

Audit Committee Quarterly

Issue 11

BELGIUM



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Background

The audit committee and other board members occupy center stage in the wake of corporate governance reforms. Their challenges are numerous, with perhaps their biggest challenge that of satisfying increased regulatory compliance requirements while maintaining their overall effectiveness.

The Audit Committee Institute (ACI) platform offers directors and audit committee members the opportunity to gain the additional knowledge, enhanced competencies and the personalized assistance they need to fulfill their demanding oversight roles.

The ACI, sponsored by KPMG, has been communicating with board and audit committee members at an international level since its formation in 1999. In Belgium, the ACI is in direct and regular contact with over 2,500 directors. Fundamentally, ACI programs support members by providing a focus on evolving issues, the sharing of best practices, and the opportunity to meet with their peers.

- The ACI publication *Shaping the Belgium Audit Committee Agenda* is the *vade mecum* for all audit committee members, providing them with the knowledge, tools and techniques to help them better fulfill their demanding mission.
- The *ACI Website* (www.audit-committee-institute.be) and the *Audit Committee Quarterly* periodical offer articles from the ACI on regulatory and technical matters, feature audit committee "hot topics", and include other content from our extensive resources.
- ACI *Roundtable Sessions* and *Seminars* provide an opportunity to gain first-hand experience, and for an exchange of views with peers and Audit Committee Institute professionals.

Audit committee members and other board members are looking for *focused knowledge* and the *sharing of best practices*. Registration at the ACI Website provides them with this helpful range of tools *free of charge*.

Please refer to the ACI Website for registration.
(www.audit-committee-institute.be)

Welcome ...

... to the latest edition of *Audit Committee Quarterly*, a publication designed to help keep audit committee members current on developments in corporate governance and related subjects. For those of you new to the Audit Committee Institute (ACI), and this publication in particular, a brief outline of the background to ACI can be found on the opposite page.

This issue sees a continuation of our **Interview Series** with a contribution from **Professor Dr. Lutgart Van den Berghe**, Doctor of Economics at Ghent University. Her viewpoints have the credibility brought by extensive experience as a non-executive director, and she is a member of a number of board committees. The interview addresses such hot-button topics as fair value accounting, the possible need for further regulation of company boards, as well as the value of independent directors. You'll find her comments thought-provoking and pertinent to current conversations on governance. Should you also wish to share your thoughts and opinions on corporate governance with the ACI and audit committee members in a similar manner, please do not hesitate to drop us a note.

The basic need for approval from others and the demands of self-interest open our discussion of the dichotomy found in the **Governance Gap**. While management has a responsibility to report accurately and timely to the board, there are times when it is driven to procrastinate in reporting anything contrary to the approved plan. Simply put, hope for recovery or divine intervention often delays bad news until it becomes disastrous news. Our article starting on page 6 discusses steps by boards and management that can avoid such calamities by installing and maintaining adequate control systems, and broaches the issues of rules versus open trust.

The **Eighth Directive** is discussed as from page 10, and, the influence of this EU regulation being transformed in Belgian GAAP, it is argued, will increasingly put European professionals in the same boat with their U.S. colleagues. They significantly charge the audit committee with responsibility to determine whether "internal controls and risk management exist and are effective"

We have included a sampler list of typical **Shareholder Questions** posed to directors at annual general meetings. These questions have been updated to reflect current concerns brought about by current conditions, and are included to help board members prepare for the difficult issues. And we continue our Audit Committee Resources series (starting on page 20) where we bring you articles of interest from around the globe. Many other interesting topics are included in this newsletter (don't miss **Financial Risks and Uncertainties** on page 16).

I trust you will continue to enjoy the ongoing benefits of ACI membership. Please contact us at info@auditcommitteeinstitute.be with any comments or suggestions of topics you would like to receive ACI attention, and visit our Website at www.audit-committee-institute.be for a wealth of information on audit committees.



Theo Erauw
Chairman ACI Belgium

Interview of Prof. L. Van den Berghe

Professor Dr. Lutgart Van den Berghe is a Doctor of Economics at Ghent University. She is Executive Director and Partner of the Vlerick Leuven Gent Management School, and executive director of GUBERNA. And, last but not least, she has considerable experience as a non-executive director and member of several board committees. It was our pleasure to welcome Prof. Van den Berghe for an interview about her corporate governance experiences.



The following summary of the interview is not intended to be exhaustive, nor does it, in any sense, necessarily reflect an opinion held by the Audit Committee Institute.

Q1. How would you assess the impact of corporate governance regulations over the past five years?

Let's take one step back to reflect upon the evolution of financial reporting – the monitoring of which is one of the audit committee's most important governance responsibilities.

Over the last couple of years, activist shareholders have got what they presumably wanted: IFRS incorporates market-to-market values in the balance sheet so as to present the actual fair value of the company, thus accounting for future risks and opportunities.

Such financial reporting policies can raise problems when combined with stringent dividend policies. As an example (e.g., distribution of a fixed percentage of reported profits), distributing future opportunities before they are realized may indeed give rise to dangerous situations.

Foremost, and more generally speaking, such fair-value accounting particularly serves day-trading purposes, as opposed to long-term investment purposes. I would say that a preference for one or the other perspective is a personal thing, but I have experienced family-held enterprises reimbursing their outstanding bond loans issued, simply to avoid the obligation to adopt this fair-value accounting. IFRS fair-value accounting is useful for short-term investment, and resides in the capital markets' belief in mobile shareholding as a cornerstone of market liquidity and price setting.

But valuation issues are complex, and we are now seeing IFRS for the first time being applied extensively in difficult market conditions. Fair-value principles are being pushed to the limits, and again are being extensively questioned by opponents. Proponents claim there are no viable alternatives, but admit that a movement toward full fair-value presentation of financial statements would not always be a reasonable option.

We could reflect accordingly upon the bedrock of corporate governance: "Is our comply-or-explain self regulation still standing strong, or are current market conditions calling for more stringent regulation—or even hard law?" No clear-cut answer comes forward, as we have seen problems within both the rules-based U.S. system and the mainly self regulation-based EU systems.

