



# Audit Committee Institute – Update

## Key topics for your agenda during times of crisis

KPMG's AUDIT COMMITTEE INSTITUTE

### **Improving governance processes for risk management oversight should be a top priority**

The business environment has changed dramatically as a result of the economic crisis, and we will likely see more changes — perhaps in the form of new legislation and regulation, a less leveraged economy, continued volatility of commodity prices and markets, and greater expectations for effective oversight. For boards and Audit Committees, understanding the company's risk profile and improving governance processes for risk management oversight should be a top priority to ensure that the company's business remains sustainable.

When a crisis occurs, the stakes are high, and a company's reputation, stability and even survival may be on the line. In these situations, time is of the essence. As a contingency, a company should always have a formal crisis management plan ready.

The global financial crisis is far from over as world economic growth continues to decline, and in the case of Western economies, become a deep recession.

Despite the Chinese government's RMB 4 trillion stimulus package and the huge potential for domestic demand, China's shores are not immune to the effects of this economic downturn.

This is changing the world in dramatic ways and audit committees will need to take the lead in addressing key issues at their agenda meetings. Items to discuss may include:

- Reassessing the company's Risk Governance Framework
- Understanding the company's liquidity risks and access to capital
- Monitoring the company's exposure to counterparties and other third parties
- Staying on top of fair value and other key financial reporting and disclosure matters
- Equipping the CFO and the finance team with the tools they need to succeed
- Ensuring a shared vision for internal auditors and maintaining frequent communication with external auditors

### **Incorporating these topics into your agenda**

We have created a checklist with some example questions for you to use during your agenda meetings to help your team navigate the challenges of the current economy. Use this as a guide to ensure people ask the right questions at the right time.

## Reassessing the company's Risk Governance Framework

As a result of the financial crisis, many boards are reassessing the adequacy and effectiveness of their company's governance processes for managing the many risks that exist in today's business world.

### Questions to ask:

To improve the way companies manage risks, asking the right questions is critical:

- 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 crossing all parts of the business?
- How tolerant is management of risks? Does management understand that a catastrophic risk posing even a "less than 1 percent" chance of causing the enterprise to fail is unacceptable and must be avoided or mitigated to the greatest extent possible?
- How frequently does management review the risks associated with its products, particularly high-growth and high-margin products? How will changes impact the company's ability to obtain economic hedges against increasingly volatile currencies, interest risk and commodity prices?
- How rigorously does management stress-test key risk assumptions?
- Are the board's risk-related information sources adequate and varied? Is there sufficient internal transparency? And how does the company's culture—including the incentive compensation structure—impact its risk profile?

## Understanding the company's liquidity risks and access to capital

As the financial crisis continues to drive down demand and prices, most companies need to tighten their belts. For companies without strong reserves, they may find their working capital locked up in inventory and unsettled accounts receivable. While the Chinese and the Hong Kong SAR governments have committed to increasing commercial lending in their bids to stimulate the domestic economy, banks are likely to tighten lending requirements and/or introduce more stringent borrowing terms.

### Questions to ask:

Audit Committees must therefore increase oversight over their companies' liquidity risks through a better understanding of the companies' liquidity positions. For example:

- Does the company need to raise debt/equity in the short and medium term?
- Are the company's credit lines still secured? Does the company have loans from only one bank?
- Has the company identified other opportunities to free up its cash flow?
- Does the company have a robust monitoring mechanism in place to ensure all bank covenants are met?

## **Monitoring the company's exposure to counterparties and other third parties**

Many export-oriented manufacturing companies in the Pearl River and the Yangtze delta regions closed down in 2008 amidst plunging global demand. Companies which supported these businesses suddenly found clients and orders disappearing.

The Audit Committee must understand how management assesses the company's counterparty exposures and ensure actions are taken on direct and indirect exposures to third parties at home and abroad: customers, suppliers, banks, and lenders, especially entities in the North American and European markets that are experiencing financial difficulty or have filed for bankruptcy.

### **Areas to challenge:**

In today's closely knit business community, the Audit Committee should regularly challenge how management protects the company from the domino effect of any corporate failure of its business associates and alliances; e.g.,

- Has the company inventoried significant counterparties?
- Has the company set up a mechanism to capture changes, monitor and act on material increases in counterparty risks?
- How dependent is the company on the North American and European markets or customers? Are the company's key counterparties significantly influenced by those markets?

For companies with deeper financial resources on the hunt for good bargains, the Audit Committee should safeguard the company's interests by ensuring robust processes are in place for acquisitions.

### **Areas to challenge:**

- Do assessments of potential targets cover their customers, suppliers, alliances and the environment in which they operate?
- Are due diligence procedures, including engaging external professionals, when necessary, performed?
- Are management approval procedures required to ensure the target is reviewed from all perspectives including commercial, accounting, tax and legal? Are the due diligence findings thoroughly discussed by management prior to executing the deal?
- Are proper post-investment monitoring and reporting procedures in place?

