



Risk in emerging markets

Introduction

On June 30 and July 1, 2009, members of the European and North American Audit Committee Leadership Networks met to discuss a number of topics,¹ including risk in emerging markets. Members were joined by Antoine van Agtmael, originator of the term “emerging markets,” chairman and chief investment officer of Emerging Markets Management, LLC, and trustee of the Brookings Institution, for a discussion of geopolitical trends in emerging markets. Afterward, members met in a private session to discuss the impact of these trends on their companies and how the audit committee can best provide oversight of risks in emerging markets.² This *ViewPoints* provides a summary of the discussions. For further information on the networks, see “About this document” on page 12. For a full list of participants, see Appendix 1 on page 13.

Executive summary

The North American and European Audit Committee Leadership Networks last discussed risk in emerging markets in separate meetings in early 2006. Since then, the world has experienced an increasing shift in economic power to the East.³ This trend, together with the severity of the financial and economic crisis, is leading developed-market companies to reassess their businesses in a multitude of ways, including a renewed approach to investing in emerging markets. At the summit, meeting participants discussed:

- **Trends and changes in emerging markets** (*Page 2*)

Mr. van Agtmael predicts that emerging markets will represent half of the world’s economy within the next 25 years, necessitating a change in strategy for developed-market businesses who seek long-term growth. He shared four major factors that companies should be aware of: (1) macroeconomic risks are shifting toward developed countries; (2) geopolitical risks are easy to forget about, but are constantly present; (3) China is a frontrunner among major emerging economies; and (4) Russia continues to be a challenge for developed-market companies.

- **Governance of risk in emerging markets today** (*Page 6*)

Given the increasing importance of the major emerging markets in the world’s economy, boards are more frequently discussing the opportunities and risks involved in having a presence there. Meeting participants agreed that it is no longer helpful to consider the emerging markets as a group; rather, companies should be assessing them individually. Meeting participants also discussed the pros and cons of more international representation on their boards as they expand into these markets.

¹ Other summit discussions included “Current issues in financial reporting: a discussion with Bob Herz,” and “Regulatory and governance reform.” *ViewPoints* for these discussions can be found at http://www.tapestrynetworks.com/networks/net_audit_summit4.html.

² *ViewPoints* reflects the use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations. However, Mr. van Agtmael has given permission for his opening remarks to be attributed. Comments by Mr. van Agtmael (whether attributed or otherwise) and network members are shown in italics.

³ Ernst & Young, *Global megatrends 2009* (Ernst & Young Global Limited, 2009), 4. Available at [http://www.ey.com/Publication/vwLUAssets/Global_megatrends_2009/\\$FILE/Global_megatrends_2009.pdf](http://www.ey.com/Publication/vwLUAssets/Global_megatrends_2009/$FILE/Global_megatrends_2009.pdf).



▪ **Audit committee oversight of risk in emerging markets** (Page 8)

Despite a trend toward stricter enforcement of the Foreign Corrupt Practices Act (FCPA) and ever-increasing fines for violation, meeting participants were not convinced that the business cultures in emerging markets have improved significantly. In that context, meeting participants emphasized the importance of effective information and data flow to the audit committee and the value of having the external auditor weigh in on risks in emerging markets, even if the financial impact of the risks is immaterial.

Trends and changes in emerging markets

Speaking at the summit, Mr. van Agtmael said, *“The global playing field is not just leveling, but tilting away from the West ... In 25 years, emerging markets will account for half of the world’s economy.”*⁴ Companies in developed markets are responding to the increasing influence of emerging markets by making a fundamental change in strategy. Whereas before they invested in emerging markets solely to cut costs and increase efficiency, now they seek market penetration and growth. In fact, an Ernst & Young survey in 2008 of over 500 global companies with subsidiaries or joint ventures in emerging markets found growth and market potential to be the main goal of investments in these markets.⁵

At the summit, Mr. van Agtmael and meeting participants discussed four key factors:

- Macroeconomic risks are shifting toward developed countries
- Geopolitical risks are easy to forget about, but are constantly present
- China is a frontrunner among major emerging economies
- Russia continues to be a challenge for developed-market companies

These four trends are discussed in more detail below.

