

Luxembourg Audit Committee Newsletter - January 2010



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Highlights from the 5th Annual Audit Committee Issues Conference

The Annual Audit Committee Issues Conference brings audit committee members to discuss the challenges, practices and priorities shaping audit committee and board agendas.

In 2009, every audit committee agenda focused on job number one: helping the company get through the next months. Understanding the impact of the economic crisis on the company and on its financial statements, disclosures, and internal controls required monitoring financial forecasts closely, focusing on liquidity and cash management, and assessing the company's risk profile as conditions change. Yet, just as businesses are rapidly adjusting their own strategies and operations to deal with unprecedented pressures and mounting uncertainty, boards and audit committees also are undertaking a more focused and intense level of oversight.

Audit committees and boards are carrying out their responsibilities with greater intensity and vigilance - and with a sharp focus on accountability. They also recognize that being effective in their oversight role - particularly in a volatile and uncertain environment - requires a solid, real-time understanding of the business, the people who run it, and the board. In other words: the "basics."

In this report from the conference, we highlight critical areas of audit committee focus - including managing through the crisis, the nature of oversight today, overseeing risk, and the changing governance landscape - and share related practises and insights as discussed by 150 audit committee members and governance luminaries attending the forum.

To be sure, 2010 will mark a critical inflection point for governance and oversight. Audit committee agendas will be notable not only for what's on the agenda, but also for how those agendas are carried out.

Top Concerns for Audit Committees in 2009¹

When asked which issues caused the greatest concern for their audit committee in 2009, conference attendees identified the following as their top five:

1. Liquidity, access to capital, and cash flow
2. Risk management (including forecasting, testing, scenario planning)
3. Financial statement issues (including fair value, asset impairments, disclosures)
4. Maintaining internal controls
5. Alignment - of business goals, incentives, culture, compliance, controls, and risk

¹. All survey results are based on responses from approximately 150 audit committee members and directors surveyed on February 3 and 10, 2009 in Miami, FL and Phoenix, AZ, respectively.

Financial Forecast Information

How satisfied are you that management has timely and accurate financial forecast information about the company's earnings and cash flow?

26%

Very satisfied

36%

Satisfied

27%

Somewhat satisfied

11%

Not satisfied

Discussing Management's Assumptions

How engaged is the audit committee in discussing the assumptions that underlie management's material accounting judgments and estimates that might be impacted by the financial crisis?

50%

Very engaged

43%

Somewhat engaged

7%

Not engaged

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 the markets, our financial system, and many of the fundamental assumptions underlying company strategies.

Helping to guide the company through the crisis, and deal with the uncertainty ahead, is a top priority for boards and audit committees and emphasized 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.

Vendor/Outsourcing Risk

How concerned are you that your company may not have adequate contingency plans to ensure business continuity in the event of a vendor failure?

6%

Very concerned

45%

Somewhat concerned

34%

Not concerned

15%

Not engaged in outsourcing

Earnings Guidance

In light of the uncertainties posed by the financial crisis and the emerging environment, has your audit committee reconsidered the company's policies regarding earnings guidance?

31%

Yes

36%

No

33%

Company does not issue earnings guidance

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 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 than it was two or three years 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. 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.

Changing Nature and Scope of Oversight

To what extent has the financial crisis caused your board/audit committee to change the nature and scope of its oversight processes?

27%
To a great extent

61%
Somewhat

12%
Not at all



- 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. 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.

Oversight of Risk

How satisfied are you that your board has in place effective processes to oversee the company's risk management activities?

12%

Very satisfied

35%

Satisfied

36%

Somewhat satisfied

17%

Not satisfied

Testing Core Risk Assumptions

How satisfied are you that your board/audit committee understands and tests management's core risk assumptions?

9%

Very satisfied

32%

Satisfied

36%

Somewhat satisfied

23%

Not satisfied

- 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. Different audit committee members provided the types of conversations that boards and audit committees 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.

Risk Assumptions and Perceptions

How satisfied are you that your board exercises an appropriate degree of skepticism regarding management's risk assumptions and perceptions?

7%

Very satisfied

40%

Satisfied

40%

Somewhat satisfied

13%

Not satisfied

Incentive Compensation Risk

How involved is your audit committee in helping to address the risks associated with the company's incentive compensation plans?

10%

Very involved

29%

Somewhat involved

61%

Not involved

Understand the risk culture.

