Directors' alert
Key issues facing boards in uncertain times

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Contents

Introduction

The ongoing economic uncertainty increases risk for many organizations. Directors may feel corporate governance in the current environment consists mostly of deciding what fire to put out first. Effective governance, however, must find a way to identify and tackle all these fires at once. This briefing discusses some of the key issues facing organizations today, to help boards through these vitally important challenges.

Financial reporting matters

The current economic and capital markets environment continues to raise a number of questions and concerns about financial reporting. In the current environment, many managements may experience more difficulty than previous years in preparing financial statements. Many organizations will find it difficult to apply fair value measurement principles given the lack of clarity about market expectations, the financial condition of counterparties, and other uncertainties. We believe that fair value provides needed – if not always pleasant – transparency about the fluctuations in asset values. Recently, standard setters have provided additional guidance to help address questions surrounding fair value measurements in inactive markets. However, it may still be difficult to determine the best approach to particular valuation matters, making the need for professional advisors who are knowledgeable in this area more critical than ever.

Other financial reporting issues created by the uncertain economic conditions include:

- Poor trading conditions may affect asset values, which may trigger requirements to recognize impairments
- Disclosures in respect of special transactions such as creation of special purpose vehicles and securitization of receivables by banks and financial institutions
- Entities with lowered credit ratings may experience refinancing difficulties
- Hedging strategies that may no longer be effective
- Disclosure of key assumptions and uncertain measurements may be reconsidered and expanded

Questions to ask

What aspects of our financial reporting face particular challenges in the current environment? How do we know the list of these challenges is complete?

How are we applying fair value measurement principles and/or arriving at estimates of future cash flows for purposes of impairment testing or other matters?

Is our disclosure clearly addressing the uncertainties we face and the assumptions that we applied?

Financial flexibility

In a weak economy, businesses often face reduced revenues, lower profit margins and net profits, and pressures with respect to banking covenants. In addition, there may also be uncertainties with regard to capital, including the availability, timing and cost of capital required for debt, equity or investment purposes.

In difficult economic circumstances, the organizations that are best positioned to survive and prosper are the ones that are financially flexible. These organizations may experience more limited financial distress in times of economic uncertainty and can fund investment, at low cost, when profitable opportunities arise.

What makes an organization financially flexible? In part, financial flexibility is dependent of an organization's size and the industry in which it operates. However, financial flexibility also results from the strategic decisions the management makes and the board oversees with respect to capital structure, liquidity, and investment.

Another key issue in today's environment is the rising cost of capital - management may wish to reevaluate its assumptions and best estimates to reflect these new market conditions. Examples of areas subject to possible reassessment include receivables, inventory, deferred income taxes, employee compensation, pension assets, and restructuring /discontinued operations.

Questions to ask

Following the recent global credit crunch, regulators may introduce new rules related to asset management. How well-positioned are we to respond to a possible increase in regulations? Can we carry additional costs related to compliance? Do we have the necessary resources in terms of human capital?

What processes and procedures do we need to put in place to enable us to identify and rectify underperforming areas before they reach crisis levels?

Do we consider a variety of possible scenarios and create a strategic response for each scenario as part of our process for developing budgets and operating plans?

A rigid business model, or one with only limited scope, may quickly crack when confronted by different business circumstances.

Business models

The businesses that survived past economic crises were typically ones that were flexible – not only had they developed a Plan B, but also Plans C and D in addition to their Plan A. A rigid business model, or one with only limited scope, may quickly crack when confronted by different business circumstances. The key to maintaining flexibility is having the right skills in the right roles. Organizations need people who are willing to make tough decisions and, in some cases, to step away from entrenched strategy positions.

Although the current environment presents significant operating challenges, including tight liquidity and a variety of other performance pressures, organizations should seek to do more than just cope with the environment. The most successful ones will also identify and take advantage of those growth opportunities that do exist so they emerge from the current economic slowdown ahead of their competition.

Boards should build a comprehensive picture that shows how all areas of the organization's business model – or business models – are affected by the current business environment, including how issues such as cash flow, cost containment and liquidity issues will be addressed and how growth opportunities will be pursued. In this environment, both short- and long-term positions should be considered since no risk scenario can be regarded as too remote.

