Risk Oversight and Assessment…
A View from the Audit Committee

Panelists:

Darryl Rains, partner at Morrison & Foerster, experienced securities and white collar criminal litigator

Bob Finocchio, private investor, experienced board member for public and private companies, serving on several Audit Committees

Deirdre Flaherty, founding partner of StoneTurn, experienced forensic accountant having conducted a large variety of corporate investigations.

Silicon Valley NACD
May 19, 2011
Why does Risk Matter?

- Barings Bank
- Long Term Capital Management
- WorldCom
- Global Crossing
- Enron
- Arthur Andersen
- Bear Stearns
- Merrill Lynch
- Lehman Brothers
- AIG
- General Motors
- Nortel
- Satyam

What did these Boards wish they had known?
- Many failures sprung from core activities and not unforeseeable events.
- Did these enterprises understand their “Going Concern” risks as much as they focused on the process of ERM, the mechanics of reporting risks, FCPA
- A forest and trees problem?
Case Study 1: Countrywide Mortgage

- Countrywide allegedly decided to match every competitors’ product offerings. (A race to the bottom?)

- Impact on brand of offering “no doc,” “stated income,” “no income,” “no appraisal,” and 100% loan-to-value products.

- Countrywide targeted 30% market share.

- Risks of focusing on revenue stream, market penetration, etc. without focus on attendant risks.
Case Study 2: Bear Stearns, AIG, etc.

- Bear Stearns: 2 leveraged sub-prime funds
- AIG: Credit default swaps

- Risk assessments based on: credit ratings, Case-Schiller historical performance, interest rate models, stress tests, etc.

- Risks of ignoring “black swan” events.

- Customers all sophisticated investors with sophisticated disclosures.

- Litigation risks of selling to sophisticated investors and reliance upon disclosures.
Case Study 3: Wells Fargo, Bank of America

- Wells Fargo bought Wachovia.
- Bank of America bought Countrywide and Merrill Lynch.

- Countrywide purchase price: $4 billion
- Write-downs so far: $2.4 billion.
- Settlements so far: $700+ million.
- Current litigation reserve for probable losses: $6.2 billion.
- Estimated potential losses above reserve: $11 to $15 billion.
Case Study 4: Berkshire Hathaway

- March 30 Press Release re Sokol resignation:
  - “Neither Dave or I feel his Lubrizol purchases were in any way unlawful.”
  - “They were not a factor in his decision to resign.”
  - “I have held nothing back in this statement.”
  - “If questioned about this matter in the future, I will simply refer the questioner back to this release.”

- April 27 Press Release re Audit Committee investigation:
  - Sokol violated insider trading policy, code of business conduct, duty of candor, and duty of loyalty.
Strategic and operational failures and the inability to assess risks in strategies have the greatest impact on share price declines.

• This analysis looks at root causes underlying market capitalization declines of 50% or more in a single year.

• Percentages refer to frequency of occurrence of each factor in the sample population.

Source: Corporate Executive Board
First Principles

• Don’t let your board dump risk management on the audit committee.

• Develop a risk “template” for the enterprise which identifies key buckets of risk and their respective owners, both oversight and management.

• Ensure board committee charters contain the respective risk oversight responsibilities.

• Ensure board committees do what their charters require.

• Those risk categories not specifically contained in a committee charter are owned by the board as a whole.
An example-- enterprise risk template:

### Board of Directors Risk Oversight

<table>
<thead>
<tr>
<th>Competitive Dynamics</th>
<th>End Market Trends &amp; Developments, and Marketing</th>
<th>Macroeconomic Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td>VP Marketing</td>
<td>CFO, VP Bus Dev</td>
</tr>
<tr>
<td>Strategy</td>
<td>Product planning</td>
<td>Foreign Operations</td>
</tr>
<tr>
<td>Resource allocation to products/markets</td>
<td>Product obsolesence</td>
<td>Foreign dependencies</td>
</tr>
<tr>
<td>Displacing Technology</td>
<td>R&amp;D strategy</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Product Development</th>
<th>Sales</th>
<th>Supply Chain Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>VP R&amp;D</td>
<td>VP Sales</td>
<td>VP Supply Chain</td>
</tr>
<tr>
<td>Product &amp; Software Development</td>
<td>Distributor concentrations</td>
<td>Supplier concentrations</td>
</tr>
</tbody>
</table>