- Directors need to consider whether a more dynamic interaction between directors and management is viewed as "too adversarial" for the boardroom. 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 non traditional risks.

- Consider non traditional 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.

Source: Extracts from KPMG International Audit Committee Institute publication



Ten To-Do's for Audit Committees 2010

When considering and carrying out their 2010 agendas, audit committees should...

1. *Regain control of the audit committee agenda.*

The challenges of the economic crisis - access to capital, cash flow, counterparty risks, impairments, etc. - have dominated audit committee agendas. As signs of recovery emerge, take the opportunity to develop more focused (yet flexible) agendas, with an eye on the company's key financial reporting risks. To improve the efficiency of committee meetings, insist on quality pre-meeting materials, spend less time on low-value or checklist activities, and engage in discussions rather than listening to presentations. Don't let compliance activities crowd-out substantive discussion.

2. *Understand the risks posed by cost reductions made in response to the economic crisis.*

Cost cutting has been a key response of most companies to the economic crisis. Every board and audit committee should be asking whether the company's delivery model has been changed permanently, and whether a "cost-reduced" business model can be sustained. Did we cut too much? How quickly can we restore critical infrastructure such as IT and sales force? How far have we extended the organization through outsourcing and off-shoring? As companies cut costs and reduce their workforce, the control environment becomes even more critical. Now is not the time to cut-back on internal audit's budget. (See #6.)

3. *Focus closely on all financial communications.*

Earnings releases and scripts for analyst calls often pose more issues than the 10-Qs because they contain important business information - which often does not come from the financial reporting system, is not audited, and is not subject to internal controls. If you haven't already done so - given the uncertainties created by the economic crisis - reconsider the types of earnings guidance the company issues. Engage early-on in reviewing 2010 proxy disclosures, particularly new disclosures regarding risk, compensation, and corporate governance.

4. *Continue to monitor fair value issues, impairments, and management's assumptions underlying critical accounting estimates.*

These issues, together with pension funding shortfalls and going-concern challenges, will continue to be a major area of focus for audit committees. At the same time, there are important new financial reporting developments - including changes in accounting for transfers of financial assets, revenue recognition, and IFRS - that may require the committee's attention. Set aside time at each committee meeting for a deep dive into a specific financial reporting development impacting the company.

5. Rethink the audit committee's role in risk oversight - with an eye to narrowing the scope.

The tremendous focus on risk today is an opportunity for the board to reassess the role of the audit committee (and the full board and the other standing committees) in overseeing risk. Does the audit committee have the expertise and time to deal with strategic, operational, and other risks? Is the expertise of other board members being leveraged? Audit committees already have a lot on their plates with oversight of financial reporting risks.

6. Make sure internal audit is properly focused and fully utilized.

Help refine internal audit's role - and focus internal audit's activities on key areas of risk, as well as risk management generally. 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 - not just compliance and financial risks.

7. Prepare for the potential impact of key public policy initiatives on compliance, risk, and governance processes.

Major public policy changes - e.g., healthcare, the environment, energy, and financial services regulation - will impact a broad cross-section of companies and industries, and may impose additional reporting, transparency, and compliance obligations. These, in turn, will require new or modified compliance, risk, and governance oversight processes.

8. The economic crisis continues to put pressure on compliance and anti-fraud programs. Be vigilant.

The economic downturn has placed tremendous pressure on management to achieve operating results; at the same time, cost cuts and workforce reductions may have exacerbated these pressures. How has the company treated its employees? How do they think they've been treated? A comprehensive review of the company's anti-fraud and compliance programs, may be in order. The right tone at the top and throughout the finance organization is critical.

9. Help link change + risk - and monitor critical alignments.

Change creates risk. During times of dramatic change, the risk of misalignment - of the company's strategy, goals, risk, controls, compliance, incentives, and people - goes up exponentially. Given the audit committee's role in overseeing risk, internal controls, compliance, and ultimately the impact of significant changes on the company's financials, the committee is in a unique position to help reduce the risk of misalignment.

10. Take a fresh look at the audit committee's composition and leadership.

The audit committee's effectiveness and accountability hinges on meaningful self-assessments - of the audit committee as a group as well as individual members. Take a hard look at the committee's composition, independence, and leadership. Is there a need for a "fresh set of eyes"?



The ten principles of effective risk oversight

1

Understand the company's key drivers of success

Effective oversight of risk, including constructive discussions with management about risk, cannot take place unless directors have a solid understanding of the company's business and industry and continue to stay abreast of the issues and developments affecting the company.

