Making sense of the senseless year: Crazy times for board committees

Audit committees should still review first forecasts and assumptions for the year—not just from January but also from two months ago—because these have changed radically

BY M MUNEER AND RALPH WARD **(HTTPS://WWW.FORBESINDIA.COM/BLOG/AUTHOR/M-MUNEER-AND-RALPH-WARD/)**

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The crazy year that 2020 has been is evident from the kind of work board audit committees have been doing to keep the balance sheet in order. Several audit committees in the USA have been demanding hazard pay although we have not seen that happening in India so far.

Material financials and disclosure matters shifted daily. Regulatory and stock exchange rules have relaxed, tightened and changed, all in no particular order. And the business may well be wrestling with near-death shutdown and revenue erosions as in hospitality and airline industries.

Now, as the calendar year 2020 ends and you prepare for likely remote committee meetings, what belongs on the committee agenda to make sense of this senseless year? For an audit committee, there are a few issues, with financials at the top.

In late June, the US SEC released a statement on the top reporting factors it would watch for during the crisis, such as estimates, disclosure practices and procedures, internal controls, going concern issues, etc. Even in India, as companies are looking at the last quarter of 2020, these SEC statements are valid.

Audit committees should review first forecasts and assumptions for the year because these have changed radically–not just from January, but also from two months ago. Examine how often management is updating its forecasts, what factors and models are being used, and what mechanisms are in place to validate assumptions. What assets are impaired, and how is that impairment being tested?

When we interact with audit committees, they confirm that they are looking at everything through the risk lens now. Supply chain issues and sharply increased cyber risks were the hot new concerns in 2020. The committee needs to gauge how well management is identifying and updating risks, and assessing the impact on strategic performance. Since board risk oversight is typically assigned to the audit committee, review how well your committee is able to handle this role virtually.

Regulatory matters facing enterprises don't go away just because a pandemic crisis is raging, and the audit committee must assure that company compliance programs aren't compromised. Data security failures and insider tipping and trading are major concerns with executives working remotely. Another heightened area of concern is whistleblower policy.

As if these complications are not enough, there is even more hassles when it comes to the board's compensation committee. Pay freezes, layoffs, tumbling revenues, emergency regulations... how can your pay plans cope? The pandemic crisis first hit us seriously in March with lockdowns. That was the sweet spot for the compensation season with most committees in much of the world wrapping up compensation and incentive plans for the new financial year. Many of the consultants, in hindsight, were wise then to tell boards to use caution, and not tinker with pay plans.

There were just too many unknowns at the moment. Six months later though corporations (and their compensation committees) need to deal with salary changes, performance targets, awards and incentives.

Following are some insights that may be helpful:

- *Salaries and cash retainers*: Cuts here have been widespread across industries, but inconsistent in application and duration. A spot survey of Fortune 1500 companies found these "pay packet" cuts most common in retail, hospitality, health care, and luxury good sectors. Also, the bigger the company, the bigger the cuts—at the S&P 500, CEO salaries were cut by 100 percent on median (but for the full S&P 1500, the haircut was just 50 percent). Now, the current-quarter comp committee meetings are taking a fresh look at the cuts they made earlier. Along with asking whether revenues and prospects have improved, committees are looking at the "ripple effects" of earlier cash cuts on incentives, bonuses, severance and pension contributions (most of these are based around the cash levels).

- *Short-term awards*: We urge committees to still hold off on tinkering with these, or perhaps look at 2020 into two or more performance periods, based on revised metrics. Flexibility for short-term award changes is crucial, as is weighing the optics of any changes among employees, especially when it comes to fairness. Consider shifting from absolute performance goals such as annual EBITDA to peer group performance, or relative total shareholder return. Perhaps your goal should not be hitting an EBITDA number now, but instead, doing 5 percent better than your peer companies?

- *Long-term awards*: It makes even less sense to mess with long-term (3-4 year) performance targets at this point. The stock market indices have been spiraling upwards without any rational reasons while many other economic indicators are still flashing red and yellow. The comp committee needs to be cautious as it may not want to create an inadvertent windfall. Adjust new equity awards to the current share price, not that of last year, to avoid such windfalls and potential stock dilution. And, don't inadvertently engage in option re-pricing. Investors will be watching closely.

- *Compensation disclosure*: Not only must your comp committee make sense of a turbulent year but also must disclose coherently and convincingly what it has done to investors and regulators. Look back on disclosures you've made in the past six months for any updates or inaccuracies that need amending since with so many changes you will likely have a few amendments to make. The company's compensation disclosure and analysis (CD&A) will need to be far more closely considered and written this year. Enterprises will have to consider making a thoughtful evaluation of what they did in a fire drill, especially since most have made more compensation changes in 2020 than in the previous several years. Look for unintended consequences in your original pay plans and subsequent decisions. Start earlier than usual, and assume your 2020 CD&A *will* be scrutinised threadbare.

About authors: Dr M Muneer is co-founder of the non-profit Medici Institute and a stakeholder in the Silicon Valley-based deep-tech enterprise Rezonent Corp. Ralph Ward is global board advisor, coach and publisher

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