For certain, while recognizing U.S. rules has initially led the way for EU countries to develop their own approach to corporate governance, I am positive about what is called "dominant firm" logic. Corporate governance, as with

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anything, shall be adjusted to the governing company model in a particular market. Substantial disclosure requirements, for example, must be an important part of corporate governance when facing a market governed by mainly external shareholders, as opposed to insider shareholders.

Q2. What improvements or amendments do you consider are still needed by corporate governance regulations?

The disclosures just mentioned are most probably, and in particular, an area for possible improvement. Unexpectedly, the core principles of our corporate governance code have been very rapidly and fully adopted by Belgian companies. Nevertheless, quality of disclosures still can be improved,

and is best driven by incorporating more specific recommendations—and even definitions—as a complement to our corporate governance code. When “fixed remunerations” are to be disclosed, shall these comprise only gross salaries, or equally include other elements of the total cost to the employer? And, what about the different status of salaries versus invoiced management fees?

As well, more direction may be needed in regard to the interpretation and application of the comply-or-explain principle. In the case of explanation, the aim is to expect and provide an appropriate explanation. Stating that the law is being followed instead of the corporate governance code, when the latter is more stringent, is clearly not sufficient.



Also, the monitoring of compliance with the governance code might be improved. Ultimately, of course, shareholders are responsible for monitoring compliance, but they might need support from a more comprehensive market analysis by a special monitoring body (like, as an example, in the Netherlands), and eventually from governance rating companies.

More generally, whenever a corporate governance directive needs to be translated into national law or regulation, it seems to me we might take advantage of the establishment of a parliamentary working group in Belgium, which would



proactively monitor the application of European regulation. Moreover, I would like to make a plea for introducing the UK obligation to effectuate a cost-benefit analysis whenever introducing new legislation and regulation. At a time when regulation is planned to drastically increase, this is more relevant than ever before.

Q3. To what extent do independent directors contribute to corporate governance? What would you see as an appropriate profile for such an independent director?

From an *ex ante* point of view, an independent director is one that complies with all company law provisions as to independence. Basically this is a box-ticking exercise, primarily serving outside perception, and is not a guarantee to actual independence. Determining genuine independence, therefore, I believe, additionally needs an *ex post* critical evaluation of the director's attitude.

From a Belgian perspective, the need for independent directors has been introduced by company law on conflicts of interest. Also, European regulations introduced independent directors as a counter-balance in situations of conflicting interest regarding management's financial reporting (audit committee), nomination (nomination committee) and remuneration (remuneration committee).

As such, a substantial number of independent directors is needed in a listed company, and this is a good thing. But at the same time, we have to be careful against overkill caused by focusing only on the independent criteria at the

expense of a diverse set of business competencies. The latter is always needed in any board of directors.

Q4. Do you believe audit committees in general are given too much or too little responsibility, and would your answer be the same in terms of audit committee rights?

We have seen an important increase in audit committee responsibilities, both in terms of volume and complexity. Responsibilities of audit committees may bring about more liability to their members. Although the audit committee is responsible for the monitoring of financial reporting, internal controls and risk management, the ultimate responsibility in these matters resides with the board as a whole. Many court cases specifically aim at audit committee members. Therefore, the question remains: to what extent does the collective liability of the board remain a crucial cornerstone of corporate governance?

As to audit committee rights, I would say the rights to being fully informed and to hire expertise as needed are of importance in helping fulfil these increasingly-charged oversight roles. Further, and as another matter, I believe that

both rights and responsibilities still require more precise definition and elaboration at all levels of the organization, especially those levels below the corporate board (the holding company).

Q5. Can you tell us about pertinent or important activities accomplished by your audit committee recently, or that will be undertaken by your audit committee in the near future?

In my experience as a member of several audit committees, I believe audit committees have made significant progress in terms of becoming more generally risk management-focused, following a strong initial focus on finance matters. Nevertheless, I would say we are still far away from a holistic risk management stance in most audit committees. But this may be exactly right, as strategic risk management in my opinion should not become, or be considered part of, the audit committee's responsibilities.

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The Governance Gap

People have a tendency of trying to live up to other people's expectations. Thus, managers proceed with extreme caution when reporting failures to its board, especially when expectations are high. To the contrary, however, the board must have access to correct and current information delivered timely, especially in an environment where social demands and the risks faced by the board are increasing. This discrepancy between inappropriate caution and needs indicates a structural pitfall just under the surface of corporate governance: The Governance Gap.

Timeline of the Governance Gap

Planned optimism

If the projected growth from all the business plans drafted were realized, the expansion of the economy would largely exceed the planning office's predictions. Nevertheless, once a plan is agreed, and expectations created, management will be keen to turn the plan into reality. Management will not construe any small setbacks as obstacles to reaching the planned result, as milestones can always be rationalized within the planned period. Management will not alarm the board immediately with detailed reports of progress contrary to the plan, as they will calculate that, by planning a bit more optimistically, the originally projected results are still achievable.

Colored facts

If the setbacks become more of a problem, despite predicted mitigation, it becomes ever more difficult to inform the board, who can raise the question: "Why wasn't this reported in an earlier stage?" Moreover, if there is still a possibility to make up lost time, it is tempting to resort to "creative" fact reporting. It is as if there is a sense within management that, while the battle may be lost, the war can still be won. In this respect, to motivate staff, one of the executives' tasks is to maintain the belief "that everything is still possible". Some creative use of the reserves and indicators allow management to buy some time without letting things get out of hand.

The Board trap

This can carry on until playing catch-up is no longer an option. At this point, it is too late, even for management, to take corrective measures. In the best-case scenario, the world will remain unaware of the set-backs. However, if things do get noticeably out of hand, management has to explain publicly why they did not intervene sooner.