Macroeconomic risks are shifting toward developed countries

A meeting participant asked Mr. van Agtmael, *“We’ve been hearing about the emergence of emerging markets for years. So when will the tilt in power actually [create some] bite in terms of capital flows?”* In response, Mr. van Agtmael said:

We are close to a tipping point. I talk with a lot of CEOs of multinationals, and I am always struck by the fact that ... [most] competitors are already in emerging markets. In the last 10 years, we have seen a fairly dramatic shift in total sales to emerging markets. Consumers are starting to buy imports. For example, three-quarters of all cell phones, three-quarters of all beer, [and] about 50% of all cars are sold in these markets. Ten years ago, each would have been below 10%. Large companies can no longer afford to see these economies as peripheral.

⁴ In *The Emerging Markets Century*, Mr. van Agtmael uses Goldman Sachs projections for Brazil, Russia, India, China, and 11 other major emerging markets and JPMorgan data for other countries to assert that the 15 leading emerging markets will together be larger than the G7 economies soon after 2030.

⁵ Ernst & Young, *Risk Management in Emerging Markets* (Ernst & Young Global Limited, 2008), 4.

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



The recovery from the economic crisis to date is also telling: while emerging markets initially appeared to be suffering as badly as the United States and Europe, several have since proved more resilient. Mr. van Agtmael said,

The headlines on the emerging markets [during the economic crisis] have been misleading. First, we have not had a global financial crisis. We have had a half-global crisis that includes the US, part of Western Europe, and part of Eastern Europe. Emerging economies turned out to be more resilient because they went into the crisis with more robust growth, trillions in reserves, lower debt at a national level, fewer current account deficits and more conservative budgets. Their industrial production fell off a cliff earlier (because they make what we use) and they have come out of it earlier.”

As a sign of the times, last September, [US Treasury secretary Henry] Paulson was begging Congress to pass the bailout plan as China was having its first space walk. The roles have essentially reversed: the developed markets are a mess while emerging markets are walking in space.

Mr. van Agtmael went on to say, “These trends have shifted the risks as well as the opportunities ... There is a very realistic risk that some emerging markets will leapfrog developed countries ... They will seriously compete for resources ... and for the best talent.”

Carbon emissions are an issue for developed- and emerging-market countries alike

Mr. van Agtmael highlighted carbon emissions as “the single biggest issue [for developed- and emerging-market companies] for the next 25 years.” He said, “Ignoring the risks [of unrestrained carbon emissions] would be the biggest mistake corporate leaders could make.” Just days prior to the summit, a cap-and-trade bill spearheaded by US Congressmen Henry Waxman (D-CA) and Edward Markey (D-MA) and driven by the White House passed in the House of Representatives by a narrow margin. That bill would place mandatory limits on the emissions of the greenhouse gases that cause global warming.⁶ In the days following the summit, the G-8, joined also by China, India, South Africa, Brazil, and Mexico, met in Italy and spent time discussing climate change. They arrived at an agreement to limit global warming to an average of two degrees Celsius.⁷ Mr. van Agtmael pointed to the development of the electric car as an example of how emerging markets may surpass developed markets in climate-focused innovation.

⁶ Steve Hargreaves, “House passes sweeping energy, climate bill,” *CNNMoney.com*, June 26, 2009. Available at http://money.cnn.com/2009/06/26/news/economy/cap_and_trade/.

⁷ Robert Marquand, “G-8 as climate change forum: baby steps,” *Christian Science Monitor*, July 9, 2009. Available at <http://www.csmonitor.com/2009/0709/p06s22-wogn.html>.



Geopolitical risks are easy to forget about, but are constantly present

Mr. van Agtmael identified four significant geopolitical risks that he feels “cannot be ruled out”:

1. The possibility of the collapse of Pakistan
2. The risk of a nuclear or destabilized Iran
3. The risk of a rogue nuclear terrorist attack
4. The “unthinkable” risk of political or economic turmoil in China.

Mr. van Agtmael went on to say that of those geopolitical threats, he sees the risk of a nuclear Iran as the most probable: “I’m convinced we will see a nuclear Iran before [we see] a democratic Iran.” He sees the risk of turmoil in China as the least likely of the four: “If the growth engine the Chinese people have built goes into reverse, the social contract would be broken. This would lead to a spilling over into the streets. But I don’t think it’s probable.”

China is a frontrunner among major emerging economies

This year is the 60th birthday of the People’s Republic of China, but the founders of the Chinese Communist movement would hardly recognize China today. Its economy is close to outpacing Germany as the third-largest in the world. Mr. van Agtmael pointed out that an increasing number of global Fortune 500 companies are from emerging markets, with currently 37 from China alone.⁸

Despite the economic crisis and China’s reliance on exports (31% of GDP⁹), projections for GDP growth in 2009 are optimistic, targeted at 7.2%.¹⁰ Meeting participants questioned Mr. van Agtmael on the impact of the Chinese economic stimulus. He said, “China had by far the biggest stimulus program by GDP – I believe it was 20% of [their 2007] GDP.¹¹ That stimulus may be what makes the global economy turn around.” Mr. van Agtmael said that the speed with which China has been able to stimulate its economy during the downturn – faster than the major developed-market countries – has contributed to its quicker turnaround.

