

On Board

The newsletter for Audit Committee members in Thailand
Issue 7: June 2008

In this issue:

- Board Performance Evaluations – gaining profile and momentum
- Do you value the work of internal audit?
- Stronger risk management – How it can help mitigate the impact of global crises
- The Audit Committee's role in Mergers and Acquisitions

Editor's comments

Welcome to PricewaterhouseCoopers' 7th edition of **On Board**, our newsletter for Audit Committee members in Thailand.

Our first article **focuses on evaluating the performance of corporate boards**. Evaluations are gaining momentum in the corporate world. In Thailand, the Stock Exchange's principles of good corporate governance recommend regular evaluations. This article looks at some emerging trends and how Thailand can benefit from the experience of other countries in looking into what is a relatively sensitive area given Thai business culture.

In the second article, **we take a hard look at the role of internal audit**. We ask "is internal audit valued by its stakeholders, in particular executive management?". We are not convinced it is, and this article encourages Audit Committees to work with internal audit leaders to help change the perception and reality of the value internal audit can bring.

In our third article, **we reflect on the fall-out from the sub-prime crisis**. We ask whether boards and senior management can learn any lessons to help them mitigate the impact of crises of this nature and scale should they happen again.

Our final article **raises the issue of mergers and acquisitions and the role that the Audit Committee should play**. With increasing domestic and cross border M&A activity, this is an area where more and more boards will need support.

We trust you will find this edition helpful and we would also appreciate your feedback on how it might be improved or your suggestions for future articles.

Varunee Pridanonda
Partner

New PwC Publications



Asia Pacific M&A Bulletin: Year-end 2007

Provides a comprehensive review and analysis of economic growth and M&A activity in the Asia-Pacific region. Features a special report on Vietnam.



The World in 2050: Beyond the BRICs

Provides a closer look at emerging economies, and reveals which ones have the potential to grow faster than established countries.

To download the above publications, please visit www.pwc.com/th

Hot topics!

Catch our Leading the Way articles in the Bangkok Post every other Tuesday.



Board Performance Evaluations – gaining profile and momentum



Boards, regulators and institutional investors are increasingly endorsing performance evaluation as a prerequisite for good corporate governance. In the UK for example, the Combined Code on Corporate Governance introduced recommendations for boards to annually evaluate their own performance, that of their committees and individual directors, and to report on it to their shareholders

What might this mean for Thailand?

We are likely to see an increase in the number of assessments taking place and the results disclosed in annual reports. This will be driven primarily by Thailand's revised principles of good corporate governance (issued by the SET in 2006). One of the recommended best practices is for regular board self assessments. This will allow all board members to consider the board's performance, and to solve any problems they have faced.

Worthy of note is one key difference between the Thai and UK principles. In the UK, the board is encouraged to include an annual assessment on each individual director to determine whether they are contributing effectively and committed to the role. In Thailand however, the SET is quite clear that individual performance assessments are not encouraged as they are deemed to be sensitive.

What can Thailand learn from UK practices?

PwC recently conducted research on performance evaluation based on published annual accounts from leading UK companies. The research found that reporting on performance evaluation evolved considerably in 2006. Compared to 2005, companies demonstrated a greater maturity in both their operations and disclosures.

The three main changes were:

1. Increased use of external advisors to conduct evaluations

This was more prevalent in 2006 although conducting performance evaluation reviews "in-house" remained the preferred option.

2. Certifying the effectiveness

More boards have confirmed the effectiveness of the board, committees, and directors by using a "certification" style evaluation. However, this has led to a reduction in more

insightful disclosures around performance evaluation. The areas that companies focused on covered structure and logistics, interaction, and focus.

3. Providing insights on the action plan emerging from their evaluation process

As noted above, companies appeared to be more open to providing an opinion on the effectiveness of the board, committees, and directors. This also included greater insights on the action plan emerging from the evaluation process. From the research, two main action points emerge:

- An increased focus by the board on strategy, both in terms of devoting more time to it and enhancing the process for receiving relevant information; and
- An increased linkage between the outcomes of performance evaluation and the content and nature of the directors' training. The focus is on strengthening the directors' knowledge of management's operations and strategy.

