

## Risk in major emerging markets

### Introduction

On October 12, 2006, members of the Audit Committee Leadership Network (ACLN) met for the network's 14th meeting. Members began by considering the future of internal audit<sup>1</sup> and then explored in depth another particular source of risk: major emerging markets. For further information about the network, see "About this document" on page 6.

Members focused on three areas during their discussion:

- **The five most common risks in major emerging markets**
- **The board's strategic decisions regarding emerging markets**
- **The role of the audit committee**

Audit chairs participating in the meeting included:

- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Marie Knowles, Audit Committee Chair, McKesson
- Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Pam Patsley, Audit Committee Chair, Texas Instruments
- Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company
- Steve West, Audit Committee Chair, Cisco Systems

Audit chairs who participated in individual discussions before the meeting were:

- Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- Gene Fife, Audit Committee Chair, Caterpillar
- Shirley Ann Jackson, Audit Committee Chair, Marathon Oil
- Oscar Munoz, Audit Committee Chair, Continental Airlines
- Sandy Warner, Audit Committee Chair, General Electric Company

The members listed above sit on the boards of over 40 large-, mid-, and small-cap public companies between them. Also attending the meeting and participating in the discussion was Tom Flannery, Partner and Director, Audit Committee Communications, Ernst & Young.

*ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations.

<sup>1</sup> See Audit Committee Leadership Network, "The future of internal audit," *ViewPoints*, November 6, 2006. Available at: [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Nov06\\_View15.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Nov06_View15.pdf)

## Executive summary

Continuing their discussions of how audit committees should respond to the specific risks identified by a company's enterprise-wide risk management process, members considered how the audit committee might best provide oversight of risks incurred in major emerging markets – the so-called BRIC countries (Brazil, Russia, India, and China). The specific topics that network members found to be most important are highlighted below, with more detailed discussion on the following pages:

- **The five most common risks in major emerging markets** (Page 2)

Members identified the five most common risks faced by companies in major emerging markets as corruption and potential failure to comply with the Foreign Corrupt Practices Act (FCPA); political risks; risks involving local joint venture (JV) partners; piracy and intellectual property risk; and reputation risk. Chief among the five is corruption, which can damage the reputation of both the company and the audit chair personally.

- **The board's strategic decisions regarding emerging markets** (Page 4)

Members believe discussion of risk in major emerging markets should begin with the board, which must understand the opportunities and potential risks. Once a decision regarding entry into a market is made, the audit committee can play a role in overseeing implementation. Members discussed several ways of getting independent, unbiased political risk analysis for the board, including bringing in local political risk advisers to talk to the board, setting up an advisory board on a specific country or region, and talking to the company's suppliers and external auditors.

- **The role of the audit committee** (Page 5)

Members agreed that the audit committee can help establish positive tone at the top in the company's operations in emerging markets. The audit committee can also monitor both the company's compliance with standards of business conduct and its disciplinary measures, which must be appropriate to support the standards. As the audit committee's "eyes on the ground" in operations in emerging markets, internal and external auditors can provide the committee with valued insight. Members also discussed the advantages of having the board and audit committee travel to emerging markets. [More tips for managing risk in major emerging markets can be found in the appendix on page 7.](#)

## The five most common risks in major emerging markets

Although members identified and discussed five common risks that beset major emerging markets, one audit chair suggested that the top five should be "*corruption, corruption, corruption, corruption, corruption.*"

### The five most common risks:

- Corruption and potential failure to comply with the FCPA
- Political risks
- Risks involving local JV partners
- Piracy and intellectual property risk
- Reputation risk

## 1. Corruption and potential failure to comply with the FCPA<sup>2</sup>

Corruption is a multifaceted problem for many companies, bringing together legal, financial, and reputation risk. Corruption also represents a personal challenge for audit committee chairs because of its potential to damage their own reputations. For this reason, members support a zero-tolerance approach to corruption, although they wonder, *“How do you know what risk is out there?”*

All U.S. publicly traded companies must comply with the rules and regulations of the FCPA. Signed into law in 1977 (and amended in 1998), the FCPA was passed in an effort to ensure that publicly listed companies (1) represented their accounting in foreign countries in a fair fashion and (2) recognized the illegality of any payment made by a U.S. citizen to a foreign entity to ensure the success of a business.

*Compliance Week* reported last year that the Securities and Exchange Commission (SEC) and the Department of Justice have stepped up enforcement of the FCPA. According to the article, the potential liabilities are much larger than they were in the past and include the possibility of being required to disgorge contracts that were won through dubious practices.<sup>3</sup>

## 2. Political risks

Most companies consider the uncertain political situation in emerging markets to be a sizable risk; boards and audit committees need to consider the nature of political risk in each country. One member pointed out that simply being a U.S. company can be a source of risk in some emerging markets: *“The U.S. is not well viewed in almost every country, and it’s getting worse all the time.”* This member pointed out that having a local partner gives the company the opportunity to sail *“under a foreign-flag vessel – smart companies will learn to do that ... This is a new skill set American companies need to develop ... American people are well accepted anywhere, but our flag, our country, and our big brands are not.”*

## 3. Risks involving local JV partners

Some members said companies take on risk whenever they team up with local partners whose approach to business may not be compatible with their own. On the other hand, other audit chairs thought the decision to enter into a joint venture was based more on an evaluation of the market’s political risks and the company’s comfort level with the market than on similarities with the potential JV partner.

