

Audit Committee Institute

Ten to do's for audit committees 2011

March 2011

When considering their 2011 agendas, audit committees should

<p>1. Understand the significant risks facing the company</p>	<p>"Risk" is the number one audit committee priority. Audit committees should ensure they have an appropriate understanding of the significant risks facing the organization, and how they are disclosed to the shareholders along with any resulting vulnerabilities. Particular attention should be paid to "scanning the horizon" for the unexpected, and to consideration of the lessons learned from the financial crisis and recent corporate failings. What has changed in the operating environment? Have there been any failures or near misses? What are the risks posed by the extended organization in procurement, outsourcing, sales or distribution channels? How good are the disaster recovery plans? Are emerging risks—whether slow-moving or fast-hitting—getting sufficient agenda time? Does the audit committee have a good sense of the company's risk culture beyond the boardroom and senior management level (with the tone from the middle seen as increasingly important)? What steps have management taken to ensure risk management is embedded in the fabric of the organization? Is the company's risk appetite clearly articulated and understood?</p>
<p>2. Ensure the system of internal control is fit for purpose, working as intended and disclosed properly in the corporate governance statement?</p>	<p>The significant risks facing the company and the company's risk appetite drive the system of internal control. Audit committees should ensure appropriate internal control procedures are in place for all significant risks (whether from operations, head office functions or from internal or external audit), including operational risk, compliance risk, and risks arising in the wider financial arena such as indirect tax, treasury, etc. Particular attention should be placed on low-probability, high-impact risks. What measures or steps have been taken to identify any changes in the likelihood of such risks crystallizing, or if, in the unlikely event, of such risks transpiring? Particular consideration should be given to the new requirement for listed companies to disclose the main characteristics of the internal control and risk management systems relating to financial reporting in the corporate governance statement of the Board of Director's annual report. Is appropriate testing being performed on the design of the internal control and risk management systems, and is sufficient documentation maintained and reviewed to support the disclosure?</p>
<p>3. Continue to monitor fair value issues, impairments, and management's assumptions underlying critical accounting estimates</p>	<p>These issues, together with loss contingencies, pension funding shortfalls and going-concern challenges, will continue to be a major area of focus for audit committees. Audit committees should recognize that the greatest financial reporting risks are often in those areas where there is a range of possible outcomes and management is called upon to make difficult judgments and estimates. Has the audit committee considered the processes in place to generate forecasts of cash flow and accounting valuation information, including the choice and consistent use of key assumptions? Are the forecasts and valuation processes supported by appropriate internal controls and reasonableness checks, and have those internal controls been tested by internal and external audit?</p>
<p>4. Look beyond the numbers when reviewing</p>	<p>Narrative reporting (such as the Management Discussion and Analysis), earnings releases and analyst briefings can pose difficult issues because they contain important business information</p>

<p>corporate reports</p>	<p>which often does not come from the financial reporting system, is not audited, and is not subject to internal controls. Ensuring management have processes in place to ensure the consistency of the narrative reporting and financial statements—particularly with respect to segmental reporting, recognition of intangible assets on acquisition and impairment testing—can prevent unwelcome attention from the regulators. The audit committee should also seek assurance as to the adequacy and appropriateness of any non-GAAP measures disclosed within reports (such as EBITDA, among others). The disclosure of risk and uncertainty is also of increasing concern to regulators and other stakeholders. Are the risks clearly and simply stated? Are there many of them, and if so, are they really the principal risks? Is it clear how the risks might affect the company?</p>
<p>5. Prepare for the potential impact of accounting and other regulatory changes</p>	<p>Audit committees should ensure they are fully appraised regarding the impact of the many changes to GAAP expected in the near future. Some of the proposed new and revised International Financial Reporting Standards (IFRSs)—not least those addressing hedge accounting, lease accounting and revenue recognition—will have a potentially profound impact on the company’s financial statements, business systems, bank covenants and performance-related remuneration. Audit committees need to be sufficiently up-to-speed to ensure management (and the external auditor) is focused on the key issues. Audit committees should also be mindful of governance developments and other regulatory initiatives. The amended Belgian Corporate Governance Code and related Corporate Law, and the EU Green Papers on corporate governance and audit policy are all likely to create particular challenges in the year ahead.</p>
<p>6. Make sure internal audit is properly focused and fully utilised</p>	<p>Help ensure internal audit is adequately resourced and has refined its scope for changes to the company’s risk profile. Internal audit is not accountable or responsible for risk management, but it should provide added assurance to the audit committee regarding the adequacy of the company’s risk management processes. Internal audit is most effective when it is focused on risk; ensure that the internal audit plan is risk-based and focuses on the critical risks to the business, and not just compliance and financial risks.</p>
<p>7. Understand the impact of performance based remuneration on behaviour</p>	<p>While no single governance model has emerged from the financial crisis as being better or more robust than the others, the importance of behavior has been demonstrated again and again. While remuneration committees have a role in setting the remuneration of executive directors and senior management, audit committees must also understand the impact of performance-based remuneration on behavior, and ensure appropriate checks and balances are in place. Particular attention should be paid when results are “at the margin”. When was the last time the audit committee met the chairman of the remuneration committee? Is there cross-membership between the two committees?</p>
<p>8. Evaluate their role in major transactions</p>	<p>With global M&A activity set to recover, audit committees are re-evaluating their role in major transactions. Responsibility generally lies with the full board, but audit committees can be asked to play a larger role, both pre-and post-transaction. In the pre-transaction phase, audit committees can provide balance in transaction discussions, oversee due-diligence activity and the risks associated with the deal, and provide assurance to the board that management is able to successfully integrate post-deal. In the post-transaction phase, the audit committee has a role in helping ensure the transaction is accurately reported, and that the right controls are in place. The committee might also have a role in monitoring post-investment return and progress, with a view to improving long-term decision making and learning from anything that went wrong.</p>
<p>9. Understand the company’s significant tax risks</p>	<p>Tax authorities are ratcheting-up their enforcement efforts and more aggressively sharing information with a view to increasing the effectiveness of their tax audits. A few examples are the increased use of data-mining techniques, and the roll-out of in-depth transfer pricing audits. Given this tax risk environment, audit committees should seek to understand the company’s tax risk appetite, and management’s processes for managing tax risk. Who is involved? When did the audit committee last meet the company’s responsible person for tax? The committee also needs</p>

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	<p>to be cognizant of changes to the tax regime, and the potential impact on both the company and key personnel. Are there tax reasons for re-locating the company, or a basis for (as an example) carrying out research and development activities in a better tax regime? What are the risks? Can existing risks be sheltered by voluntary declarations of liabilities, and can tax positions be confirmed by tax rulings?</p>
<p>10. Review the anti-bribery and corruption processes</p>	<p>There are an increasing number of bribery and corruption investigations around the world. Penalties are higher, profits are being eliminated, directors and employees are being exposed to extradition, reputations are damaged, and companies have been disqualified from public sector work. Audit committees should ensure that management has implemented adequate procedures to prevent bribery, and that particular attention is paid to risky countries and operations, as well as to some of the less well-understood areas such as facilitation payments, entertaining costs, etc. Is there a comprehensive and regular evaluation of the nature and extent of the bribery and corruption risks to which the company is exposed? Is the "tone from the top" correct? Are the policies and procedures clear and practical and appropriately embedded across the organization? Are they applicable to all employees and to all entities over which the company has control? Does the company engage in appropriate due-diligence with respect to all its business relationships, including the supply chain, agents, intermediaries and joint ventures? Do whistle-blowing and other feedback mechanisms support the continuous improvement of the anti-bribery regime?</p>

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