Even with the clear opportunities China’s massive market offers, members continue to worry about the prevalence of fraud and corruption. In a pre-meeting conversation, a member said, “With a US economy that is weakened, but China offering growth, human nature says there is more opportunity for some foolishness.” See “Audit committee oversight of risk in emerging markets” on page 8 and Appendix 2 on page 14 for tools and processes audit committees can use to enhance the oversight of risk in emerging markets.

⁸ A list of the Chinese companies in the global Fortune 500 is available through CNNMoney.com at <http://money.cnn.com/magazines/fortune/global500/2009/countries/China.html>.

⁹ Oxford Analytica, *International: China is well-placed in ‘long’ crisis* (Oxford, UK: Oxford Analytica, 2009), 5. Available for purchase at <http://www.alacrastore.com/storecontent/oxford/DB149850>.

¹⁰ The World Bank in China, *Quarterly Update* (Beijing: World Bank, 2009), 2. Available at http://siteresources.worldbank.org/INTCHINA/Resources/318862-1237238982080/5923417-1245206005835/CQU_June2009_full_06-18-09.pdf.

¹¹ Mr. van Agtmael’s estimate is based on a stimulus package of \$586 billion and the Chinese GDP in 2007 (exchange rate basis) of just under \$3 trillion.

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



Tips for audit committees overseeing operations in China

A subject matter expert in China told Tapestry Networks that 2009 – 10 audit plans should have an increased focus on how operations in China are absorbing costs, costing inventories, and assessing how excess capacity is written off. Revenue recognition for sales operations should be closely scrutinized.

Russia continues to challenge developed-market companies

Of the major emerging economies, Russia concerned network members the most. One said, *“Russia is the most difficult [of the emerging markets we operate in].”* In pre-meeting conversations, members and subject matter experts said problems for companies from developed markets that conduct business in Russia include a government bias in favor of domestic companies, lack of reliable access to Russian courts, and the unreliability of third-party contracts. At the meeting, Mr. van Agtmael said, *“In terms of corporate governance and transparency, Russia is the most difficult [of the major emerging economies]. In the financial system, the big banks will be okay, but many oligarchs became incredibly greedy and over-leveraged themselves.”*

Russia has suffered significantly from the financial crisis, given its dependence on foreign capital. In the final quarter of 2008, Russia suffered a net private capital outflow of \$131 billion.¹² Its banks and non-financial companies face large debt repayments in 2009. Mr. van Agtmael commented, *“The [Russian government’s] response to the crisis was amateurish, although it ultimately has had the right effect.”* The World Bank has projected real GDP in Russia will contract by 7.9% in 2009.¹³

Meeting participants who have been active in Russia reflected upon the difficulty of dealing with the Russian government. One said, *“My firm has had a good economic return in Russia. But it has been challenging. At one point, we withdrew. We are going back in, because we persuaded the government that they needed our technological expertise. But it is a question of the industry you are in.”*

Other meeting participants highlighted Russia’s challenging business culture. Mr. van Agtmael said, *“They have a long history of pride in not embracing Western ways ... [However,] there is a new group [of businessmen emerging], a class in their late 30s and early 40s that is well educated and has a more Western-like sense of business ethics.”*

Tips for audit committees overseeing operations in Russia

A subject matter expert recommended that developed-market companies instill strong internal controls and have staff regularly review them. Another suggestion was to bring Russian staff to developed-market countries for training to improve the quality of work on internal controls.

¹² Oxford Analytica, *Russia: External debts pose risks for companies* (Oxford, UK: Oxford Analytica, 2009), 1. Available for purchase at <http://www.alacrastore.com/storecontent/oxford/DB150685>.

¹³ The World Bank in Russia, *Russia Economic Report No. 19* (Washington, DC: World Bank, 2009), 1. Available at <http://siteresources.worldbank.org/INTRUSSIANFEDERATION/Resources/305499-1245838520910/rer19-eng.pdf>.

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



Governance of risk in emerging markets today

As company strategy in emerging markets has shifted, so too has the board discussion on risk in those markets. During the summit, meeting participants addressed two important questions:

- What is the board's role in discussing risk in emerging markets?
- Should boards of global companies have more international representation?