## 4. Piracy and intellectual property risk

Companies want to ensure that their technology and technology content cannot be stolen. In a survey conducted in 2005, U.S. companies doing business in China indicated that securing intellectual property rights was their number one priority.<sup>4</sup> Before the meeting, one member reflected on the fact that his

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<sup>2</sup> For more information, see <http://www.usdoj.gov/criminal/fraud/fcpa.html>.

<sup>3</sup> Paul J. Martinek, “Anti-Bribery Law Poses Growing Threat For The Unwary,” *Compliance Week*, June 14, 2005. Available to subscribers at: [http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article\\_ID=1831](http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=1831).

<sup>4</sup> US-China Business Council (USCBC), *American Companies Building Success in China; Significant Issues Remain* (Washington, DC: USCBC, 2005). Available at: [http://www.uschina.org/public/documents/2005/08/2005\\_membersurvey.pdf](http://www.uschina.org/public/documents/2005/08/2005_membersurvey.pdf).

company had determined that an intellectual property theft was sanctioned by the government in one emerging market.

## 5. Reputation risk

All members agree that reputation risk in an emerging market is quite high. Yet it is hard for an audit committee to gauge the impact a risk may have on the company's reputation if the risk is not financially material and thus does not command much time on the audit committee agenda. An aspect of reputation risk that some members contend with is the question of vendor ethics. One member said before the meeting, *"It is increasingly difficult to ... make assessments of the quality of vendors. There are certain policies in place, and we do lots of reviews, but in small countries, it can be difficult."*

### The board's strategic decisions regarding emerging markets

Members felt discussion of risk in major emerging markets should begin with the board. *"How top management thinks about [risk] and how they deal with the board is important. Management wanted the board to understand the opportunities and potential risks. There are a bunch of risks the audit committee can cover naturally under its charter, but it's the big reputation and big money bets that the whole board is involved in."*

Some members felt that the board's discussion of whether to go into new markets or not was insufficient. One member said, *"I am not sure I am getting the right information, but I have enough to be worried."* Members discussed several ways of getting independent, unbiased political risk analysis for the board:

- **Bring in local political risk advisers.** At one member's company, *"when management discusses strategy, they get people from the region with deep political and regulatory background to talk to the board and help them assess political risk. It is a very constructive session. They present options and scenarios. People on the board can tell if [the advisers] are blowing smoke."* Members also warned, *"You need to avoid rent-a-names. They are not bilingual; they are not current. They need to live there."* Another audit chair said it was important that advisers *"do not have a second play – they don't do implementation."*
- **Set up an "off-board committee" or advisory board.** One member said that one of his companies had *"supplemented [risk analysis] with an advisory board who will talk [directly] to the board ... There are more advisory boards and kitchen cabinets for management and the board to draw on... You get perspective, debate, and disagreement."* This audit chair predicted, *"There will be more off-board committees that are not classic consultants trying to sell something."*
- **Talk to the company's suppliers in the region and to the external auditors.** One audit chair pointed out, *"[Your suppliers] have to give you good advice."* This member also recommended asking the external auditor *"for a history of substantial write-downs of investment in [the country]."*

## The role of the audit committee

Reiterating the different roles of the board and the audit committee, one member stated, *“Approving acquisitions and start-ups is strategic and a full-board issue. Once the issue is decided, the audit committee can play a role to set boundaries and put infrastructure in place to ensure we are comfortable.”*

Members mentioned several ways the audit committee can ensure the company addresses risk in emerging markets satisfactorily:

- **Help reinforce good tone at the top.** Members agree that part of their role is to help establish positive tone at the top in the operations in emerging markets. One member said, *“The audit committee can reinforce standards and tone at the top. Management needs to make us feel comfortable with how [the company] deals with those issues.”* Another said the policy should be that *“we will run on corporate standards or local standards – whichever are higher. If you don’t start with that, it is a slippery slope.”*
- **Use the audit committee agenda to send a signal of interest or concern.** Conversations with members indicate that there are many ways in which emerging markets may appear on the audit committee agenda. One member stated before the meeting, *“We treat [operations in emerging markets] as consolidated operations, with the same liabilities and responsibilities.”* Another member’s audit committee *“looks at compliance with standards of business conduct and [at] discipline, which needs to be appropriate to support standards. We monitor discipline.”*
- **Oversee implementation of an FCPA compliance program.** A recent Corporate Board Member article stated, *“The criminal and civil consequence for violating the FCPA can be astronomical. A written, well-documented, and thoughtful internal FCPA compliance program which takes into account the risks and vulnerabilities of working with foreign parties, along with training and monitoring of those foreign parties, is the first line of defense against liability.”*<sup>5</sup> One member said, *“FCPA training is the first training for any acquisition and for all new hires, too.”*
- **Use internal audit’s insight.** Members utilize internal audit as their “eyes on the ground” in emerging markets. One member mentioned that the organization decided to send internal audit every year into *“the top five most-risky countries. That is the cost of doing business. We need to ensure the compliance people reinforce code-of-conduct signing and training.”* Another member commented, *“Internal audit needs to do more testing overseas.”*
- **Use external auditors for their perspective.** Audit chairs also rely on external auditors to assess risks in emerging markets. One member remarked, *“The audit committee reviews [external audit’s] risk assessment alongside internal audit’s – [the two assessments] are never quite seamless, but they do a pretty good job. Two sets of eyes on audit risks [are useful], especially when looking at specific risks in certain countries.”* One member also talked about the challenge of ensuring that the external auditors have the appropriate capabilities in those markets: *“Some firms are better in some countries; it depends on their*

