue final accounting standards by June in five areas: leases, revenue recognition, financial instruments, fair value, and presentation of other comprehensive income. Although panel members suggested that this schedule may be too aggressive—and that a more realistic schedule might be year-end 2011—they emphasized that these new standards (and others to follow) will bring profound change to U.S. GAAP and the way companies and investors report and interpret corporate financial statements.

Among the recommendations for audit committees to help their companies prepare for implementation of these standards:

- Stay close to where the projects are headed and the time line.
- Identify the major FASB projects that will impact the company over the next several years, and understand the impact on the financials.
- Consider the implementation requirements for each project—including resource requirements (people, cost, technology), time line for the project, as well as the financial expertise and educational requirements.
- *“Take it in bite-sized pieces: We devote 20–30 minutes at every audit committee meeting to get a briefing from management and the external auditor on a new accounting standard impacting the company.”*
- *“Understand the impact on your IT systems. Will they be able to generate the necessary reports?”*

MD&A and Disclosures

Panel members also identified a number of disclosure areas that will require particular attention from audit committees in the coming year. While FASB has delayed its project on loss contingencies, the SEC is focusing closely on *disclosures* regarding loss contingencies. *“It’s not enough to say they’re not material,”* noted one panelist. And disclosures regarding short-term financing must be viewed in the context of the SEC’s recent interpretive guidance on liquidity disclosures and its proposed rule on short-term borrowing disclosures.

Other areas of focus include revenue recognition, impairments, segment reporting, pension funding, and valuation methodologies.

One panel member noted an ongoing concern—shared widely—about *“the quality of disclosures versus the volume. It’s gotten to the point that we need highlights of the executive summaries.”*

Disclosures regarding accounting judgments and estimates generated significant discussion. How does the audit committee oversee management’s judgments? What is the process? One

panel member referred audit committee members to the framework for making accounting judgments and estimates contained in the Pozen Report (at <http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf>).

- *“The company’s greatest financial reporting risks are often in management’s estimates, where the dollars are big, and there is a range of possible outcomes.”*
- *“I hope scenario testing on the sensitivity of judgments and estimates becomes common practice.”*
- *“Understand the cumulative effect of the judgments and estimates. As a matter of routine, I ask our external auditor: How close are we to the center of the page?”*

Education on New Accounting Standards

Do you have a plan—and agenda time—in place to educate your audit committee about new accounting standards and pronouncements that may impact your company?

57%
Yes

43%
No

Streamlining Disclosures

Do you believe that your company’s disclosures—including the MD&A—are overly complex and voluminous, and could be streamlined and clearer?

64%
Yes

36%
No

Conference Speakers, Panelists, and Thought Leaders

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