These two questions are addressed in more detail below.

What is the board's role in discussing risk in emerging markets?

Meeting participants report that in recent years, the full board has often taken up the question of whether or not to have a presence in emerging markets. One said, *"For my company, strategically, we have no choice but to consider emerging-market opportunities. Developed markets do not support our growth aspirations ... Expanding into emerging markets [came out] of our major strategic review [several] years ago."*

A study completed in June 2009 by Ernst & Young and the Economist Intelligence Unit found that the financial crisis is prompting companies to consider opportunities in new markets: 33% of over 550 global "C-suite" executives and board directors reported plans to expand into new geographical markets, a significant increase since January 2009.¹⁴ Emerging markets are among them.

In conversation at the summit, meeting participants emphasized that the risks and opportunities of emerging markets require a customized analysis. One meeting participant said, *"I don't think it's helpful anymore to think of the emerging markets as a group. My company no longer has [a single] emerging-markets strategy. We have now disaggregated our strategies, so we can try to get more focused on specific risks and opportunities. [Now], we have an India strategy, a China strategy, etc."*

However, Mr. van Agtmael suggested boards should address two general trends as they consider investing in emerging markets: *"The consumer, not just in China and India, is going to be much more powerful than before. And, there is a new breed of company coming up that didn't exist before which will be important as competitors and partners. These trends would not be captured in a country-level strategy."* Mr. van Agtmael said that this new breed of emerging-market company is successful not because it relies on cheap labor but because of its ability to make the right strategic decisions, such as a relentless focus on superior execution and quality.¹⁵

In preparation for board discussions on risk in emerging markets, boards may work with local risk advisers, create dedicated risk advisory boards, and speak directly with local partners and external auditors.¹⁶

¹⁴ Ernst & Young, *Opportunities in adversity: Accelerating the change* (Ernst & Young Global Limited, 2009), 20. Available at www.ey.com/opportunities-in-adversity.

¹⁵ In *The Emerging Markets Century*, Mr. van Agtmael presents 25 of these world-class emerging-market multinationals, companies that he asserts should be emulated globally, based upon his first-hand research with them and with many other emerging-market companies.

¹⁶ Ernst & Young, *Risk Management in Emerging Markets*, 25.

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



According to meeting participants, board discussions of risk in emerging markets may focus on:

- **Opportunities and threats.** One meeting participant said, “*We look at major emerging-market acquisitions on a case-by-case basis in the board.*” A member said in a pre-summit conversation, “We discuss the issue of a hostile takeover. This may be something we have to watch out for, but we don’t know where it might come from.”
- **Geopolitical risks.** In a pre-summit conversation, a member said, “We have yearly strategy meetings to talk about geopolitical risk. [It] can come up in every board meeting [as well] ... If something is taking place in a country that is an issue – for instance, extensive crime near the border of Mexico, or the swine flu – we can have a discussion on it at any time. If instability [rises] in a country, it may come up [at the board].”
- **Government relations.** Many multinationals face difficulties in winning government contracts and securing government approval for projects and investments in the major emerging markets. For example, a member said in a pre-meeting conversation, “Our joint venture partner [in one emerging market] was corrupt and uncooperative. We closed it down and started again with 100% ownership ... [but] it was hard to get government licensing.” A subject matter expert noted that boards need to be aware of the increasing importance of environmental regulation in emerging markets.

For members of supervisory boards of European companies with a two-tier board structure, these discussions are more limited. One such member said prior to the summit: “We look at the risk, of course ... [However] it’s a management board decision and doesn’t require the approval of the supervisory board.”

Should boards of global companies have more international representation?

In recent years, US and European companies have sought to diversify their boards by including board members with backgrounds or experience in the geographies in which they operate. However, while many have been successful in attracting members from outside their own domestic markets, most boards still do not have representation from the emerging markets.

The 2008 *Spencer Stuart Board Index* found that 47% of the top 200 boards in the S&P 500 have at least one director from outside the United States, with non-US directors accounting for 6.4% of all directors on these boards.¹⁷ Of these directors, the majority (24%) come from the United Kingdom, followed by 14% from Canada, 9% from both Germany and India, 7% from France, and 5% from both Australia and the Netherlands.¹⁸ Similarly, a Heidrick & Struggles study found an average of 23% of European board members are non-national directors, but two out of three international directors in European boardrooms are still European.¹⁹

¹⁷ Ibid.