Questions to ask

Are we clear where the key stress factors in our business strategy lie?

Are we taking a broad enough view of the current situation? Have all opportunities been considered?

Do we have appropriate mechanisms in place to provide the board with timely feedback on the organization's progress against its strategy, the underlying causes of any performance variance, and any changes in the internal/external environment or risk factors that may cause the board to consider altering the organization's strategy?

Competitiveness

In good economic times, competitiveness is an important issue to manage for every for-profit organization (and, in certain respects, for not-for-profits too). In difficult environments, an organization's competitive abilities are even more critical.

Entities may consider reassessing the way they compete (e.g., improving productivity) and where they compete (e.g., entering better markets). Given the connectedness of today's marketplace, to be truly competitive, organizations must ensure that they consider their competitors and their opportunities on a truly global basis – not just the ones that exist in the country next door. Succeeding as a globally competitive organization requires addressing many factors, including the competitiveness of capital markets, effect of various tax policies, relevant investments made by your organization, and the practices and policies of its competitors. The most important factor, however, is the effectiveness of the organization's own leadership, including the CEO and management team as well as the board of directors.

Questions to ask

What are the top three issues our organization faces with respect to competitiveness and what is our response to them?

Within the area of strategy, where and how do we, as the board, draw a line between our responsibility to oversee the process and senior management's responsibility to develop and manage that process?

A key element to surviving and prospering in uncertain times is prioritizing recruitment, development, and retention of top talent. What are we doing, as a board, to ensure that these issues do not get overlooked?

In today's market place, to be truly competitive, organizations must ensure that they consider their competition and their opportunities on a global basis and not just look at the organizations and opportunities that exist in the country next door.

Risk management

Recent events in the credit market and their effect on the economy as a whole have thrown the board's responsibilities for risk management into stark relief. Directors must take a more holistic view of risk than ever before; they need to question the assumptions behind even the most conventional wisdom about strategy, financing, and the health of counterparties. Boards of directors must be more than just risk-aware; they must also be risk-intelligent. To meet their fiduciary responsibilities, therefore, directors must share a common vision of risk and adopt a framework to support their risk oversight activities.

In the past, many boards were reluctant to take an active role in establishing levels of risk appetite, either because they did not have the requisite knowledge or were concerned that doing so would step on the toes of management. Today, however, increasing numbers of third parties want the board to be actively involved in risk oversight. Credit rating agencies are incorporating risk oversight into their opinions of creditworthiness; institutional investors are asking more pointed questions about risk; SEBI requires all listed companies to discuss the risk exposures as part of their annual agendas; and providers of director and officer liability insurance (D&O) have a vested interest in ensuring that the board is mitigating and disclosing large risks.

Boards may wish to consider a number of steps to integrate risk oversight from a separate agenda item at board meetings to a topic that is suffused throughout every item the board discusses. While there is unlikely to be a one-size-fits-all solution to how boards address risk, there are some common approaches. These include consideration of whether a board-level risk committee would be useful in sharing the workload among directors, identification of risk oversight as one of the board's activities, and creating a process for setting or monitoring risk appetite levels of the firm.

Questions to ask

How can we best work with management to set a framework for thinking about risk and setting our risk appetite level? How can we begin viewing risk not just in terms of potential losses to mitigate, but also in terms of potential rewards for intelligent risk-taking?

How can we move risk from a separate board agenda item to something that is integral to all our decision-making about strategy, capital allocation, and even succession planning?

How should we structure our responsibilities for risk oversight? Should we form a separate, board-level risk committee? How can we best share information about risk among all board members without overwhelming directors?

Executive compensation

The long-standing controversy surrounding executive compensation has intensified with the current faltering performance of many organizations. Some organizations claim they apply the "pay for performance" concept although the measures of "performance" are not clearly defined. In some cases, executive compensation plans and decisions about executive pay can appear unconnected to the organization's real risks and exposures. In some cases – for example, when the incentives inherent in the compensation plan focus excessively on short-term indicators rather than on long-term economic sustainability – the resulting compensation plans may not serve the organization's real best interests.