In extreme cases

At this point, management experiences immense psychological pressure not to disclose the big picture. Proof of this could be observed during the recent accounting scandals when

managers continued to portray a positive image, even to the financial markets, despite the fact that the underlying reality had been disastrous for a long time.

How to avoid the Governance Gap

The question now is how this “board trap” is to be avoided, without the board of directors having to switch roles, or having to reinvent the wheel. Two existing tools can be applied to provide management with reliable and timely insight into the risks.

Business plan due diligence

The first approach is taken from an M&A practice. In the case of an acquisition, companies can commission due diligence investigations to identify potential risks and uncertainties, carefully underpinning an investment decision. In general, due diligence investigations result in a number of corrections, and a list of points of interest relevant to the integration. The same “required caution” can be applied when the Board of Directors has to approve a business plan or important investment decision. An independent investigation of the business plan is needed to identify the risks and the points of interest during the implementation. It could be that some expectations must be adjusted, or corrections need to be made.

This proves that management displays the “required caution”. Moreover, the value of the business plan will increase, the expectations will be more realistic, and a recognizable list of points of interest will help implement the plan.

Key Risk Indicators

The second approach is to proactively review and identify the key risk indicators (KRI's). This approach is a limited application of the more elaborate Key Performance Indicators (KPI's).



Each strategy, budget or policy plan contains a number of elements indicating whether the planned success is feasible. A great number of companies identify and report these factors, referred to as KPIs. Similarly, a number of weaknesses are revealed, e.g., assumptions, assessments and factors not taken into consideration, optimistic prospects (such as market development), and conditions that still need to be satisfied (the recruitment of staff to carry out certain plans). These are the equivalent to leaving for a meeting with plenty of time, then facing a small number of setbacks ultimately amounting to big consequences. In a complex business environment, the director cannot always foresee these events.

Rules versus Trust

Standard corporate governance does not always offer solutions to these problems, as the board continues to depend on the information provided by management. An audit of the accounts is only performed in retrospect. Furthermore, the board cannot switch roles with management. The board of directors has to trust its management—it cannot undermine management by directly approaching staff to determine whether management has kept it completely informed.

Discussions about being “in control” usually focus on “hard” control measures. The current COSO framework, for example—which is often used as a guideline by people trying to ensure they are “in control” in their organization—attaches limited importance to informal behavioral controls, such as those scientifically recognized in social organization. The influence of the environment on the internal management of an organization (contingency factors) is also not discussed

enough. Experience has shown consistently that hard controls are essentially meaningless unless they are implemented in the context of the right organizational culture. Regulations are, after all, no more than paper tigers if most of the employees in an organization do not take them seriously. There is, therefore, a need for a culture in which people attach much importance to achieving goals, both collectively and individually, a culture in which both management and employees have the right approach with regard to aspects of internal management, and a culture where integrity is paramount.

The integrity climate comprises the perceptions and opinions that management and employees have about the way in which the organization is organized, and how the organization guides and influences their behavior. The integrity climate is also about how people within an organization are encouraged to behave in an honest way, and how they are discouraged from fraudulent and corrupt behavior. Largely, the integrity climate determines the effectiveness of the controls. If employees have the impression that fraudulent practices are not punished—or are even rewarded—within their organization, they may take advantage of this. Many people recognize this. There is also the need to move from a state of compliance, i.e., with rules and legislation, to a corporate culture where being “in control” is an established part of employee culture and values. However, few organizations are able to implement this change in practice. Often, the problem is that they are inclined to use these “soft” factors in an instrumental way, in an attempt to show that they are “in control.” This can lead, among other things, to the creation of codes of conduct that have not been developed specifically for the company, or that are just paper tigers that seem to have little practical use.

Breaking the fear culture requires courage. We are convinced that the fear culture that is becoming more and more dominant is not tenable in the long term; however, breaking free of it will require a lot of courage.

One of the ways in which the current spiral can be broken is if people begin to have faith in other people taking responsibility. Traffic experiments have shown that when there are no rules and regulations, people are more inclined to follow their own instincts. Removal of traffic signs at roundabouts can actually lead to improved safety, as people are forced to take responsibility for their behavior.

Too many regulations, on the other hand, can suffocate natural instincts. The “art of omission” can also be useful when it comes to being “in control”. The trust factor plays a crucial role. There is a well-known mantra that goes: “Trust is good, control is better”. The trust factor seems to be catching on more and more in management literature, as a counterbalance to the current obsession with organization as described.