¹⁸ Spencer Stuart, *Spencer Stuart Board Index 2008* (Spencer Stuart, 2008), 18. Available at http://content.spencerstuart.com/sswebsite/pdf/lib/SSBL_08.pdf.

¹⁹ Heidrick & Struggles, *Corporate Governance Report 2009: Boards in Turbulent Times* (Chicago: Heidrick & Struggles, 2009), 13. Available at <http://www.heidrick.com/NR/rdonlyres/A03A8F3A-A676-43FC-BBBA-06105F43B034/0/CorporateGovernance2009Europe.pdf>.

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



Meeting participants had mixed views about whether their boards need directors from emerging markets:

- **Representation is not necessary.** One meeting participant said, *“I am ambivalent about having internationals on boards. I would certainly avoid putting people on boards that feel they are only there to represent the view of that country or region. They need to have general knowledge also.”* In a pre-summit conversation, a member said, “It doesn’t matter what passport someone carries. It’s more about the experiences they have ... You need someone who has had involvement with the activities of enterprises [in these markets] to deal with the business and financial risks.”
- **Representation adds value.** In a pre-meeting conversation, a member said, “There is not enough [emerging-market] representation on boards.” This member went on to say that a few years of experience managing in a particular emerging market does not suffice when it comes to being a valuable representative of this market on a board, and suggested value is really gained when a director is actually from the emerging market.

International representation on the board creates additional challenges. One meeting participant said, *“I have seen that there can be significant language barriers in the boardroom ... when we are discussing nuances, it can be challenging for foreign board members.”* Another meeting participant highlighted the logistical challenge of scheduling board meetings and ensuring the board and committee workload is balanced when directors are scattered across the globe.

Audit committee oversight of risk in emerging markets

Network members who spoke to Tapestry Networks before the summit tended to agree with one audit chair who said, “The audit committee has got to be very clear about where their role [overseeing emerging-market risk] starts and stops. [Overseeing] performance and strategy – those are the role of the board, not the audit committee. And a lot of emerging-market issues are about management and strategy.”

The specifics of audit committee oversight are highly dependent upon the nature of the company’s operations in emerging markets – whether fully or partially owned, or whether the company has major offshoring arrangements in place. Nonetheless, common areas of focus include ensuring compliance with the company’s code of conduct, oversight of internal controls (including non-financial controls) to ensure compliance with the FCPA and other anti-bribery and corruption rules, and demanding high-quality, transparent financial information.

At the summit, meeting participants discussed two topics in particular:

- The impact of the FCPA in fighting fraud and corruption
- Key elements of audit committee oversight of risk in emerging markets

These two topics are addressed in more detail below.

The impact of the FCPA in fighting fraud and corruption

In the wake of the global financial crisis, regulators have increased their efforts to fight fraud and corruption. In the United States, the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ)

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



work together in the enforcement of the FCPA. The DOJ is responsible for all criminal enforcement of the FCPA and for civil enforcement of the anti-bribery provisions for domestic concerns and foreign companies and nationals. The SEC is responsible for civil enforcement of the anti-bribery provisions with respect to issuers.²⁰ There have been increases in both:

- **SEC activity.** Speaking during a separate session at the summit, John White, the former director of the SEC's Division of Corporation Finance, warned audit committee chairs, *"For those of you who think you don't have to worry about enforcement, just think about the FCPA. The FCPA touches everybody that is registered with the SEC, including foreign and domestic issuers. If you are providing benefits, such as gifts and entertainment, to employees of government-owned companies (such as doctors at a state-owned hospital in Germany), you could run afoul of FCPA."* Christopher Conte, associate director of the SEC's Division of Enforcement, recently pointed out that the SEC "has filed more than 35 FCPA cases since January 2006 – more than the total it filed in all prior years combined since enactment of the FCPA in 1977 – and that more are expected in the future."²¹
- **DOJ activity.** Data shows the DOJ is also increasing its FCPA prosecutions. Mark Mendelsohn, a deputy chief in the DOJ division overseeing the prosecutions, told the *Wall Street Journal* in May that "at least 120 companies are under investigation ... up from 100 at the end of last year."²²

Russell Ryan, former assistant director of the Division of Enforcement and now a partner at the law firm King & Spalding, recently told Tapestry Networks that multinational companies are more aware than ever about the risks of violating the FCPA: "Companies are more conscientious now. Twenty to thirty years ago, they may have looked the other way, whereas today, they search out violations and deal with them. More companies are coming forward to self-disclose violations to the SEC or DOJ, in hopes of leniency."