### Audit Committee Risk Oversight

<table>
<thead>
<tr>
<th>Financial Operations and Reporting Risk</th>
<th>IT Security and Backup</th>
<th>Legal Compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFO</td>
<td>CIO</td>
<td>General Counsel</td>
</tr>
<tr>
<td>Fraud &amp; Restatement</td>
<td>Information security</td>
<td>China &amp; IP protection</td>
</tr>
<tr>
<td>Disaster recovery</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Compensation Committee Risk Oversight

<table>
<thead>
<tr>
<th>Compensation Programs, Policies, &amp; Practices</th>
<th>Succession Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>VP HR</td>
<td>VP HR</td>
</tr>
</tbody>
</table>

### Nominating and Governance Committee Risk Oversight

<table>
<thead>
<tr>
<th>Corporate Governance</th>
<th>General Counsel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right people</td>
<td></td>
</tr>
</tbody>
</table>
Typical *audit committee* assignments include oversight of risks associated with:

- Financial reporting and public disclosure
- Compliance, including tax, FCPA
- Information Technology
- IP security
- Disaster planning/recovery
- Traditional risk mitigation (e.g. insurance)
- Investments
- Capital structure
Audit Committee Tools

- Normal process of meetings, agendas, reviews
- External auditors
- Internal auditors
- Internal and external counsel
Suggestions from my experience:

- Map the internal audit plan to the buckets of identified enterprise risk.
- Have lots of people in the audit committee meeting room, pay attention to the “back benchers.” Watch the body language.
- Find opportunities to have a variety of people present to the committee.
Suggestions, cont.

• Individual, informal relationships among committee members and:
  
  – CFO
  – Controller
  – Treasurer
  – Internal Audit
  – External audit
  – General counsel
  – Internal compliance function
Suggestions, cont.

- Pay attention to the internal organizations, understand reasons for turnover.
- If you don’t understand something, stop the music.
- If you still don’t understand something, don’t do it.
Suggestions, cont.

- Require Rep letters deep into the organization, especially sales
- Listen to the conference calls, read the research reports
- Read the filings very carefully
- Read press releases very carefully
- **Routine** private sessions with key players
But, these suggestions may not help with the really big enterprise risks

- Risk of form over substance
- False sense of security from lots of activity
- Risk from too much delegation (those other guys are paying attention to it)
- Compliance ≠ risk management
- GAAP ≠ risk management
- Disclosure ≠ risk management
Remember, history has demonstrated that the really big risks

• Are **not** from stochastic shocks, unforeseen shocks
  – Earthquakes, famines, plagues...

• **Are** from core activities and strategies

• The really big risks are **going concern, existential risks**
So what do you do about those?

- **Know** what they are
- Must be owned by the **board** as a **whole**
- Must always be on the board’s agenda
- Cannot be delegated or disclosed away
So, my most important suggestions to oversee existential risks:

1. Know what business you are really in.

2. Know, really know how you make money.

3. Know with whom you are really doing business, and how they make money.
Continued:

4. Beware of businesses and business models too good to be true. (TINSTAAFL)

5. Understand the balance sheet, really understand cash. Watch out for cashless profits.

Be the most diligent when business is good
No news is simply no news – inquisitive and involved vs. “Contrarian”

- Corollary to Murphy’s Law… “Murphy was an optimist!”
- Take the time to “interview” direct sources of information
- Ask the same question and compare the answers!
- Value the candid discussion – reward that candor (punish obfuscation?)
- Challenge the conventional wisdom – “WHY” is a powerful word
- Social relationships and “team player” mentality can create a false sense of trust
“It Will Not Happen To Us (Here)” Trap

- Actively look for the warning signs – red flags rarely look red except in a rear view mirror
- Think through your risks from a “front-line employee” perspective
- Pressure + Opportunity + Rationalization = PROBLEMS
- Middle Management is critical, if not more so, than senior management
Today’s news is Today’s Lesson

- In every failure there is lesson(s) that can be applied to your organization and your relationship with it

- Focus on the “WHY”
  - WHY did it happen to them
  - WHY could it not happen here
Common Traits in Ethical Collapse

Marianne Jennings, Seven Signs of Ethical Collapse

1. INTENSE PRESSURE TO ACHIEVE NUMBERS
2. FEAR AND SILENCE; DISSENT IS ABHORRED
3. A BIGGER-THAN-LIFE CEO AND INEXPERIENCE
4. “WEAK” BOARD OF DIRECTORS
5. CONFLICTS OF INTEREST--NO CONFLICT, NO INTEREST
6. INNOVATION LIKE NO OTHER--SUSPEND NATURAL LAW
7. GOODNESS IN ONE AREA, ATONES FOR EVIL