

Major emerging markets risk

Introduction

The European Audit Committee Leadership Network held its sixth meeting in Paris on 12 May 2006. Following a discussion of enterprise-wide risk management in June 2005¹ and a discussion on insuring against risk in February 2006², network members explored how best the audit committee can provide oversight of risks incurred in major emerging markets. Members also considered information technology (IT) governance and the associated technology risks.³

The network's discussion on major emerging market risk focused on three topics:

- **What are the common major emerging market risks?**
- **Role of the board and audit committee**
- **Assessing one major emerging markets risk: an avian flu pandemic**

The members of the network participating in the meeting, or contributing through individual discussions beforehand, sit on the boards of about 50 large, mid and small cap public companies. For further information about the network, see "About this document" on page 6.

Members attending the meeting included:

- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Mr Jan Hommen, Audit Committee Chair, Royal Ahold
- Sir Anthony Greener, Audit Committee Chair, BT
- Mr Daniel Lebègue, Audit Committee Chair, Alcatel
- Dr DeAnne Julius, Audit Committee Chair, Roche Holdings
- Mr Tom McGrath, Global Managing Partner, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business, Ernst & Young
- Sir Ian Prosser, Audit Committee Chair, BP
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Mr Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services
- Lord Sharman of Redlynch, Audit Committee Chair, ABN-AMRO

Members who participated in individual discussions before the meeting were:

- Mr Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Dr Ronaldo Schmitz, Audit Committee Chair, GlaxoSmithKline

¹ European Audit Committee Leadership Network: "Audit committees: converging roles, diverging practices?", *ViewPoints*, 15 July 2005. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_EuroACLN_Jul05_View3.pdf

² European Audit Committee Leadership Network: "Preventing, detecting and investigating fraud/Insuring against risk", *ViewPoints*, 15 March 2006. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_EuroACLN_Mar06_View.pdf

³ See European Audit Committee Leadership Network: "IT governance", *ViewPoints*, 30 May 2006. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May06_View8.pdf

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. Comments described as being provided before the meeting were drawn from discussions with all those listed on page one.

Executive summary

The growth of business in the BRIC countries (Brazil, Russia, India and China) is pushing the topic of emerging markets risk up the corporate agenda in Europe.

- **What are the common major emerging market risks?** (Page 2)

Members identified six common risks associated with major emerging markets: (1) political and legal risks; (2) availability of infrastructure; (3) competition for local talent; (4) corruption and money laundering; (5) dependency on local joint venture partners; (6) piracy and intellectual property risk. In assessing these risks, audit chairs believe that in the longer term higher risks should mean higher returns. They also recognise that many companies cannot afford to stay out of the major emerging markets.

- **Role of the board and audit committee** (Page 3)

Most members said that their board reviews major emerging market risk, market by market, up to four times a year. However, members differed about the role of the audit committee: some see a limited role, for example when there is a fraud problem; others see an active role reviewing major emerging markets, often triggered by the internal audit function's work. [Tips for board and audit committee oversight of emerging markets risk can be found on page 4.](#)

- **Assessing one major emerging markets risk: an avian flu pandemic** (Page 5)

While avian flu is a global risk, it can also be considered an emerging market risk that may start in Asia. Although some audit chairs are sceptical about the risk, most believe contingency planning for the pandemic is essential – even if they disagree about the precise role of the audit committee. A member reported that one company had analysed the impact on employees and customers and calculated the impact on the bottom line. Several other members' companies had built inventories of either anti-viral treatments or face masks for their employees.

What are the common major emerging market risks?

Small emerging markets are not material to most companies, so boards tend to focus on the major emerging markets – the so-called BRIC countries (Brazil, Russia, India and China). One member commented: *“There is no way our company can avoid being in these four countries. We have to be there while not losing our souls”*.

Members are interested in the risks that these major emerging markets have in common, as well as those risks that are identified with particular countries. The six common risks include:

- **Political and legal risks.** For most companies, uncertainty is the main political issue.

Companies also need to develop relationships with the key authorities, including those for tax and accounting. One member said: *“Government relations are the biggest issue in our industry... You need good relationships with people”*.

