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Corporate Governance:
Averting Crisises Before They Happen

A sharp rise in the restatement of financial reports has placed a fresh spotlight on the role of audit committees and their responsibility in heading off and averting corporate crises. One thing for certain is that they can no longer accept at face value what has been presented to them. Rather they must now be equipped to ask the right questions and go beneath the surface to fully grasp their company's true state of health.

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A sharp rise in the restatement of financial reports, WorldCom and Enron among them, has placed a fresh spotlight on the role of audit committees and their responsibility in heading off and averting corporate crises.

While they have always had some responsibility over outside auditors and internal accounting, most audit committees have been rubber stamps for senior management. Today that is no longer the case. Inaccurate financial reporting and resulting corporate scandals have raised serious concern over how to improve the performance of boards and their vital audit committees; and Sarbanes-Oxley has mandated the rules.

The key in the future will be how audit committees understand and view the financial reporting of the senior management they are overseeing. One thing for certain is that they can no longer accept at face value what has been presented to them. Rather they must now be equipped to ask the right questions and go beneath the surface to fully grasp their company's true state of health.

It has always been a given that audit committee members should have a deep understanding of the business that they serve. By this I mean they must understand the corporation's products, customers and markets, business processes, accounting, reporting and internal control systems and the competitive, technological and other risks to which the corporation may be exposed. Further, they must have a good sense of the corporate culture and ethical standards and must understand how all of the above factors are considered and fit together to ensure accurate financial reporting and corporate transparency.

The foregoing are all subjective, qualitative inputs which when taken as a whole, will provide the audit committee with a sense of how the business flows and how the corporation delivers value to its customers. This knowledge will be of great help in assessing the effectiveness of management and in evaluating management proposals put to the board of directors for their approval.

But it is the quantitative data that will be the harbinger of trouble ahead. Strategic, operational and financial problems always find their way into the quantitative data. And by quantitative data I am not referring to monthly, quarterly and annual financial statements, but rather to the wealth of operational data that is generated every minute, every shift, and every day, week and month, within each corporation. This is the mother lode of data that must be mined by the audit committee and used in conjunction with the financial statements when assessing how the corporation is performing and detecting problems ahead.

The data can range from order backlogs, to delivery lead times; from quality rejects per week to productivity per shift. Not all of this data is critical to detecting whether the operating metrics are leading the corporation on a downward spiral. But some of this data, what I call the key drivers of profitability, is essential to understanding how the business is doing.

In every business there are a handful of drivers that determine the success of the operation. And they are not the same in every business. For example, in manufacturing businesses, order backlogs are important, as are production quality, labor, raw material costs and selling prices. But ultimately, it is the measures of productivity that will determine how profitable and successful the business is.

To be specific, in the injection molding business high volume molders use multi-cavity molds in their production processes. Most costing and pricing models assume that 100% of the mold cavitation will be operational at all times. In reality this is not always the case. And when it is not the case, productivity is lost. For example, a 16-cavity mold with only 12 cavities operating has lost 25% of its productive capacity. That means that 75% of the rated output must absorb all of the labor and overhead costs. It is very difficult to make a profit in that environment.

In the farm produce business market prices, fertilizer costs, yields per acre planted, and packing labor costs are all important drivers of profitability. But the most critical driver of profitability is the pack-out yield: The percentage of the total harvest that is actually packed and shipped to customers. By the time the produce reaches the packing lines, all the costs of planting, growing, harvesting, grading and packing have been incurred. The quantity of produce that is rejected at the point of packing has a huge impact on the overall productivity and hence, profitability, of the crop.

One might ask how audit committee members can be expected to delve to the level of detail described above. The answer is to work closely with the internal audit staff and management to gather and identify the data that is truly important to track. The corporation may have already prepared internal reports that track much of the important data. These reports may then be supplemented by additional data that the audit committee wishes to see.

Understanding the flow of the business and then following the daily, weekly and monthly trends of the key operating data, the drivers, will lead to a real "feel" for the business. Adverse trends among the key drivers and other operating data that the audit committee chooses to monitor are the early warning signs of trouble ahead. The negative impact of these adverse trends will be seen in the monthly financial statements. If the operating performance reflected in the corporation's financial statements does not trend downward when the key drivers are trending downward, then the audit committee should immediately ask why.

When it is time to review annual operating budgets, the corporation's five-year plan or the quarterly and annual financial statements, the inconsistencies between the key data and the financial statements will be much more apparent. And the level of questioning on the part of the audit committee members will be much more challenging.

Finally, the audit committee should make it a point to understand the company's cash position. Trends for cash in the bank, credit line availability, capital spending commitments, and changes in working capital requirements are all key indicators of the health of the corporation.

In conclusion, the process described above goes well beyond the level of detail that has typically been thought of as appropriate for audit committees. The contention of this article is that unless audit committee members develop this level of detailed knowledge, they cannot possibly be conversant enough with the corporation's affairs to identify early warning signs of trouble ahead.

Yes, audit committees and boards are entitled to rely on the work of the internal auditors, the outside auditors and other professionals, as well as the corporation's system of internal controls. But ultimately there is no substitute for the committee member's own knowledge of the business when fulfilling his or her fiduciary responsibilities. It could make a big difference in avoiding the embarrassment and the liability of undetected trouble. abfj

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