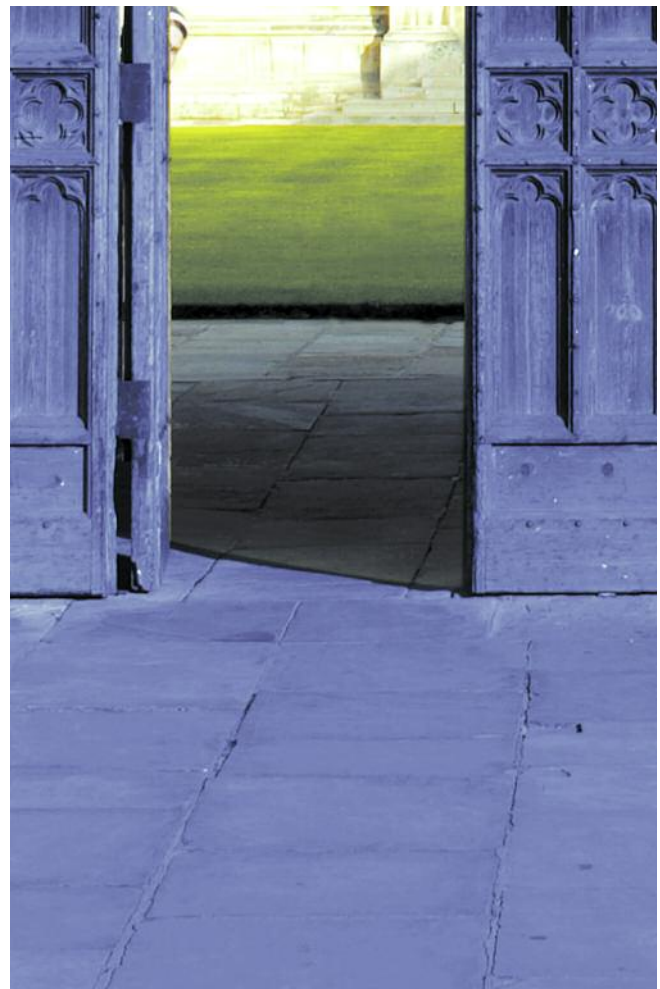
Horizontal supervision

Of course, it is nice to write about trust, but building trust in practice requires a lot of courage. An interesting case in this context is the development of horizontal supervision at the Dutch Tax and Customs Administration. The concept of horizontal supervision is the result of the mutual trust between taxpayers and the tax authority, of each party notifying the other of responsibilities and possibilities related to upholding the law, and of the creation and observation of mutual agreements. This puts the government and the public on a more equitable footing in their underlying relationships and the communication between them.

Here’s what the Dutch administration thinks about horizontal supervision: “If you ask people around the world, many think we are being rather naïve, because taxpayers are crooks, after all. We, on the other hand, are convinced that it works. We have had enforcement agreements with a number of large companies for some time, and now other companies are beginning to express an interest in this. This way of working gives them legal security while saving us

time. We are moving towards a similar set-up for public use. It fits in with the development toward giving the public greater personal responsibility. In this sense, we are doing our bit to help build trust in our society.”

Every link in the chain needs to take responsibility. After the accounting scandal surrounding Enron at the beginning of this century, the American senator Joe Lieberman looked into the causes of this debacle. One of his main conclusions was that several “links in the chain” had not fulfilled their roles properly, and that directors, auditors, supervisory board members and investors should all take some of the blame. There is an analogy that can be applied to control systems: to get the idea of being “in control” back into perspective, there also needs to be a breakthrough at the level of several of the in the chain.



Close to European SOX

SOX has been part of business life in the USA for many years now. The Eighth Directive¹ is generally considered as the European post-Sarbanes-Oxley regulatory retaliation. The directive closely follows U.S. regulation, and companies listed in Europe will most likely be directly affected very soon.

From the changes in the audit committee and the role of the board of directors, to the new internal controls requirements, professionals in European listed companies will face similar challenges with their American colleagues. By 2008, every country's national regulations must be updated to reflect these directive requirements in local law, to which every company must be compliant—this is something to which audit committees must keep a close and continuous scrutiny.

More precisely, this article, as a reminder, discusses the impact of two European Union Directives (2006/46/EC & 2006/43/EC) released in 2006, which have set a minimum threshold for national law that each Member State must meet by 2008, and which are applicable to all "public interest" companies.

The EU proposed these directives because there was a need to ensure that investors and other parties could rely fully on the accuracy of audited accounts, and to enhance the EU's protection against the type of scandals that occurred in companies such as Parmalat and Ahold.

Moreover, these directives, according to the EU, will serve to enhance disclosure and transparency, and will require company boards to keep issues of risk management and control under regular review. Finally, the directives were also an answer to the best practices of other international legislations, such as the Sarbanes-Oxley act of 2002. By issuing the two directives, the EU wanted to take another step forward on harmonizing European company law.

Directive 2006/43/EC on Statutory Audit: An overview

First of all, the new directive is the key measure for the EU to rebuild the trust in the audit function. It clarifies the duties of statutory auditors and their independence and ethics by introducing new requirements.

Secondly, it requires the set up of an audit committee to strengthen the independent monitoring of the financial reporting process and of the statutory audit. The audit committee must be composed of non-executive directors and, to fulfill its tasks effectively, at least one of the independent members must be competent in accounting and/or auditing.

According to Art. 41 of the directive, the duties of the audit committee are:

- Monitoring of financial reporting
- Monitoring the effectiveness of internal controls, internal audit and risk management of the company
- Monitoring the audit of financial statements (consolidated or individual)
- Ensuring the auditor's independence and monitoring of non-audit services
- Appointing the registered public accounting firm

In respect of the above, companies should therefore assess their current Internal Control System (ICS) to see where they are now, and where and how they are to be going to comply with the directive's requirements. An appropriate balance should be found somewhere in or at the extremity of the maturity spectrum (on page 11) between a simple ICS, which is typically in place within smaller companies, and a more thorough ICS as required under SOX 404.

¹ The 8th Company Law Directive on Statutory Audit (Directive 2006/43/EC)



For the first time, the new EU Directive emphasizes the role of risk management and the requirements of internal control. As the new directive states: “Effective internal controls contribute to minimize financial, operational and compliance risks and enhance the quality of financial reporting.”

Accordingly, the directive requires the audit committee of listed and other eligible public interest entities to monitor the effectiveness of the company’s internal control, its internal audit (where applicable), and its risk management systems. It further stipulates: “The audit committee will collect information from management and determine whether internal controls and risk management exist and are effective.”

Directive 2006/43/EC on Statutory audit: An overview

According to the EU authorities, this new EU directive will enhance the quality and transparency of companies’ financial reporting. In that regard, the new proposition states that a “Corporate Governance Statement is to be included in the annual report” (Art 46).

This Corporate Governance Statement must include:

- a reference to the corporate governance code that applies to the company, or the code that the company has voluntarily applied;
- the extent to which a company departs from the applicable code and the reason for doing so;

- a description of the main features of the company’s internal control and risk management systems in relation to the financial reporting process;
- information relating to the company’s share and securities structures where the company is subject to the directive;
- the operation of the shareholder meeting and its key powers, and the shareholders’ rights and how they can be exercised, and
- the composition and operation of the board and its committees.

Conclusion

For the first time, the new EU directives emphasize the role of the audit committee over risk management and the requirements of internal control.