Disclosures about an organization's executive compensation are highly susceptible to being second-guessed by stakeholders and may, in fact, generate significant distraction or embarrassment for your organization and its board. In fact, the new disclosures may serve to highlight the unsophistication of some compensation strategies relative to the organization's real needs.

Few compensation committee members are compensation experts, and so they must rely to some extent on the advice of consultants and other inputs when assessing their organization's executive compensation plans and practices. Given the growing scrutiny that continues to be applied to executive compensation, directors will be expected to apply an increasing degree of skepticism in their oversight of this area.

Questions to ask

How much have we thought about what constitutes "adequate performance" for the purposes of our compensation plans? How much does our plan reflect what we know to be the key organization risks? Have we performed enough tests on how our existing plans would respond to a range of plausible economic scenarios?

Does our external disclosure around executive compensation clearly and accurately communicate how executive compensation actually works within our organization?

Do our compensation committee members have all the support they need to pull together all the inputs into the compensation process and provide informed, independent oversight on what is best for our organization? If not, how can this be fixed?

Overall, boards may benefit from a rigorous ongoing process to identify changes in relevant regulations and to understand how management implements them.

Regulatory issues

Amid the economic downturn and the faltering performance of many public organizations, new concerns have been raised about the effectiveness of the regulatory oversight of capital markets. This comes despite the steady increase in regulatory requirements in recent years – details vary among jurisdictions, but prominent recent new rules include requirements for reporting on the effectiveness of internal controls and executive compensation disclosures. Each year, regulators also typically address existing rules, including further clarifying the way in which they expect those rules to be applied.

The agenda for coming years will be no less demanding. In addition to the transition to International Financial Reporting Standards (see the discussion below), other short- to medium-term initiatives range from reconsidering the basic building blocks of corporate reporting to changing the technology by which this information is prepared and filed, in particular through the continuing migration toward using interactive data eXtensible Business Reporting Language (XBRL) in regulatory filings.

Many of these regulatory initiatives provide opportunities to improve shareholder communication, such as by making greater and more active use of corporate websites to disseminate information. It is important, therefore, for boards of directors to have a rigorous, ongoing process that allows them to identify changes in relevant regulations and understand the steps management implements in response to them. Boards of organizations that are subject to industry-specific regulations related to capital adequacy or other matters face an even more complex task of monitoring and assessing the effect of regulatory changes.

Questions to ask

What process do we have in place to help us fully understand the changes in regulatory requirements and expectations affecting us?

What is our attitude toward regulatory compliance? Are we doing all we can to unlock the benefits of new requirements and not just incurring the costs?

What contacts have we had with our regulators?

IFRS transition

Although the transition to International Financial Reporting Standards (IFRS) is sometimes viewed as primarily a technical accounting challenge, it has implications that range widely and deeply through an organization. Virtually every organization will have to make multiple changes to its accounting policies and underlying control systems. Some of these changes may create additional volatility or unfamiliarity in the reported results. The volume of disclosure in the notes to the financial statements will increase.

Since requirements under IFRS are more "principles-based" than the accounting requirements they replace, the transition brings organizations the opportunity to revisit some existing inefficiencies or to better align certain accounting policies with underlying economic realities. Of course, any change in financial reporting could also impact other business processes linked to those numbers. Therefore, it is important to fully diagnose and manage the impact of the transition on the control systems, budgeting processes, debt covenants, performance measures applied in compensation arrangements, and more. Organizations should not underestimate the demands of internal training and change management, investor relations, and other aspects of external communication.

Questions to ask

What are the current or pending requirements for our organization to implement IFRS? What are our plans and processes for achieving this?

Has our organization responded to all the implications of IFRS, ensuring all connections and consequences are identified and dealt with, while paying attention to maintaining a coherent overall internal culture?

How do our personal risks and obligations change in an IFRS world? For example, for those board members subject to a "financial literacy" requirement, have we set up an appropriate training program to support maintaining that personal standard?

Boards and audit committees play a crucial role in overseeing the transition to IFRS and its related impacts on the organization, and will want to know how management will exercise and demonstrate due diligence when it makes financial reporting decisions in an IFRS environment. Directors may wish to ensure that details of the organization's transition plan that are communicated in the (Management's Discussion & Analysis) MD&A allow stakeholders to evaluate the potential impact of such a transition thereby, avoiding any surprises in the future. Audit committee members identified as having audit committee financial expertise may wish to ensure they have obtained appropriate training to retain this qualification under an IFRS regime.