## **Staying on top of fair value and other key financial reporting and disclosure matters**

From fair-value accounting and the convergence of the new PRC GAAP, IFRS and U.S. GAAP, to critical accounting policies, judgments and estimates, Audit Committees are constantly challenged to understand the implications of important financial reporting issues and developments affecting the company. Given the scope and complexity of these issues, the Audit Committee should consider asking management to cover each key financial reporting issue or development (including key assumptions and estimates) in detail at each Audit Committee meeting and asking the external auditor how an item is audited.

### **Points to consider:**

In view of the current financial turmoil, the Audit Committee needs to strongly focus on the adequacy of company disclosures, in particular:

- Review the company's investment portfolio, including debt and equity securities to identify declines in value and/or impairments
- Identify triggering events that may warrant impairments of goodwill, deferred taxes, patents and other intangibles, and assess whether any fair values determined by management and valuation experts are realistic in light of the current markets conditions
- Understand the impact of the financial market on the valuation of pension plan assets and funding requirements

## **Equipping the CFO and the finance team with the tools they need to succeed**

CFOs today often play significant roles in strategy, risk and control, treasury management, M&A, IPOs and compliance, on top of the traditional book-keeping role. With increasing pressures from stakeholders, issuances of new accounting standards and other regulatory requirements, the job of the CFO and his team has become even more demanding.

The Audit Committee's support of the CFO and his finance team is critical in helping to maintain focus on the long-term financial performance of the company, inject objectivity into financial disclosures, and ensure the CFO and his finance team have the right expertise and resources to do their jobs well in this tough environment.

### **Areas to assess:**

In particular, the Audit Committee should assess:

- Whether senior finance executives have strong governance mindsets?
- Whether despite cost-cutting pressure the Accounting and Finance function is and remains adequately staffed with the appropriate resources?
- Whether the CFO and his team have adequate and relevant training and knowledge (from both accounting and business aspects) to prepare a proper set of financial statements including disclosures?
- Whether appropriate succession planning is in place for key finance personnel?

## **Ensuring a shared vision for internal auditors and maintaining frequent communication with external auditors**

The Audit Committee can be a catalyst to improving the company's risk management processes. Given today's business climate, the Audit Committee needs to ensure that the internal audit plan is adequately focussed on areas with increased exposure to market and credit risks. In addition, the communication channel between the Audit Committee and the company's external auditors should be more open to ensure that critical issues are addressed and resolved before it is too late.

### **Points to note:**

- With the economic crisis placing tremendous pressures on management and employees, the Audit Committee should ensure the company's internal audit function is technically equipped to tackle the challenging business environment, where business risks abound. Risks related to the supply chain, financial instruments, fraud, data privacy, and liquidity are some of the risks to be more aware of. They require more highly specialised auditing skills to provide the Audit Committee with the same level of assurance as before
- Many Audit Committee chairs now meet with the external audit engagement partner prior to each committee meeting--and with greater frequency--to consider the issues that should be the focus of the committee's agenda, and to stay abreast of issues and developments
- The Audit Committee should request that it receive important information on a real-time basis, and expect the engagement partner to call to its attention areas of concern before they become major problems. These informal communications are critical for the establishment of a solid working relationship with the auditor, and they can pave the way for more effective formal communications at committee and board meetings

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## Succeeding in turbulent times

Navigating through the current economic conditions will be challenging. Are there ways to reduce short-term pain and increase long-term competitive advantages?

- What costs should be cut and what should not?
- What lessons can be learned from previous downturns and how organisations managed during those times?

To help you, we have sponsored the Financial Times Mastering series "Mastering Managing in a Downturn", a four part series published from the 23 January to 13 February. The ACI has the pleasure to provide you the link to the full series at [www.kpmg.com/succeeding](http://www.kpmg.com/succeeding).

The first part of the series covers the context and the costs of the crisis; the second edition concentrates on strategies to get through the crisis; the third section focuses at strategies for beyond the crisis; and the last instalment looks at the future business environment.

For more information on how KPMG can help you to succeed in these turbulent times, please do not hesitate to contact us.

## KPMG's Audit Committee Institute (ACI)

KPMG's ACI helps to enhance the awareness of effective Audit Committee processes, and provides timely information about relevant corporate governance issues and challenges in many countries and regions around the world. KPMG is the only firm in the Big Four with such a dedicated institute to provide help to Audit Committee members worldwide.

## ACI worldwide

Our ACI ensures we have open discussions and up-to-date information for Audit Committee members:

- in 25 countries
- for 1000s of ACI members
- through 100s of workshops, presentations and meetings.

More information: <http://www.kpmgauditcommitteeinstitute.com/>

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