At the summit, meeting participants asked Mr. van Agtmael whether the FCPA may lead to less corruption in emerging markets, for example in China. In response, he said, *"Not immediately. It is a lever for change ... but it will be a longer-term change."* He added, *"Without a doubt, there is more corruption in emerging markets. Not having special audit procedures for this would be foolish."*

The European Union has no direct equivalent to the FCPA. However, European countries that are members of the Organisation for Economic Co-operation and Development (OECD) Working Group on Bribery are subject to the legally binding OECD Anti-Bribery Convention. Thirty-eight countries are now members of the working group, having ratified the convention, which means their governments have agreed to adopt legislation necessary to criminalize bribery of foreign public officials in their countries. Of Brazil, Russia, India, and China (the so-called BRIC emerging economies), only Brazil is a member of the working group.

²⁰ US Department of Justice, "Foreign Corrupt Practices Act: Antibribery Provisions," <http://www.usdoj.gov/criminal/fraud/docs/dojdocb.html>.

²¹ King & Spalding, "New Enforcement Initiatives at the U.S. Securities and Exchange Commission," *Client Alert*, March 12, 2009. Available at <http://www.kslaw.com/Library/publication/ca031209.pdf>.

²² Dionne Searcey, "U.S. Cracks Down on Corporate Bribes," *Wall Street Journal*, May 26, 2009. Available at <http://online.wsj.com/article/SB124329477230952689.html>.

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



Key elements of audit committee oversight of risk in emerging markets

In discussions leading up to the summit, ACLN and EACLN network members shared a number of valuable tools and processes for effective oversight of risk in emerging markets, stressing the importance of supporting an ethical company culture, ensuring staff and experts are positioned to add value (such as deciding whether to deploy internal audit staff in emerging markets or at headquarters), and establishing effective audit committee practices to uncover and proactively address issues. These tools and processes are outlined in more detail in Appendix 2 on page 14. For a list of questions that audit committees can discuss as they consider these issues, please see Appendix 3 on page 16.

Speaking at the summit, meeting participants focused specifically on two key elements of effective audit committee oversight: the importance of effective information flow and robust data, and the role of external audit.

The importance of effective information flow and robust data

One meeting participant said, *“We need reliable, good information on a regular basis that helps us discuss strategic [risk] issues.”* Meeting participants shared the sources and tools they find most valuable for such information gathering:

- **The CFO.** *“[The information] generally comes via the CFO, who has to determine from a mountain of information ... what he considers useful.”*
- **Internal audit.** Meeting participants said they rely on internal audit and continually push executives to talk with all levels of the organization. A member said in a pre-meeting conversation, “I went to a meeting [because] I was curious how corporate audit staff reported problems they found ... It is amazing how much ground these people cover. There is an [extraordinary] level of supervision and insight and discipline that is applied to get this stuff remedied. And if not, it gets to the CFO, unfiltered. He’s seeing it for what it is. It was very reassuring.”
- **Board-level site visits.** *“[Site visits] help in understanding the political and economic issues. But it is especially helpful to see how local managers are receiving and coping with messages from the top.”*
- **Informal discussions with management.** *“We rely on [these] to see who is running the business. It’s not the rehearsed conversation we have [with them] at the board or committee level.”*
- **Whistleblower hotlines.** *“While I don’t like them, [they] play a role. It is a useful way to get information.”*
- **Quality reporting.** *“When I first joined the company, I couldn’t figure out how we made money! The segment reporting didn’t allow sufficient granularity, in my view. We forced management to get more specific. It made one realize the importance of having high-integrity IT systems.”*
- **“Mystery shopping.”** One meeting participant said that random, personal testing of company services or products is a *“powerful tool,”* particularly for consumer service businesses.

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



- **Media coverage.** *“[Press clippings] provide good questions for the audit committee, particularly when used unprompted in committee meetings. It is interesting to see who reacts and how.”*

The role of external audit

Audit chairs have expressed an interest in greater involvement by the external auditor when it comes to understanding exposures to risk in emerging markets, even if the financial impact of the operations in the emerging markets is considered immaterial. One member said in a pre-meeting conversation, “The kinds of things we may be talking about from a fraud nature would be immaterial from an external audit perspective. At the same time, we want them to keep their eyes open.” A meeting participant said, *“Audit committees should lean on auditors in this area.”*

Another meeting participant speculated that if none of the Big Four auditing firms have a presence in an emerging market, it might be a red flag for companies: *“If they’re not there, maybe we shouldn’t be there either.”* However, several agreed that as developed-market companies continue to expand more deeply into new emerging markets, they are going to need an external auditor who can help them to address the issues that emerging markets bring with them.