Climate change

All organizations, and not just oil and gas, utilities or organizations in extractive industries, may be concerned about the growing impact of climate change. Increasingly, customers, institutional investors, shareholders, regulators, and governments are taking an interest in what organizations are doing to protect themselves from and adapt to the effects of a changing climate, as well as what they are doing to help combat climate change itself.

Climate change represents a series of highly interdependent risks that carry a global impact. These risks cover a broad range of types (including physical, operational, regulatory, price, etc.) that have implications across an organization's value chain, from suppliers and operations to products and services. Because climate change can create significant uncertainties, organizations should ensure they take an integrated approach to identifying opportunities and managing risk related to climate change.

Whether driven by a broader need to demonstrate a proactive corporate responsibility strategy or a need to comply with impending regulation, sound oversight of environmental and social issues is considered a barometer of good governance and can significantly enhance competitive advantage. On the other hand, mismanagement of these issues represents potential liabilities and reputational harm to directors and management.

Board composition and training are the first steps to ensuring that the competencies are in place to understand and manage these risks. Moreover, boards may wish to consider how well they understand and identify the strategic and operational opportunities associated with climate change and corporate responsibility.

Finally, directors may ensure timely disclosures about climate change and environmental risks, related strategies and potential financial impacts are provided to the regulators and the capital markets.

Questions to ask

Should a substantive discussion on climate change be included on our board’s agenda each year?

Does our risk or governance committee consider Climate-change-related risks? Are these risks addressed by our Enterprise Risk Management (ERM) or risk management program?

Should we set goals, either informal ones or those to be disclosed formally, related to greenhouse gas emissions?

Investor and shareholder activism

The recent Satyam saga has been a high profile case of investor activism which forced the software giant to cancel its plan for a $1.6 billion acquisition of two companies linked to the company's founder. Both analysts and shareholders criticised the move, terming it a disregard for shareholders' interests. Such incidents may affect the relationships between organizations and their shareholders. Many investors may seek to address weakened financial performance by actively engaging with management. Investor activism will vary depending on the country of listing and investors' own approaches, but could include publicity campaigns, shareholder proposals, proxy fights, contested director elections, and more.

Investor activism may result in positive corporate change. In some instances, however, it has also led to less favourable outcomes including distraction of management, changes in financial policy that may unduly privilege the interests of shareholders over those of creditors, discord on the board of directors, and unexpected changes in management.

Boards may wish to remain sensitive to anticipate investors' needs – a task that requires frequent and clear communication to investors. It also requires organizations to deepen their levels of trust with investors and other stakeholders. The way in which organizations go about accomplishing these objectives may vary from one organization to another, but in all cases it will require a commitment to being transparent and listening to investors. Such openness may reinforce stakeholder trust in entities in the areas of risk management, compensation, business strategy, appointment of directors and auditors and environmental and social practices.

Questions to ask

How well do we know our investors? What steps are we taking to maintain good relationships with all our stakeholders?

Does our risk management plan consider our susceptibility to investor or creditor activism? What would we, the board of directors, do as our first steps if it were confronted with an activist investor?

Have we developed a sound shareholder communication plan in the event of an activist campaign? Do we have a team of people prepared to respond quickly when an activist event occurs?

With these as potential challenges, today's boards may wish to be sensitive to and, in some ways, anticipate investors' needs. Doing this right requires frequent and clear communication and disclosure with investors.

Conclusion

The current unsettling economic environment has increased expectations for boards and directors to assume closer oversight of a rapidly multiplying number of risks. Yet for boards comprised of increased numbers of independent directors, time and attention are limited, making the decision about where to place the board's focus a critical one. The issues outlined here will manifest themselves in different ways at different entities, and some will no doubt be more pressing across particular industries. Yet they represent a current view of the handful of issues that will be foremost in the mind of most directors as they navigate the way forward. With the application of rigour and flexibility to these ten issues, and by taking advantage of the variety of tools, resources, and research that are available to Deloitte clients, today's boards can position themselves well to weather the storm.

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