Areas for improvement

From PwC's research, scope for improvement was reported in the following areas:

- Succession planning and talent pool management,
- Training, including site visits, refinement of the induction programme and more information on risk issues and operations,
- Board processes, including agenda papers and ensuring that sufficient time is available for debate and exchange of ideas,
- Strengthening communications between board and principal operating subsidiaries through regular presentations, and
- Consideration of the board's risk appetite.

So how does this impact the Audit Committee?

In support of sound corporate governance, Board assessments are clearly considered a good thing. As such, Audit Committees should ensure that evaluation is on the board's agenda and push for an assessment to be undertaken.

Audit committees should also ensure that the lack of individual director assessments does not result in the "watering-down" of the overall picture. If so, then based on the old adage "what gets measured gets improved", board evaluations provide another opportunity to improve overall corporate performance.

Do you value the role of internal audit?



In our role as professional services providers, we are constantly battling with the question as to how stakeholders, and particularly management, can get better value from internal audit.

In a market such as Thailand, where corporate ownership tends to rest with a small group of individuals, the cost of implementing or strengthening an internal audit function can seem counter-intuitive:

“Why encourage a function to dig into company affairs which are considered confidential? Why spend money on a function that does not seem to provide tangible benefits?”

In short, many stakeholders see little connection between corporate profitability and the work of internal audit.

In theory, we would challenge this perception, particularly if it is based on a misunderstanding of the aims and benefits of good corporate governance. However, in practice, our experience suggests many internal audit functions rarely deliver on the promise to “add-value”.

Too often, the work of internal audit is based around low-level compliance activities such as double checking expense report reviews or monitoring bank reconciliations.

This approach is unlikely to uncover anything of real importance or highlight any suggestions for improvement that really impress management.

An opportunity for fundamental change.

As an Audit Committee member, there is then, a real opportunity to encourage and drive some fundamental changes to the nature and scope of internal audit’s work.

A first step is to consider what creates value, both within an organisation and across its extended business network, and how can this value be captured. On this one, PwC’s view is that a successful business is one that can manage people and process effectively, capture and sustain value from transactions, navigate regulatory environments, and make smarter risk decisions.

A more forward thinking internal audit function can help here by looking into less traditional audit areas such as corporate treasury, supply chain management, sales and marketing, corporate social responsibility, and working capital management.

So what to do?

As an Audit Committee member, we suggest you revisit the question as whether internal audit is doing the “right things”:

- **Right environment:** are internal audit’s objectives clearly defined and understood? Is internal audit actively supported by management, objective and suitably independent?
- **Right coverage:** does internal audit focus on the key risks of the organisation, allocating time appropriately between ‘fundamental assurance’ and process improvement work?
- **Right resources:** does internal audit have access to sufficient resources with the right skills to discharge its remit effectively?
- **Right quality:** does internal audit use best practice procedures to ensure that its conclusions are robust and add value?
- **Right outcome:** do internal audit reports address the real risks of the business with practical solutions that add real value?

The timing is right

As Thai organisations seek to become more global, they will also be expected to have advanced control and governance processes typically found in the US, Canada and Europe.

A PwC survey of internal audit leaders in Asia Pacific already suggests that internal audit functions in the region will start to experience stepped-up requests for assistance from their chief stakeholders in areas such as corporate governance, risk management, fraud prevention and detection, ethics, and internal controls.

But there are obstacles

Currently, few internal audit functions in the region would be able to respond effectively to more demanding requests. Our research indicates internal audit functions face a number of obstacles in their drive to strengthen their position.

- Due to the low-value compliance focus noted above, they often lack strong connections with executive management – an essential element in enhancing functional value.
- Cultural norms in some countries tend to inhibit promotion of a dynamic and independent role for the internal audit function.
- Internal audit functions often issue reports with watered down findings and without recommendations for improvement. They do this to avoid upsetting or embarrassing their auditees.
- Corporate management is often slow to demand a strong internal audit function.

Internal audit leaders must rise to the challenge

All this presents opportunities to enhance internal audit’s value proposition. Audit Committees can help by encouraging change. However, internal functions will need to be far more proactive if they are to change the perception and reality of the value they bring to their organisations.

It is vital for internal auditors in Thailand to learn from the experiences of their peers in other regions of the world and take advantage of new tools and techniques to make the most of today’s opportunities.

Stronger risk management - How it can help mitigate the impact of global crises

The global economy is a risky place...