The external auditor can also add value by supporting the internal auditor. A member said, *“In one firm, we were concerned about several small outposts in emerging markets. On an aggregate basis, they were miniscule. But there was significant reputational risk. So we relied heavily on the internal auditor to assess these outposts ... [and] the external auditor helped.”*

Conclusion

For years, headlines have pointed to the growing importance of the emerging markets and the waning influence of America in the global economy, a trend that the financial and economic crisis seems to have accelerated. This trend is also shifting the risks and opportunities for developed-market companies with operations in emerging markets. At the summit, Mr. van Agtmael urged network members and their companies to consider the growing importance of both the middle-class consumers in the major emerging markets and the new breed of emerging-market multinational companies that will be the competitors and partners of their companies. Boards can also encourage their companies to transition away from an aggregate emerging-market strategy to country-specific strategies.

Summit participants agreed that strategic and investment decisions about emerging markets should take place in the boardroom, as should a review of corporate performance in these markets. In the meantime, audit committees should focus on the control and ethical environment. Audit committees continue to struggle with the business cultures in these markets. Meeting participants emphasized the importance of continued vigilance on the part of internal audit staff, the external auditor, and audit committees to combat fraud and corruption in emerging markets. While Mr. van Agtmael noted that corruption remains a major challenge in many emerging markets, he pointed out that over time, the attention that developed-market companies give to these issues will serve as a *“lever for change.”*

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



About this document

The European Audit Committee Leadership Network (EACLN) and Audit Committee Leadership Network (ACLN) are groups of audit committee chairs drawn from leading European and North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee 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. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management, and advisers 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 or North American Audit Committee Leadership Networks. 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.

This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



Appendix 1: Participants at the Audit Committee Leadership Summit

European and North American Audit Committee Leadership Network members participating in the summit, who sit on the boards of over 50 large-, mid-, and small-cap public companies between them, included:

- Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- John Dillon, Audit Committee Chair, Caterpillar
- Gene Fife, former Audit Committee Chair, Caterpillar
- Dick Harrington, Audit Committee Chair, Xerox
- Phil Hodgkinson, Audit Committee Chair, BT
- Judy Richards Hope, Audit Committee Chair, Union Pacific
- Labe Jackson, Audit Committee Chair, JPMorgan Chase
- DeAnne Julius, Audit Committee Chair, Roche Holding
- Marie Knowles, Audit Committee Chair, McKesson
- Daniel Lebègue, Audit Committee Chair, SCOR
- George Muñoz, Audit Committee Chair, Altria and Marriott International
- Oscar Munoz, Audit Committee Chair, Continental Airlines
- Anders Nyrén, Audit Committee Chair, Sandvik and SCA
- Pam Patsley, Audit Committee Chair, Texas Instruments
- Ian Prosser, Audit Committee Chair, BP
- Pierre Rodocanachi, Audit Committee Member, Vivendi
- Guylaine Saucier, Audit Committee Chair, Areva and Danone
- Tom de Swaan, Audit Committee Chair, GlaxoSmithKline and Ahold
- Bernd Voss, Audit Committee Chair, ABB
- Sandy Warner, Audit Committee Chair, General Electric Company
- Chris Williams, Audit Committee Chair, Wal-Mart
- Mario Zibetti, Audit Committee Chair, Fiat Group

Ernst & Young partners participating in the meeting included:

- Tom Hough, Americas Vice Chair of Assurance Services
- Steve Howe, Americas Managing Partner
- Tom McGrath, Managing Partner, EMEA Financial Services
- Christian Mouillon, Global Vice Chair of Assurance Services



Appendix 2: Additional audit committee tools and processes to enhance oversight of risk in emerging markets

The following suggestions are drawn from input from members and subject matter experts in pre-summit conversations as well as from the 2006 network discussions. The advice covers:

- Supporting an ethical culture
- Ensuring staff and experts are positioned to add value
- Establishing effective audit committee practices

Supporting an ethical culture

- **Good tone at the top.** Members agree that part of their role is to help establish an ethical tone at the top of the organization, including in operations in emerging markets. This is reinforced by taking up specific questions about ethics and behavior with senior management and pushing management for consistency in messaging.
- **A clear company code of conduct.** In pre-meeting conversations, many network members discussed the difficulties of understanding and working within the cultural norms of countries in emerging markets, where bribery and corruption are commonplace. In that context, a company code of conduct must be sufficiently strong and well communicated to supersede the culture of the country in which the company operates, at the deepest levels of the organization. One member said, “I continue to be worried in every one of these regimes – how well are our employees behaving at a transactional level?”