The audit committee is to be informed, possibly by using the questions from the summary table on page 12. Also, the audit committee shall see that the organization understands the requirements of the European directives and the national law to follow. It must also assure that:

- management buys into the necessity to be compliant,
- the content of the directive is formalized into the organization’s internal procedures,
- a governance framework is established with clear policies and procedures, and

	Risk management	Internal control	Internal audit
Questions	<p>Is the risk management system documented?</p> <p>What are the substantial risks of the company?</p> <p>Are there certain trends to those risks?</p> <p>Which actions were taken to manage those risks?</p>	<p>Are significant controls determined to monitor the most relevant risks?</p> <p>Is the design of significant controls documented?</p>	<p>Which internal audits are planned for the upcoming fiscal year?</p> <p>Why were certain audit topics chosen?</p> <p>Which were the most relevant internal audit results of the past year?</p>
Challenge	<p>Establishment of</p> <p>(1) A strategy-oriented risk profile that considers all types of risks.</p> <p>(2) A risk management system that is able to handle the company's risks.</p>	<p>Implementation of effective and efficient internal controls.</p>	<p>Establishment of an internal audit which works within defined standards and optimized processes.</p>
Measures	<p>Identification of risk categories, based on the company's strategy.</p> <p>Continuous identification, monitoring and management of identified risks.</p> <p>Monitoring of risk management's effectiveness by key risk indicators.</p>	<p>Risk-oriented identification of key controls.</p> <p>Documentation of key controls.</p> <p>Monitoring the effectiveness of key controls by establishing and monitoring relevant key performance indications and test procedures.</p>	<p>Establishment of an internal audit charter that defines the purpose, authority and responsibility of the internal audit activity.</p> <p>Effective management of the internal audit activity to ensure its adds value to the organization.</p>
Documentation	<p>Documentation of:</p> <p>(1) The complete risk management system.</p> <p>(2) Relevant risks.</p> <p>(3) Agreed measures to manage risk and the current status of these measures.</p> <p>(4) The company's risk profile.</p>	<p>Documentation of control designs that are relevant to the company's strategy.</p> <p>Documentation of the performed test procedures and the results of the evaluation.</p>	<p>Internal audit charter documenting the purpose, authority and responsibility of the internal audit activity.</p> <p>Documentation of the audit planning.</p> <p>Documentation of the internal audit results and reporting.</p>

Shareholder Questions

Shareholders today are better informed and are more motivated to participate in the Annual General Meetings (AGM) than ever before. Shareholders can obtain industry and government trends and indices, and in some cases business strategies, through a variety of media sources and the Internet. They also have ready access to, and are influenced by, reports from institutional investors, corporate governance organizations, special interest groups and the media. A major focus of shareholder questions will definitely be the current market instability and the effect the financial crisis has on the company.

The AGM provides the shareholders with the unique opportunity to engage in active dialogue with the board of directors. Management needs to listen to shareholders and respond appropriately. The drive for transparency among regulators and other parties should also be borne in mind. Directors need to do their homework and be prepared to answer.

This short article summarizes a selection of hot topic questions that shareholders are likely to ask, and allows directors and management to plan and develop informed responses. However, the industry or environment in which the company operates will also greatly influence the nature of questions raised by shareholders. Consequently, this publication should be seen only as a guide. Furthermore, there will inevitably be queries regarding the specific company and the disclosures made in the latest financial statements. Directors should

ensure that they fully understand the financial statements to address questions appropriately: item relationships, why items have included, how they are accounted for, and why they have fluctuated.

The intent is not to suggest that a question should be asked, but rather to alert management and the board to questions that *may* be asked. Each company should consider these questions as they relate to its own particular activities and circumstances.

Given the current economic environment, there will probably be a number of topics which will be on the agenda of many shareholders, such as:

- Current economic conditions
- Corporate governance
- Narrative reporting
- Executive remuneration
- Corporate failures
- IFRS
- Pensions
- Information technology/e-commerce

Below are some examples of hot topic questions:

- How has the current state of the domestic/global economy affected the company's earnings?
- What is the company's strategy going forward, given current market conditions?
- Have currency fluctuations affected the company's ability to compete in foreign markets? How does the company manage this risk?
- What impact has the weakening/strengthening of the euro had on exports/imports?
- What has been the effect of credit market events on the company's stock price? Was the fall in stock price anticipated? What specific steps is the company proposing to restore investor confidence in the company?
- Does the audit committee provide meaningful protection for investors? Is the audit committee in a position to challenge executive management and draw sufficient attention to dubious practices—even though the company is apparently successful?
- Is the audit committee proactive in seeking to ensure the quality and integrity of financial statements and accompanying reports? Are audit committee members dedicated, independent, financially literate and able to challenge the views of executive management?
- How did the company decide which key performance indicators (KPI's) to disclose? How did the company calculate the KPI's? How do these KPI's compare to the company's competitors?
- Are there any risks and uncertainties that the company face which have not been disclosed?
- What is the Transparency Directive? How will it affect the company?
- Exit payments paid to former directors represents total board salaries for seven years. How can the effects of this on the company share price and dividends be justified?
- What assurances can the board give shareholders that further excessive payments will not be made in the future?
- There has been a significant reduction in dividend and a significant overall increase in executive pay. Can the board explain how the current pay structure aligns the interests of executives and shareholders?



- How can the group assure their finances are 100 percent correct?
- In the light of recent corporate failures, is the board confident that they have set the proper tone-at-the-top of the company, and set an expectation that only the highest-quality financial reporting is acceptable?
- Has the board reviewed all significant elements of the company's system of internal control, including the control environment, risk assessment, control activities, information and communication, and monitoring? Is the board satisfied that the company is not susceptible to the events surrounding recent high profile corporate failures?
- Is the audit committee satisfied that internal audit is sufficiently independent, so that it would report significant issues to the audit committee that could reflect negatively on senior management?
- What comments have analysts/institutional shareholders made about the results prepared under IFRS?
- What is XBRL? How will this affect the company?