2

Assess the risk in the company's strategy

The board's oversight or risk should begin with assessing the appropriateness of the company's strategy and the risk that is inherent in that strategy and establishing the company's risk appetite.

3

Define the role of the full board and its standing committees with regard to risk oversight

It recommends, that as a general rule, the full board should have primary responsibility for risk oversight, with the board's standing committees supporting the board by addressing the risks inherent in their respective areas of oversight.

4

Consider whether the company's risk management system, including people and processes, is appropriate and has sufficient resources

5

Work with management to understand and agree on types (and format) of risk information that the board requires

Many directors express concern that the quality and quantity of the risk information they receive hinders their oversight efforts.

6

Encourage a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions

An important question for every board is whether it has an engaged culture. Business leaders today understand that we have reached an inflection point for corporate governance. Management and the board act as a team, yet, effective oversight requires that directors understand and test management's strategic assumptions, as well as its core risk assumptions and assessments. An open, participatory culture is essential.



7

Closely monitor the potential risks in the company's culture and its incentive structure

Among the most critical risks facing any organisation today are the risks posed by its tone at the top, culture and incentive structure.

9

Consider emerging and interrelated risks: what's around the next corner?

Beyond current strategic decisions, the board needs to look forward to understand elements in the environment - macroeconomic, political, technological, demographic, climatic/environmental - that may impact the conduct and effectiveness of the business in the future.

8

Monitor critical alignments of strategy, risk, controls, compliance incentives and people

Understanding and strengthening these critical alignments is essential to the successful execution of strategy.

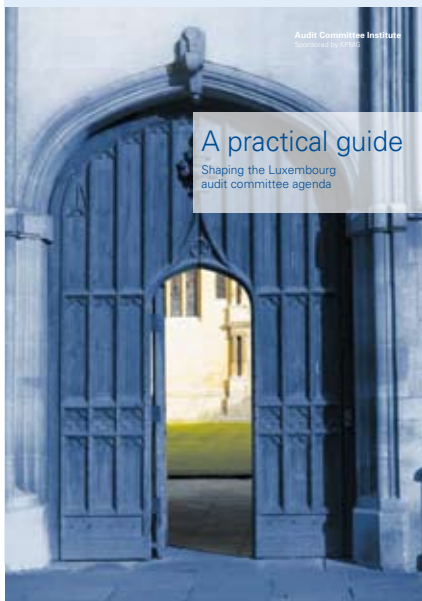
10

Periodically assess the board's risk oversight processes: Do they enable the board to achieve its risk objectives?

Just as the board must monitor and test the effectiveness of management's system for managing risk, the board must also look closely at its own processes and capabilities to oversee risk.

Effective risk oversight... cannot take place unless directors have a solid understanding of the company's business and industry and continue to stay abreast of the issues and developments affecting the company.

The audit committee should review its own effectiveness annually. A suggested framework for such a review – an audit committee self assessment is set the publication “**Shaping the Luxembourg Audit Committee Agenda**”



Take a pen and assess the effectiveness of the audit committee

The purpose of this audit committee self-evaluation approach is to assist committee members in assessing the effectiveness of the audit committee. We believe that a self-evaluation process can be very helpful to the committee in identifying possible improvement areas and we suggest that if an “evaluation form” is adopted by the audit committee, it should only be one step in the process. The following is an overview of possible steps in an evaluation process:

1. Discuss the self-evaluation process that will be adopted, decide who will coordinate the process, and create the evaluation form and compile the results.
2. Determine who will participate in providing initial input to the audit committee - this will include the audit committee members and chair and might also include the chairman of the board, CEO, chairs of other board committees, CFO, director of internal audit, independent auditor, corporate secretary, inhouse counsel, and others who interact with the audit committee.
3. Provide the evaluation form to all participants and have them return it to the coordinator for compilation.
4. Use compiled reports that reflect each response and the average rating - possibly reflecting (1) the overall average, (2) the averages of the audit committee members, and (3) other participants - as the basis of a conversation concerning

Upcoming Events in 2010

The Luxembourg Institute of Directors (“ILA”) in collaboration with Luxembourg Audit Committee sponsored by KPMG will organize a conference on the following topics:

- Lessons to learn from the crisis from an Audit Committee perspective
- Agenda priorities in 2010
- Key role of the Audit Committee in risk management mapping oversight

Registration details coming soon!

Audit Committee Institute Sponsored by KPMG

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