- **Availability of infrastructure.** *“The level of infrastructure is an issue – airports, electricity and the distribution system.”*
- **Competition for local talent.** In the BRIC countries, there is real competition to recruit able and ethical leaders and they are hard to retain. Members advocate searching for talent in the US business schools: *“They are more expensive than locals but are well trained”*. Another member added: *“If you replace expats with local management with the same culture, you can make some real money”*.
- **Corruption and money laundering.** Corruption brings legal, financial and reputation risk. One member said: *“China is a major challenge – for the future of the company must be developed in China. How do you do that while implementing your own standards and code of conduct and without losing clients and partners? It is difficult to find the equilibrium”*.
- **Dependency on local joint venture partners.** Members raised issues about finding local partners and working with partners that may not think along the same lines. However, one member said: *“[We can] help improve their controls, help them grow in the right way and help improve their reputation”*.
- **Piracy and intellectual property (IP) risk.** US companies doing business in China indicated that protecting intellectual property rights was their number one priority in a survey last year.⁴ One member agreed saying: *“If a Chinese company wants to build [a product], they will”*. However, another member suggested: *“If people filed patents in China, they would have had some protection... IP is a political issue in the US context and has been blown up”*.

Role of the board and audit committee

Most members said that their board reviews major emerging market risk, market by market, between one and four times a year. One member said: *“Every meeting of the board focuses on India, China and one other emerging market”*. These reviews often include political risk analysis with the same time horizon as the projected return on investment.

However, members differed about the oversight role of the audit committee:

- **Limited role for the audit committee.** One member said: *It goes to the audit committee if there’s a problem, such as fraud or it’s Section 404 related”*.
- **Primarily an issue for another committee.** Some members said that emerging markets risk was dealt with by a risk committee, or other standing committee of the board.
- **Active role for the audit committee.** Another approach is for the audit committee to review major emerging markets – once or twice a year: *“The audit committee looks at Russia several times a year and other countries annually”*. These reviews are often triggered by the internal audit function. One member said that emerging markets risks were dealt with by the audit committee and did not go to the board.

⁴ US-China Business Council (USCBC), “American Companies Building Success in China; Results of the 2005 USCBC Member Survey”, 30 August 2005. Available at http://www.uschina.org/public/documents/2005/08/2005_membersurvey.pdf

Tips for board and audit committee oversight of emerging markets risk

- **Good preparation.** Conduct due diligence in advance of entering the market; check joint venture agreements provide safeguards to ensure control. The audit committee should insist that the company screen local partners and key hires using several different organisations to do background checks. The focus should be on professional skills over language skills.
- **Scale provides for better infrastructure.** *“The smaller the entry, the bigger the disaster”,* cautioned one member. Members recommended getting to scale quickly so that the local operations can afford good internal controls. *“Getting the scale to get structure in place is very important”.*
- **Develop personal contact.** The board and/or audit committee ought to travel once a year to a major emerging market. Along with the meeting, there are opportunities for top level political discussions and assessing local talent. Also bring local leaders, including the head of internal audit and lead external audit partner to relevant board or audit committee meetings.
- **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 mission of internal and external auditors in the country concerned. Other audit committees have had a detailed presentation from an outsource vendor. The audit committee should have a clear view of authorisations – who can sign for what, who does payroll, who disperses money – and ensure there are good controls.
- **Look intensively at local leaders.** *“Make a generation cut and hire young people with different value systems.”* Bring them to Europe: *“The Chinese are desperate for training; secondment to Europe is a strong [retention] incentive”.* Another incentive used in China was to provide a home, which had more value than a higher salary. The external auditor is also a good source of information on local management.
- **Rotate headquarters people.** The audit committee should review the rotation plans for top finance people. Members disagree about the benefits of having home-grown managers in the local finance organisation, as finance director or controller. In China there is an opposite trend to localise for operational effectiveness. One member recommended having all subsidiaries and other entities on the same IT platform: *“All financial control IT is on a global standard... It forces discipline into the culture”.*
- **Ensure 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 and to be responsible for what happens and be accountable to the audit committee.”*
- **Ensure code of conduct is rolled out across company.** *“Maintain your values wherever you are”,* make telephone hotlines available: *“when employees have confidence in the code, calls increase”.* The roll out needs to be backed up with a training and education programme.

