

Across the Board

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Audit Committees Intensify Oversight: Focus on ‘Basics’ and Accountability

In 2009 a key focus of every audit committee agenda is how to help the company get through the next 18 months. This newsletter will discuss the concerns, challenges and tools available to audit committees during this time. It draws on some findings of the ACI in the US which recently held a conference of 150 audit committee members and governance experts.

Managing through the crisis

Business leaders and economists are painting a sobering picture of the depth and likely duration of the economic crisis and its impact on companies. While the crisis has placed tremendous stress on virtually all companies, that stress is now compounded by unprecedented uncertainty - about individual and world economies, the markets, financial systems, and many of the fundamental assumptions underlying company strategies.

Helping to guide the company through the crisis, and deal with the uncertainty ahead, is now a top priority for boards and audit committees - and audit committee members emphasize a number of important oversight activities, including the following:

Closely monitor the impact of the economic crisis on the company.

- Timely and accurate forecast information is critical to obtaining a clear picture of where the company is heading. Identify possible red flags, and closely monitor the company's performance, including forecasted earnings and cash flow, and compliance with debt covenants. Be sure to test the forecasting models being used, and develop worst-case scenarios.
- Given the increasing consolidation in the financial industry, consider the need to diversify sources of capital and establish new lines of credit; expect to operate with tighter debt-to-equity ratios and more restrictions on use of capital.
- Monitor the impact of the crisis on the company's ability to hedge (against currency, interest rate, and commodity price volatility).

Assess the company's exposure to third parties affected by the economic crisis.

- The impact of the crisis on the company's supply chain, key customers, and other third parties is a major area of exposure for most companies. Monitor the company's exposure to all companies in financial distress; in addition to the supply chain and sales and distribution channels, key third-party dependencies include customers, banks, lenders, underwriters, insurers, guarantors, and counterparties. Identify critical dependencies, such as foreign suppliers and key customers.

- Understand who in management is responsible for managing these risks, and ensure that the company has an inventory of its third-party exposures.

Focus on internal controls, particularly as the company cuts costs.

- As management seeks to reduce costs and implement layoffs, maintaining internal controls may pose a particular challenge. Test management as to whether proposed cost cutting and layoffs may adversely affect internal controls.
- With the economic crisis placing tremendous pressure on management and employees, there may be an increased risk of fraud. Inquire about the adequacy of fraud controls.

Understand the impact of the financial crisis on the company's financials - particularly the balance sheet.

- Understand how vulnerable the company's investment portfolio is to changes in value in this environment - and help ensure that all exposures have been identified and quantified.
- Consider how changes in financial markets have impacted the valuation of pension plan assets and funding requirements.
- Focus on possible asset impairments: Has management identified all assets that should be tested for possible impairment? Has management identified triggering events that may warrant impairment assessments

of goodwill and other intangibles? If so, are the values that are determined realistic based on current market conditions - or were they based on historical assumptions?

- Test the assumptions that underlie management's accounting judgments and estimates that might be impacted by the economic crisis.
- Help ensure that disclosures (MD&A) accurately describe the impact of the financial crisis on the company, including the company's liquidity risks, and the application of fair value.

A more focused and intense oversight

Just as the economic crisis and unprecedented uncertainty have placed tremendous stress on companies, so too have the demands and pressures on audit committees and boards increased. Indeed, because of the gravity and urgency of the situation, board oversight today is very different from a year or two ago. Whether it's the nature of the board's interactions with management, the discussions at executive sessions, or the review of disclosures and earnings releases, audit committees and boards are applying greater focus and intensity to their oversight activities. Accountability and vigilance are the hallmark. Suggesting that they were perhaps overly focused on "process" in recent years, a number of audit committee members reported a renewed focus on the "basics" of effective oversight. Among the basics they stressed:

Know the people.

- Directors need to develop strong, personal relationships with the CEO and CFO - understand how they think and what makes them tick. (Are they generally optimistic, pessimistic, or realistic in their views?) Some audit committee chairs have regular weekly calls with the CEO or CFO, as well as periodic calls "whenever the information changes." In a time of crisis, a director's effectiveness is enhanced by such informality.
- Similarly, get to know the internal and external audit teams, and business unit heads through frequent and informal communications. Listen to what they say (or don't say), and establish an open line of

communication. Expect them to contact you promptly about significant developments, or when they find that the information they have previously provided is wrong or incomplete.

- Developing these relationships takes time, but the relationships are critical to effective oversight, and in helping to foster an appropriate tone and culture throughout the organization.

Understand the business.

- Effective oversight, including a constructive dialogue with management, cannot take place unless directors have an understanding - a solid understanding - of the company's business and industry, and are diligent in staying abreast of the issues and developments affecting the company.
- Find the time to read - about the business, the industry, and the competition. Carefully read reports from the analyst community - both buy- and sell-side reports - about the company and its competitors, as well as the SEC filings of competitors. Set aside time - whether formal agenda time or informal time - to educate audit committee members about the critical issues and risks facing the company.
- Consider having each business unit head meet with the audit committee periodically (perhaps once a year) to discuss the unit's strategy and the risks to that strategy. Visit foreign offices and meet with local business unit leaders, as well as internal and external auditors - and even local regulators of the business.