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<sup>5</sup> Randall Fons, “The SEC Takes a New Look at the Foreign Corrupt Practices Act and Foreign Parties,” *Corporate Board Member*, August 14, 2006. Available at: [http://www.boardmember.com/network/index.pl?section=1146&article\\_id=12594&show=article](http://www.boardmember.com/network/index.pl?section=1146&article_id=12594&show=article).

*history and client base.”* Members also said they want to see U.S. audit team members “*go out there*” to oversee the work.

- **Consider traveling to emerging markets.** While some members believe that such travel is not feasible, given board members’ schedules, others feel that the full board and the audit committee should travel annually to a major emerging market. One member suggested the board or the audit committee bring management from the emerging markets into board and audit committee meetings instead, and another recommended attending management strategy offsites, which are attended by people from all around the world. At the very least, the audit committee should ensure “*management is visible. If I know that’s going on, I don’t need to sit in a conference room in the country. If it’s a tour to understand the depth and breadth of the business, maybe.*”

## Conclusion

Deciding whether to invest in major emerging markets is a key strategic matter for management and the board. However, once a decision has been made, it often falls to the audit committee to oversee the risks involved in doing business in particular countries. Often these risks are not financially material for the company, but they have the potential to negatively impact corporate and personal reputations. Audit chairs need support from internal and external auditors to answer the question “*How do you know what risk is out there?*” The practices identified in this issue of *ViewPoints* should help audit chairs answer that question.

## About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

*The views expressed in this document represent those of the Audit Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.*

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#### Appendix: Tips for managing risk in major emerging markets<sup>6</sup>

- **Be prepared.** Conduct due diligence in advance of entering the market; be sure joint venture agreements provide safeguards to ensure control. One ACLN member stated, *"You have to understand the worst-case scenario because that might happen."* The audit committee should insist that the company screen local partners and key hires, using several different organizations to do background checks. The focus should be on professional skills over language skills.
- **Develop personal contact.** Bring local leaders, including the head of internal audit and the lead external audit partner, to relevant board or audit committee meetings. One ACLN member also said, *"We bring in the foreign CFOs and internal auditors. They go through a course about tone [at the top] for about a week, where I speak. We bring them in for education."*
- **Regularly review operations.** One audit committee examines accounting procedures, tax questions, anti-corruption measures, audit processes, and resources, based on the findings of a special joint assignment of internal and external auditors in the country concerned. The audit committee should have a clear view of authorizations – who can sign for what, who does payroll, who disperses money – and ensure there are good controls.
- **Look intensively at local leaders.** One European Audit Committee Leadership Network (EACLN) member said, *"Make a generation cut, and hire young people with different value systems."* Bringing those young people to headquarters on temporary assignments can be *"a strong [retention] incentive."* The external auditor is a good source of information on local management.
- **Rotate headquarters people.** The audit committee should review the rotation plans for top finance people. One ACLN member said, *"The CFO should be a legacy company person."* Another ACLN member mentioned that the finance organization leadership team travels to various markets and works there for about two weeks each time: *"It is about them working within the region."*
- **Use the same technology and accounting platforms across the company.** Several members of both the North American and European networks recommended having all entities on the same technology and accounting platforms. One EACLN member said, *"All financial-control IT is on a global standard ... It forces discipline into the culture."*
- **Ensure a strong internal audit focus.** Corporate internal audit should focus on high-risk emerging markets as part of its annual plan, even if these operations are immaterial from a revenue perspective. *"The most important thing is to put the corporate head of internal audit in charge of [assessing internal] controls and technology,"* said one European audit chair.
- **Ensure that a code of conduct is rolled out across the company.** An EACLN member said, *"Maintain your values wherever you are."* Make telephone hotlines available: *"When employees have confidence in the code, calls increase."* The rollout needs to be backed by a training and education program.

<sup>6</sup> This list of tips is drawn from interviews with ACLN members, discussions at the meeting, and previously published advice from the European Audit Committee Leadership Network, "Major emerging market risk," *ViewPoints*, May 30, 2006, 4, which is available at: [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Euro\\_ACLN\\_May06\\_View9.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May06_View9.pdf).