On top of such hot topic questions, shareholders might, of course, still raise more common questions in respect of finance, revenue recognition, liquidity, tax, dividends, derivatives, accounting standards, business operations (e.g., future plans), external auditors, share price, investor communication, social and environmental items, etc.

An extensive and regularly updated list of Shareholder Questions can be downloaded free of charge from the Other Publications section of our Website:

www-audit-committee-institute.be



Financial Risks and Uncertainties

Liquidity, valuation, asset impairment and going concern are among the key areas of audit committee focus. The global financial system has peered into an abyss, but has been pulled back from the edge by the unprecedented intervention by governments worldwide. In Europe alone, policy makers have committed more than EURO 1 trillion to banks in fresh capital for equity stakes and guarantees for bank funding and lending. It will take more time before we can be sure of stability—full transparency of exposures is still lacking, asset prices continue to fall, deleverage will continue and more capital is probably needed by the global banking system.

While opinions may vary about the magnitude or length of the current economic downturn, it is clear that the ongoing financial crisis will have a huge impact on the audit committee agenda for some time to come. Audit committees need to understand how the credit crunch and economic downturn has affected their company's business. From financial risks, such as liquidity, access to capital, valuation of assets, and cash management, to strategic, operational, and third-party risks such as reliance on suppliers and other business partners, audit committees must now focus on management's plans to manage these risks.

Set out below are a number of specific risk and going concern issues that audit committees should consider this financial reporting season. There are, however, other areas worthy of audit committee consideration. For example: Is the audit committee satisfied with the quality, breadth and timeliness of the information produced by management? And, is management's understanding of risk up to date? Events are moving very quickly, and rolling forward the risk register from the half-year stage is unlikely to be sufficient.

Fair value

"Fair value" continues to be a hotly-debated and fluid issue. On 13 October 2008, the International Accounting Standards Board (IASB) amended IAS 39 *Financial Instruments: Recognition and Measurement* to permit an entity to reclassify any non-derivative financial asset, other than those designated at fair value through profit or loss upon initial recognition, out of the trading category (and hence out of the "fair value through profit or loss" category) if it is no longer held for the purpose of being sold or repurchased in the near term. The amendment establishes different criteria for transfers of loans and of other qualifying assets:

- If the financial asset would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition), then it may be reclassified outside the "fair value through profit or loss" category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity; or
- If the financial asset is not of the type described in the previous bullet, it may be reclassified, only in rare circumstances, outside the "fair value through profit or loss" category.

Furthermore, a financial asset that is classified as "available for sale" that would have met the definition of loans and receivables if it had not been designated as available for sale, may be reclassified outside the "available for sale" category to the "loans and receivables" category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.



The amendments were developed and finalized—with no exposure draft or comment period—in approximately one week in response to concerns expressed by European Union (EU) leaders that European financial institutions are disadvantaged vis-à-vis their U.S. competitors.

Audit committees should consider discussing with management their approach to valuation and the current and potential impact on the company's assets (including possible impairments of investments, pension plans, and other assets, as noted below).

Key financial risks

Audit committees should be alert to the following array of financial risks and challenges that might arise in the months ahead, particularly in light of the ongoing credit crisis and economic downturn—both of which may exacerbate financial risks.

Ability to raise capital/liquidity

- To what extent is the company dependent on short-term financing to operate?
- What are the company's plans with respect to raising debt and/or equity capital in the short- and medium-term, and how do current market events affect those plans?
- Have the company's sources of financing been disrupted by recent market events?
- Has management determined the impact of the current market on its ability to dispose of its financial assets when necessary, and at an acceptable price, to meet the planned repayment of liabilities?
- Is the company in default or at risk of defaulting on any of its debt covenants?

Audit committees should consider challenging management's presumptions regarding long-term banking relationships and drawdown facilities as they may no longer be relied upon. The rule book has, in effect, been torn up. One company with a large, unused secured facility proposed entering into a cash-raising transaction to increase its liquidity. On hearing of the potential disposal, the company's banker said that the facility would be withdrawn if this happened—with no renewal on any terms!

Pensions asset valuations and funding

How have/will changes in financial markets impact valuation of pension plan assets, and mandatory or desired funding requirements?

Market turbulence

- Net yields have increased by 90 to 120 basis points over 2008, driving pension liabilities down by around 20 to 25 percent. For a scheme that invested 60 percent in equities and 40 percent in bonds, assets may have fallen by 15 percent.
- Bond yields have moved by up to 0.15 percent, and equities by up to 9 percent in a single day.

Impact on accounting results

- Balance sheet positions at 30 September 2008 may have improved due to sky-high corporate bond yields.
- Bond re-ratings in the coming months could lead to balance sheet deterioration.
- Forward looking P&L charges are higher than for 2008 due to higher inflation expectations and lower asset values. Companies should consider P&L mitigation options in advance of the year end.

Financial assumptions

- Anomalies in corporate bond data are leading to a large spread of discount rates.
- Many companies are likely to adjust data for “credit crunch” conditions.
- Lower inflation assumptions can be justified for shorter term liabilities.
- A lower discount rate could be combined with a term-specific inflation assumption to be balance sheet neutral, but have a positive P&L impact.
- Current conditions could justify a higher expected equity return, boosting the forward looking P&L financing credit.

Counterparty default

- Has management considered the potential exposures to other entities that are experiencing severe financial difficulties, or whose parents are experiencing severe financial difficulties?
- Has management considered the legal treatment of contracts or other arrangements involving an entity falling into administration or liquidation?
- Has management decided whether to terminate (or substitute) its swaps or other derivative contracts with entities that are experiencing financial difficulties?
- Were any such derivatives or other contracts automatically terminated as a result of counterparty default?
- Will there be disruptions to securitizations or similar vehicles that were sponsored by an entity that now finds itself in severe financial difficulties?

Ability to hedge commodity costs

- What will be the impact of inflation or recession on commodity costs and procurement strategies?

- How will any changes impact the ability to obtain economic hedges, and what will be needed to enable qualifying hedge accounting under IAS 39?

