



10 To-Do's for Audit Committees in 2011 – China

While China will remain the focus of Asia's economic growth, the continuous strengthening of Chinese economy may also bring risks of overheating, excessive investments and other challenges. When considering and carrying out their 2011 agendas, audit committees should:

1. Understand the significant risks facing the company

Audit committees should ensure they have an appropriate understanding of the significant risks facing the organisation and how they, and any resulting vulnerabilities, are disclosed to shareholders. Particular attention should be paid to 'scanning the horizon' for the unexpected and consideration of the lessons from the financial crisis. Is the company's risk appetite clearly articulated and understood? What has changed in the operating environment? Have there been any failures – or near misses? What are the risks posed by the extended organisation – procurement, outsourcing, sales and distribution channels? Is it clear how the risks might affect the company? How good are our 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 (as the tone from the middle is increasingly important)? What steps has management taken to ensure risk management is embedded in the fabric of the organisation? Are the risks clearly communicated to shareholders and other stakeholders?

2. Keep the audit committee's eye on regulatory changes

The challenges in the business environment coupled with the impact of major public policy changes – for example new corporate governance requirements – will require attention of every audit committee. These new regulatory initiatives may impose additional reporting transparency and compliance obligations on companies, and therefore may have a broad impact on a company's compliance, risk

management, and governance processes.

Audit committees should develop more focused yet flexible agendas to properly evaluate the impact of existing and impending regulatory changes. They should also engage in more discussions with management as opposed to presentations to promptly react to the related compliance issues.

3. Ensure the system of internal controls is fit for purpose and working as intended

The company's risk appetite and the significant risks facing the company drive the system of internal controls.

Audit committees should ensure appropriate internal control procedures are in place (whether from operations, head office functions or internal/external audit) for all significant risks including operational risk,

compliance risk and risks arising in the wider financial arena - such as indirect tax, treasury. Particular attention should be placed on the low probability, high impact risks. What measures have been taken to identify any changes in the likelihood of such risks crystallising? What steps are in place in the unlikely event of such risks crystallising?

☑ 4. Look beyond the numbers when reviewing company reports

Narrative reporting (such as Business Reviews and Corporate Social Responsibility Reports), earnings releases and analyst briefings can pose difficult issues because they contain important business information, which often does not come from the financial reporting system and is not audited.

Audit committees should ensure management have processes in place to ensure the consistency of the narrative reporting and financial statements – particularly with respect to segmental reporting and the recognition of intangible assets on acquisition - and that can prevent unnecessary attention from the regulators.

Audit committees should also seek assurance as to the adequacy and appropriateness of any disclosures within corporate reports. Given the importance of transparency to the investor community, as well as regulators' increasing focus on disclosures, audit committees should consider how disclosures can be improved – perhaps going beyond what's 'required' – to better address expectations. At the end of the day, do the disclosures in corporate reports, together with the financial statements, tell the company's true story?

☑ 5. Prepare for the potential accounting changes, and continue to monitor management's assumptions underlying critical accounting estimates

Audit committees should ensure they are fully appraised regarding the impact of the many changes to the accounting standards expected in the near future. With IASB's undertakings to revise

IFRS, the new PRC GAAP's continuous convergence with IFRS will bring ongoing challenges to Chinese companies. Changes in the accounting standards will have a potentially profound impact on a company's financial statements and business systems. Stay close to where the revised accounting standards are headed and the timeline of implementation, and ensure management (and the external auditor) is focused on the major issues, are keys of audit committee's current year agenda.

These issues, together with loss contingencies, impairments, and fair value issues, will continue to be the major areas of focus for audit committees. 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/or external audit?

☑ 6. Review the anti-fraud process and whistle-blowing policy

There are an increasing number of frauds around the world. China's Basic Standard of Enterprise Internal Control and the proposed changes to the Hong Kong's Code on Corporate Governance Practices both suggest the establishment of a whistle-blowing policy, which should be effectively communicated with all stakeholders. Audit committees should ensure that management have implemented adequate anti-fraud programmes and control procedures, and that particular attention is paid to 'risky' operations including procurement/payment and some of the less well-understood areas / complex processes. Is there a comprehensive and regular evaluation of the nature and extent of the fraud risks? Is there a right 'tone from the top'? Are the policies and procedures clear and practical, and appropriately embedded across the organisation?

Audit committees should also be mindful of regulatory initiatives on anti-bribery and corruption processes such as the new Bribery Act in the UK, the Foreign Corrupt Practices Act and the Dodd-Frank Act in the US, which are likely to bring particular challenges in the year ahead.

☑ 7. Evaluate audit committee's role in major transactions

With the rapid economic development and the continued growing of foreign reserves, more Chinese enterprises are making or planning outbound investments through mergers and acquisitions (M&A). While oversight of M&A activities generally lies with the full board, 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 are 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/progress with a view to improving long-term decision making and learning from anything that went wrong.

☑ 8. Discuss the audit committee's role in IT governance

Audit committees should ensure they understand the opportunities and risks posed by IT as a critical challenge for companies today—from IT spending and strategic alignment of IT resources to system implementation and outsourcing, information privacy and security, cloud computing, internal controls, business continuity and ultimately to information quality and the company's competitive position. Does the company have a social media networks policy in place? Is there a need for IT expertise on the board? Does management—particularly the CIO—communicate with directors in plain English, and in a business context? Clarify the role of the audit committee (versus the board and other board committees) in IT governance and oversight—and keep IT on the radar.

☑ 9. Make sure internal audit is properly focused and fully utilised

Although the internal audit function is not accountable or responsible for risk management, it provides added assurance to the audit committee regarding the adequacy of the company's risk management processes. Audit committees should help ensure the internal audit function is adequately resourced and has refined its scope in response to changes in the company's risk profile and exposure. Does the internal audit function have adequate resources? Is the internal audit plan risk-based? Are the internal audits focused on the company's key business risks, and not just compliance and financial risks?

☑ 10. Understand the impact of performance based remuneration on behavior

While no single governance model has emerged from the financial crisis as being 'better' or more 'robust' than the others – the importance of 'behaviour' has been demonstrated again and again. While remuneration committees have a role in setting the remuneration policy of executive directors and senior management, audit committees must also understand the impact of performance-based remuneration on behaviour and ensure appropriate checks and balances are in place. When was the last time the audit committee met the Chairman of the remuneration committee? Is there cross-membership between the two committees?

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