- Amidst the worries of the subprime crisis and potential global economic recession, global capital markets plummeted on January 21, 2008. In response to the plunge, US FED cut US interest rates twice in ten days.
- Along the way, massive subprime losses have been announced by big-name banks and further write-downs are expected as the year progresses.
- We can expect continued volatility in exchange rates and the reduced purchasing power of the US (which accounts for 19% of world consumption).
- Asian economies are likely to experience a slowdown due to lower export volumes and greater price competition from China.

This all poses challenging questions for business leaders, particularly in relation to risk management.

So what can we learn from the crisis either as bankers or business leaders in other industries?

You can usually do better, sometimes a lot better

From an industry perspective, banking risk management systems are regarded as the most sophisticated of all practices. Given the complexity of financial markets, product types, and regulatory frameworks, banks clearly need to be on top of risk to survive.

Still, despite this, it looks as if risk management systems failed to protect many big-name banks from huge losses on subprime loans. This raises questions over the integrity and effectiveness of their risk systems and it looks as if a number were found wanting.

For example, Moody's downgraded a Canadian bank for not addressing risk management at senior levels. The report also indicated concentration risk in the bank's derivatives portfolio.

Another report commented on inadequate controls over the credit portfolio of one of Germany's largest banks. The bank had invested over 1.5 billion Euro in subprime securities but the board was only informed of the bank's portfolio investment risks and subprime exposure as the crisis broke in July 2007.

As a result, we are likely to see more internal reviews as boards seek to make sure "it could not happen here". We are also likely to hear a call for tougher and more conservative risk management practices from regulators.

Boards and senior management are also in the spotlight

Boards should provide strategic direction and articulate a company's "risk appetite". Risk appetite is the type and level of risk an organisation is willing to accept in pursuing its business objectives. Portfolio risk management is also relevant – this concept helps diversify risks while optimising returns.

Risk levels must be monitored regularly and any activity generating excessive risk should be reported to the board, and management practices reviewed accordingly.



However, based on what has been reported to date, it looks as if a lack of board and senior management understanding of the risks being run seems to have played a part in the size of losses relating to the sub-prime crisis.

Sophisticated risk management techniques can be applied beyond the financial services industry

The concept of risk appetite and portfolio risk management is also applicable to non-bank businesses. For example, one company in the export business faced a dilemma. Many of its key customers settled using non-secured payment methods, rather than using letters of credit (a higher cost option). Rejecting this payment method would probably result in the exporter losing key customers. Accepting non-secured payment however, exposes the company to increased credit risk.

The answer is for the company to take a calculated risk. Management can classify customers based on their credit worthiness and link this to the company's risk appetite using a financial model. The model will then enable management to set, and control, sale volumes to maintain credit risk at an acceptable level.

In addition, as the impact of the subprime crisis and a potential US recession become clearer, the company can adjust its portfolio by limiting export volumes to US customers, and diversifying exports to other countries.

Helping to make better business decisions

Greater use of quantitative risk management systems can provide the information management to make better, risk based business decisions. To enable management to do this, boards must also help to set risk appetite – this enables management to operate within acceptable limits. To minimise surprises, the board should also monitor overall risk levels and risk concentrations.

For the audit committee, it is important that members understand how management has tailored risk management processes to meet the company's specific needs, consistent with its risk appetite.

The Audit Committee's role in Mergers and Acquisitions (M&A)

Is growth through acquisition a strategic priority of your company?
Is your company a likely takeover target?

Historically, the answer for most Thai companies would have been no. There was little need for companies to engage in serious M&A activity – the domestic market was sufficiently competitive.

However, as we move towards greater regionalisation and globalisation, both domestic and cross-border deals are becoming key to success.

Be prepared Audit Committee

Given these changing business dynamics, audit committees need to consider what role they should take in a company's overall M&A process.

They can also find themselves a little behind the game if they have not been through the process before (and even more so if the deal “comes out of the blue”).