Restructuring or curtailing of capital expenditures

- In the event of a deep recession, what restructuring is being considered by the company?
- What capital expenditures should be deferred?

Identification of risk

- How does the current market affect the company’s liquidity, leverage, and risk profile?
- How does the company assess risk, and should risk assessment methodologies change as a result of recent events?
- Is the audit committee alert to the increased risk of inappropriate earnings management, as well as the risk that budget cutbacks may be “excessive” and adversely affect the long-term performance of the business and the quality of the finance function?

Attendees at recent ACI events overwhelmingly identify risk management and the quality of risk intelligence as one of their top concerns. Many audit committees and boards want a better understanding of the processes used by management to identify and assess significant strategic, financial, and operating risks. At the same time, they are sensitive to the risk of missing the “big picture.”

Operational risk

- Have recent market events highlighted unexpected risks that management was not previously aware of?
- Have recent events confirmed or highlighted any weaknesses in established trading strategies?

- Has management put in place necessary arrangements to cover any unexpected funding needs and avoid any breaches of covenants or regulatory requirements?
- Have recent market events increased the likelihood of litigation against the client?
- The range of variability of an estimate (e.g., a litigation claim) in difficult times may affect going concern.
- Insurance company unable to meet claims

Going concern

In more benign market conditions, management's review of the going concern assumption has been a relatively easy exercise. However, with the speed of events over recent weeks, it is important that management consider whether current market conditions have resulted in material uncertainties that cast significant doubt over the company's ability to continue as a going concern. Some examples of material uncertainties include:

- Inability of lending banks to honour existing facilities
- Undue reliance on hitherto strong relationships with lending banks
- Difficulties with re-financing when existing facilities mature—automatic renewals should not be assumed.
- Difficulties with re-financing after covenant breaches triggered by not meeting financial statement measures or other tests
- Uncertainty as to future trading forecasts and projections on which re-financing plans are based
- Dependency on future asset sales to stay within facilities (for example, sales of property which cannot be assumed to happen as in the past).
- Dependency on a significant customer and the risk of such a customer terminating the arrangement where no long-term contract is in place, or where it is no longer in a position to honour such a contract
- Dependency on a significant supplier and the risk that they fail to meet their commitments, endangering those business without a contingency plan in place

Audit committees may wish to consider challenging the assumptions used by management in the cash flow forecasting models, and the validity of the models used for the forecasts. The accuracy of previous forecasts is also important as is ensuring the forecasts cover a period of at least twelve months from the date of approval of the financial statements.



Monitoring Issues

In certain circumstances:

- The fair value of assets may no longer be obtainable by reference to prices in active markets, resulting in the need for management to rely on complex valuation models.
- The measurement, presentation and disclosure of certain assets and liabilities and/or the appropriateness of the going concern assumption may be dependent on management's intent and ability to carry out certain actions.
- Disclosures in the financial statements may use data from systems and models whose inputs cannot be easily observed under current market conditions.

Changing the nature, timing or extent of the audit committee's monitoring procedures to appropriately respond to such increased risks may involve, for example, asking for more supervision, corroborating evidence obtained, or hiring more expertise.



Resources

Challenges for Audit Committees arising from current economic conditions

The Financial Reporting Council (FRC) has issued two reports regarding the challenges for Audit Committees given the current economic conditions. These conditions provide particular challenges to all involved with annual reports and accounts.

The purpose of these documents is to assist audit committees by identifying key questions that they may need to consider when preparing for the year end and in carrying out their role in relation to annual financial statements. It does not establish any new requirements.

These documents bring together existing guidance in the context of recent developments relating to going concern and liquidity risk disclosures to assist directors, audit committees and finance teams of listed companies during the forthcoming reporting season. It does highlight the importance of clear disclosure in current economic conditions. This update may also be useful for directors of

unlisted companies who have similar responsibilities to assess going concern and make appropriate disclosures.

The full reports and further guidance can be found free of charge from the Website of The Financial Reporting Council: www.frc.org.uk

The use of non financial measures to assess fraud risk

A study by the Institute of Internal Auditors (IIA) has examined whether internal and external auditors or other interested parties (e.g., directors, lenders, investors or regulators) can effectively use non-financial measures to assess the reasonableness of financial performance, and assist in the detection of financial statement fraud.

For several decades, the audit profession has attempted to find efficient and effective methods of improving auditors' fraud risk assessments so as to enhance audit quality, reduce auditor liability, and improve investor protection.

The study explains that if financial measures (e.g., facilities growth) can be identified that are correlated with financial measures (e.g., revenue growth), inconsistent patterns between the non-financial and financial measures can be used to detect organizations with high fraud risk. The difference between non-financial measures and financial performance is significantly greater for fraud organizations than for their non-fraud competitors. In short, for fraud organizations, the performance portrayed by their financial statements is not supported by their non-financial measures. Overall, the results of the study provide empirical evidence suggesting that non-financial measures can be effectively used to assess the likelihood of fraud.

Findings include:

- That the difference between non-financial measures and financial performance is significantly greater for fraud organizations than for their non-fraud competitors.
- For fraud organizations, the performance portrayed by their financial statements is not supported by their non-financial measures.
- That, non financial measures can be effectively used to assess the likelihood of fraud.

The full report, *Using Non-financial Measures to Assess Fraud Risk*, can be found and downloaded free of charge on the Website of the Institute of Internal Auditors: www.theiia.org

Assessing an organization and its operating environment within current market conditions

The American Institute of Certified Public Accountants (AICPA) has issued an alert which should assist audit committees to assess an organization and its operating environment in the light of the current market circumstances. Furthermore, the AICPA has released an information paper regarding enterprise risk management.

The alert includes questions for the audit committee and executive management to consider, plus topics they can use to assess an organization and its operating environment—including its customers and suppliers. It is important to remember business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies – and from the setting of inappropriate objectives and strategies.

Audit committees must continue to address all types of risks with their senior management team, in addition to focusing on risks in the financial statements.