Exercise skepticism.

- Business leaders today understand that we are at an inflection point for corporate governance, and that effective oversight often requires that directors question, challenge, and sometimes test management. Indeed, a fundamental reexamination of the viability of the company's strategy may be appropriate. Healthy skepticism is an important tool for discovering the facts, integrating disparate pieces of information, and understanding the company's risk profile.

- Pay particular attention to accounting judgments and estimates that may be impacted by the financial crisis, and to models that drive important information - such as information about sales, revenue, liquidity, and compliance with debt covenants.

Insist on accountability - for management and the board.

- Make sure that the board's relationship and the "rules of engagement" with the CEO (and likewise, the audit committee's with the CFO) are clear.
- Remember who's accountable to whom - i.e., management to the board, and the board to shareholders - and act accordingly. (As one audit committee chair said, "Management works for me. And I work for the woman [who] depends on those 200 shares she has in our company.")
- Key to the audit committee's effectiveness and accountability is a critical self-assessment - of the audit committee as well as individual members. A focus on the committee's composition, independence, and leadership is essential.

Overseeing risk: The emerging environment

There is clearly an intense focus on risk management today, given what's happened in the financial markets and the economy. And while risk management has been on the radar - if not a priority - for most companies and boards over the past several years, many are asking whether we are really "moving the ball forward," and if we need to be thinking about risk management in a different way. During the Issues Conference, audit committee members took a different approach to the topic, and discussed the types of conversations that boards and audit committees (whoever oversees risk) are having - or perhaps should be having - about risk. Among their recommendations:

Ask the basic questions.

- Can management provide a holistic view of the company's major risks - both on and off the balance sheet? What are the top five risks facing the business?
- How tolerant is management of risks (including low-probability yet "catastrophic" risks)?
- How rigorously does management stress-test key risk assumptions?
- Are the board's information sources sufficiently varied and objective?
- How does culture - including incentive compensation - impact the company's risk profile?

Insist on a robust conversation about risk - a dynamic interaction and exchange between management and directors.

- Ensure that directors agree on the purpose of the risk discussion - namely, to satisfy the board that management can, and does, identify, assess, and manage risk effectively.
- Invite the right people to the table - the CEO, CFO, chief risk officer, general counsel, auditors, business unit leaders responsible for managing the risks, and others.
- Effective oversight requires that directors understand, question, and test management's core risk assumptions and perceptions; be prepared to ask that incisive "second question."
- Focus on the models and on the underlying assumptions - and here visualization can be helpful so that directors can see the impact of changing key underlying assumptions.
- Obtain input from third parties - auditors, outside counsel, consultants, and others - to test and validate management's core risk assumptions and perceptions.
- Be particularly sensitive to the effect of compensation/incentives on the company's strategy and risk culture.

Understand the risk culture.

- Directors need to consider whether a more dynamic interaction between directors and management is viewed as "too adversarial" for the board room. If so, that may speak to the health of the organization's culture. Consider the nature and flow of information and dialogue about risk within the company, and watch for any reluctance, or "spinning," when discussing risk.
- Periodically talk to the heads of the operating units, who own and manage risk on a daily basis.
- To get a view of the risk culture from outside the boardroom, visit remote locations, "walk the halls," attend employee gatherings, etc.

Consider nontraditional risks.

- Consider nontraditional risks, such as long-term shifts in demographics, climate, or technology; the impact of organizational design on how the company manages risk; the risks posed by the company's culture, tone at the top, and compensation structure; and reputation risk.
- "Management risk" - the risk that management may be unable or unwilling to perform - should be a key area of focus, as should the risks posed by succession planning.
- Use a "mystery shopper" approach to probe for risks and vulnerabilities from the outside-in.
- Consider the risk that the audit committee/board may not be performing its duties effectively.
- Discuss "black swan" risk scenarios and "dark-side budgets" - and play them out on paper.

Prepare for a crisis.

- More than half of the audit committee members attending the Issues Conference said their committee had been involved in a crisis. The message: be prepared - ideally, with a written crisis response plan.
- In developing a crisis response plan, the audit committee should think about the range of issues that could trigger a crisis - from financial statement errors to compensation issues, fraud or misconduct, and going concern issues.
- Knowing who to involve - independent outside counsel, forensic accountants, auditors - as well as when (and what) to communicate to various stakeholders is critical to ensuring confidence in the process, and a thorough and timely resolution.
- As directors who have been involved in major crises emphasized at the Issues Conference, "getting it right the first time" is essential.

More information

Audit Committee Institute (ACI) Thailand is sponsored by KPMG. The institute's primary mission is to serve as a forum and dedicated resource to keep audit committees informed of regulatory matters, company law and accounting and auditing issues. Ultimately the Institute seeks to enhance audit committees' awareness of, commitment to, and ability to discharge their responsibilities. To learn more about the Audit Committee Institute in Thailand or to access our resources please visit www.acithailand.org or email us at auditcommittee@kpmg.co.th

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