Ensuring staff and experts are positioned to add value

- **Internal audit staff responsible for emerging markets need to be “A-players.”** A member said, “[What is critical is the] curiosity of internal audit [staff] and the openness of the enterprise to a recognition of risks in various parts of the world ... The importance of this competency increases as the company does more and more work in different regimes. You have to have an A-player, someone who has a lot of self-confidence and respect in the organization.”
- **Internal audit staff can be based in the emerging market(s) or centrally located.** While most members agree a centrally directed internal audit organization is important, staff deployment is highly subjective. Member comments indicate making a satisfactory decision is difficult. A member said, “We need to get better at shifting [internal audit] resources from one place to another. What we’re wrestling with is how much is central and how much is on the ground.” Some audit chairs worry that internal audit staff based in emerging markets will lose objectivity. One said, “It’s almost better to have people flying in.”
- **Internal audit staff in emerging markets need technical accounting expertise.** Given the current pace of accounting change and important differences in accounting standards in many emerging markets, companies should either import or train for technical accounting expertise: “We need depth

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



more than breadth; specialization has real value – for example, specialization in revenue recognition ... Too often ... people didn't have the specialized training and experience to spot a problem."

- **Rotation of local leaders is common and effective.** Rotation is used to prevent business leaders from prioritizing their relationships in the local markets over their loyalty to the company. One member said, "In general, we don't have a country chairman ... That's where you can have relationships that are too cozy." Another said, "We have started [rotations], and it is effective ... Last year we had [to conduct] layoffs due to the fact that we were concerned about their [un]ethical behavior."

Establishing effective audit committee practices

- **Audit committees should conduct spot checks and dig deeper.** Audit chairs must look carefully at emerging markets, even if the operations are not material. Some members report that spot checks, or surprise audits, are useful. One member said, "We target a handful of countries that we know have business practice problems. We know they have issues by reputation, or because of hotline [calls] ... We decided it doesn't make sense to visit these on a rotational basis. We need [internal audit] to visit [these countries] every year." Other audit chairs suggest digging deeper into data. A member said, "I am always in favor of getting country site data, not just consolidated data. [I look] at the factories, etc. If they are extremely profitable, [I look further]. That's the first view. If you have excessive profitability, it might be something you should be more suspicious about."
- **Audit committees should travel to emerging markets.** Several members have discussed visiting operations throughout the world on a yearly basis and meeting with local staff to get a firsthand view. One member said, "When you go to emerging countries for board meetings, you go and look at operations. Audit committees need to go separately too – we're going to juice that up."
- **Audit committees should be proactive about addressing issues.** Given the trend toward increased enforcement of the FCPA and the imposition of higher fines, companies are taking some proactive steps to address problems when found. Mr. Ryan said, "One of the best and fastest ways for a company under investigation to earn credibility with the SEC is to assure the SEC that the audit committee is playing an active role in the matter with the help of its own independent advisers." In one member's company, every case of internal fraud is prosecuted in order to send a strong message: "If we find something, we always take it to court. It is a signal to the company that this is not acceptable ... We lose a lot of money on this ... But we have decided it is worthwhile to take legal action all the time."



Appendix 3: Questions for audit committees

- ? Looking back over the last decade, have emerging markets delivered on their promise for your companies? If not, why not?
- ? What geopolitical trends impact your business today? How do the different business cultures in emerging markets reduce or enhance opportunity for your companies? Have you seen any changes in business cultures in the last few years? Have these trends been affected by the economic downturn? What steps can you take to mitigate the risks inherent in these business cultures?
- ? What questions are being raised by the board concerning investment in emerging markets? How has your board's discussion on risk in emerging markets changed over the past several years? Do you expect to see increased competition from emerging-market multinationals over the next decade?
- ? Do you feel the roles your board committees play in overseeing risk in emerging markets are clear? Is there too much or too little overlap with the full board's discussion of risk?
- ? If your company has extensive operations in emerging markets, have you considered adding board members from those markets?
- ? What do you consider best practice for audit committees in overseeing risk in emerging markets?
- ? As your company expands deeper into emerging markets, how is it ensuring sufficient internal audit coverage? What would you like to see from your external auditor in this regard?
- ? How has the FCPA or other anti-bribery and corruption legislation and enforcement impacted your business in these markets? How has your audit committee responded?