Assessing one major emerging markets risk: an avian flu pandemic

While avian flu is a global risk, it can also be considered an emerging market risk that may start in Asia. Whether avian flu becomes a broader influenza pandemic, as happened in 1918, 1957 and 1968, is still uncertain.

The case of the SARS virus in March 2003 is instructive. Just over 800 people died, yet the overall cost of SARS for Asia in 2003 is estimated at about US\$18 billion. Economies such as Singapore and Hong Kong are estimated to have lost as much as 3% of GDP to SARS. *Business Week* reported: “the Asian Development Bank predicts that [an Avian flu] pandemic would reduce gross domestic product growth in Asia by as much as 6.5 percentage points, meaning almost zero growth for the region”.⁵

SARS in Asia is seen as a trial run for how many corporations will deal with avian flu. Watson Wyatt recently reported that while 32% of Asia-Pacific multinationals have plans in place to deal with avian flu, only 15% of US companies and 11% of European companies have such plans.⁶ Indeed, one sceptical member said: “*You might as well plan for an invasion from Mars*”.

However, avian flu does represent an unusual business continuity risk and not only for those companies with operations in major emerging markets. As one member commented: “*We all have contingency plans but if a large number of issues occur at one time, do you need anything in aggregate that’s different?*”.

Experts suggest an avian flu pandemic:

- Will not be limited by geography or industry
- Would appear suddenly in the population and swiftly escalate
- Is likely to persist for three to four months and impact a wide number of people who may not be affected by the pandemic itself (they may refuse to go to work or have to stay at home to care for the sick or children whose schools have been closed)
- Will impact the governmental response, as well as each company’s supply chain. One member pointed out: “*There is a risk of what governments do on this. Be aware of the government plan*”.

Another member said his company was treating this as a human resources issue: “*The company needs to be seen to protect its employees*”. One company had adopted a policy combining the issuing of anti-viral treatments for those who have to work and insisting that other employees stay at home. Several members’ companies had built inventories of either anti-viral treatments or face masks for their employees but this prompted another concern as one member asked: “*What about spouses and partners and their children? This needs a lot of thought*”. The ability to stockpile drugs and other sources of protection for employees creates many difficult questions for directors and management.

Audit committee chairs are divided about how involved they should be in contingency planning:

- One member said: “*It is a business continuity issue. We have a well thought through plan as with any other major disaster. But it’s not an audit committee matter, although it went to the board*”.

⁵ Dexter Roberts, “This time, Beijing gets transparent”, *BusinessWeek Online*, 17 November 2006. Available at: http://www.businessweek.com/print/bwdaily/dnflash/nov2005/nf20051117_9543_db039.htm

⁶ Watson Wyatt press release available at <http://www.watsonwyatt.com/news/press.asp?ID=15840>

- However, another member speaking before the meeting said: *“It has come up on two of my four boards. We are looking at technology for remote working. [We have] analysed the impact on employees and customers and calculated the impact on the bottom line”*.

Conclusion

Discussing the world’s major emerging markets, one network member commented: *“We have to be there while not losing our souls”*. That audit chair was echoing the words of Matthew’s gospel: “For what does a man profit, if he should gain the whole world and suffer the loss of his soul?”. This is the dilemma facing many European companies and one that audit chairs wrestle with as they attempt to provide essential oversight of emerging markets risk.

The American humourist Josh Billings’ response to the question was: “I suppose this depends somewhat upon the size of the soul. I think there are cases where the trade would do”. The response of modern European audit committee chairs is rather more ethical and certainly more practical: a whole series of tips and techniques for ensuring that companies can profit from emerging markets while keeping their reputations intact.

About this document

The European Audit Committee Leadership Network is a select group of audit committee chairs from leading European 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, their advisers and auditors, as they endeavour to fulfil their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from discussions among members of the European Audit Committee Leadership Network. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, advisers and auditors who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European Audit Committee Leadership Network, a select group of audit committee chairs from Europe’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

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