A growing consensus is that companies must take a more comprehensive approach to enterprise risk management (ERM), and that both management and the audit committee

must play meaningful roles in the process.

Building on the passage of the Sarbanes-Oxley Act (SOX) in 2002, which spurred greater emphasis on corporate governance in general and on risk management and internal controls in particular, ERM is seen as a way to facilitate the change to a broader focus on risk management. This information paper provides an overview of the latest thinking on ERM, how public companies are addressing it, and what it means for audit committees.

The related publications can be downloaded free of charge from the Audit Committee Effectiveness Center of the Website of the American Institute of Certified Public Accountants: www.aicpa.org

A European Perspective on Executive Remuneration

Recently the Economic and Financial Affairs Council (ECOFIN) adopted conclusions on executive pay that tighten rules on excessive payoffs or "golden parachutes" for top executives.

In light of the high growth rates of executive pay in recent years, a public discussion has started in a number of countries on the level and structure as well as on the transparency of managers' compensation. From an economic viewpoint, the key questions are whether executive pay is appropriately linked to performance, and whether shareholders have adequate control over remuneration.

The recommendations of the Council provide that governments shall have an influence in determining pay packages for senior executives, remuneration should "correctly and exhaustively" reflect performance, golden parachutes should be linked in an appropriate way to an executive's contribution to the success of the company, and that remuneration systems shall encourage the long-term profitability of companies and not be incentives focused on short-term profits.

The Economic and Financial Affairs Council is one of the oldest configurations of the Council. It is composed of the Economics and Finance Ministers of the Member States. The Ecofin Council covers EU policy in a number of areas including economic policy coordination and economic surveillance.

The full version of the Council conclusion, can be downloaded free of charge from the Website of the Council of the European Union: www.consilium.europa.eu

Board of Directors Evaluation

There is an increasing interest on how to assess the performance of the board of directors. This is stimulated by for example national corporate governance codes, where a strong emphasis is put on the way the board evaluates its performance.

GUBERNA has released a toolkit (Version 2008) which provides a general framework on how to incorporate an efficient and sound evaluation process of the board within an organization.

The toolkit is split into three main phases: introduction, reflection and action. The first phase describes the reasons and justifications for evaluating the board of directors. This could help introducing the evaluation process. The second phase comprises a number of success factors for a successful evaluation process. The third phase provides questionnaires which could be used during the evaluation process. The results from these questionnaires have to

be discussed among the board. An important step in this process will be the creation of an action plan which incorporates the key points raised in the questionnaires.

This toolkit is addressed to each organization who's aim is to professionalize its board through a process of self assessment.

The Dutch version of the toolkit can be found and on downloaded free of charge from the Website of Guberna: www.guberna.be

How should companies report on corporate sustainability?

The Sustainability Reporting Program (SRP) has completed a review of current approaches to sustainability reporting by business and industry. Their findings are based on reports from several companies that evaluate progress from the perspective of sustainability or environment, health and safety.

All of the reports reviewed by the SRP cover environmental performance; some also give information on economic performance as well as contributions to community and social well-being. However, none of them links all three dimensions, and only a few mention a relationship between environmental and economic activities. Examples of best practice have been collected. Current reporting trends have been identified and give a good indication of how "corporate sustainability" is understood by the business sector.

The selected corporations have headquarters in North America, Europe or Australia, although most also operate in developing regions. Sectors represented include aerospace and defense, automotive and transportation, bio-industries, chemicals and plastics, consumer products, forestry and building products, health, metals and minerals processing, petrochemicals and power generation. A number conduct business in more than one sector.

This report:

- discusses the conceptual issues underlying corporate sustainability reporting;
- explores current sustainability reporting trends;
- presents three templates for reporting on progress; and
- recommends report elements that would demonstrate leadership in sustainability reporting.

The full report and further guidance can be found free of charge from the Website of The Sustainability Report: www.sustreport.org

ACI Events

Roundtable Series

ACI facilitates interactive audit committee roundtables twice a year. Every Roundtable features one or more guest speakers, and provides for an exchange of views and insights on topics of interest to members of boards and audit committees for a limited number of professionals.

The ACI roundtable sessions can provide you with knowledge you will find helpful in your increasingly responsible oversight role through a focus on current topics, enhanced competence by the sharing of best practices, and personalized assistance by providing opportunities for interaction with your peers.

The next Roundtable event will be organized on **Monday 15 December 2008**. Members of audit committees and boards of listed (and other large) companies will receive a personal invitation to participate. We will explore many **Developments in IT Governance** whereas prominent experts such as **Mr. R.G.A. Fijneman** – professor and academic director IT Auditing at Tilburg University and its TiasNimbas Business School, and **Prof. Dr. W. Van Grembergen** – professor and academic director IT Alignment and Governance at University of Antwerp and its Management School UAMS, will definitely flavor our fields of interest.

Seminars

The ACI Seminar is an exclusive event organized by the Audit Committee Institute for selected board members who share similar challenges to their oversight Roles. The Code Lippens states under its fourth corporate governance principle that “Directors should update their skills and improve their knowledge”.

Our ACI Professional Development Seminar program aims to enhance both the awareness of Board members and their ability to implement effective oversight processes. It is focused on the needs of Board and Audit Committee members and provides, on a timely basis, an understanding of the principles and developments in financial reporting, tax, company law and corporate governance.

ACI Seminars are held at a carefully chosen venue and attendees will hear pertinent and practical information presented by knowledgeable guest speakers. The Seminars offer you a unique and valuable opportunity to exchange best practices and enjoy contacts with your peers.

For more information on ACI please visit our Website www.audit-committee-institute.be or contact us via e-mail at info@auditcommitteeinstitute.be



About us

The Belgian Audit Committee Institute (ACI) was established with the purpose of providing members of audit committees and other board members with the knowledge required to carry out their responsibilities. ACI follows developments in the field of governance, audit issues, accounting, and financial reporting, both in Belgium and internationally.

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