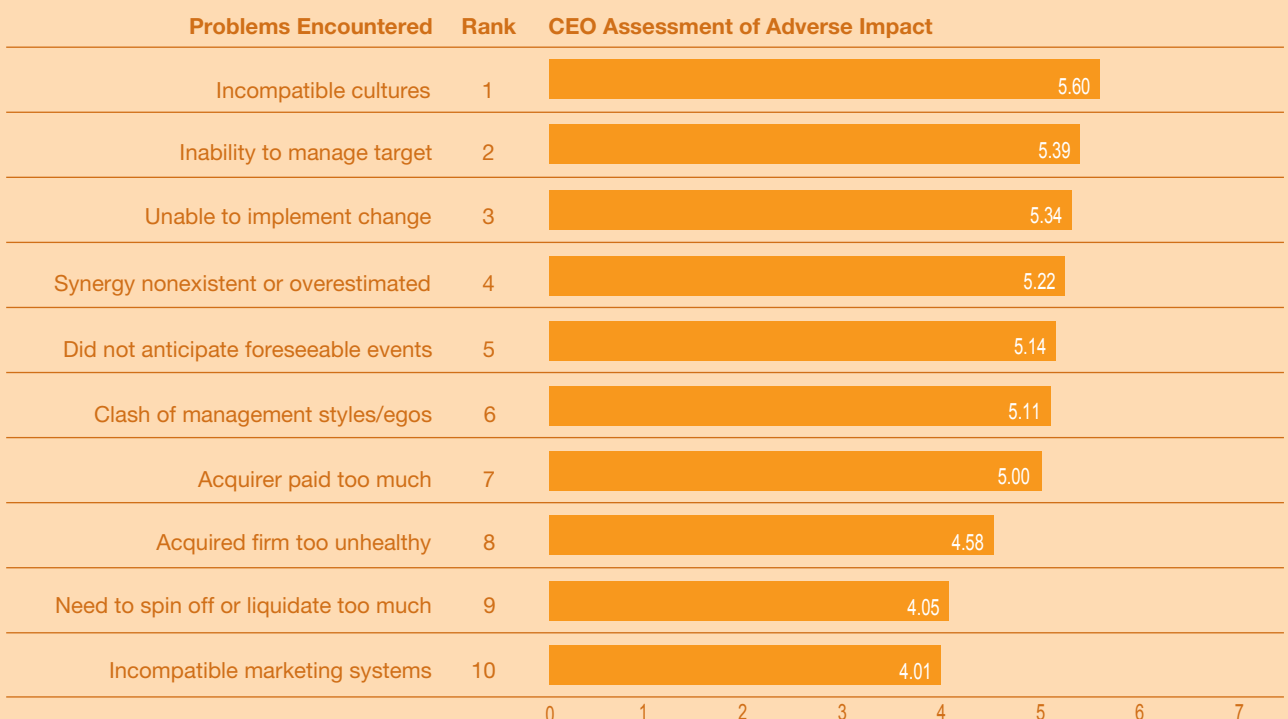
Learn from the numerous failures

So where to start? A good - albeit negative - learning point is to acknowledge that deals are not usually successful. It has been well documented that deals invariably “fail” to meet stakeholder expectations.

While most acquisitive companies are also the ones that dominate their industries, the frustration of mergers and acquisitions are well known with numerous surveys pointing to failure rates as high as 70%. The following highlights a number of reasons behind such failures:

“As we move towards greater regionalisation and globalisation, both domestic and cross-border deals are becoming key to success.”

CEOs Give Reasons for M&A Failures



Get specific

Once you have a good understanding of what constitutes success and failure, you should focus on the following specific areas when acquiring a company.

- **Corporate strategy** – Is the Board clear on management’s assessment of the benefits that the acquisition will bring? Have the plans been reviewed by executives with appropriate experience?

As independent members of the Board, audit committees can bring value here by challenging the Board on these issues, including identifying potential conflicts of interests within the management team and request that they be appropriately managed.

- **Due diligence** – Is the company’s process (including the use of advisors) robust and well managed?

The audit committee should ensure that this includes specific consideration of the target’s internal control framework, and its implications for both external reporting requirements and the ability to standardise controls post-acquisition.

With many cross-border acquisitions taking place, audit committees should also familiarise themselves with the governance requirements in the market in which the target operates. There are likely to be a number of differences, particularly in emerging markets such as Vietnam (which is seeing a significant amount of M&A activity).

- **Post-deal integration** – Does your company have a detailed plan, and will it devote adequate resources and attention to making the deal work?

Our experience points to the need for buyers to better understand what constitutes deal value, and how to best ensure they capture it. Management’s momentum often falls away once the “deal has been done”. It takes a different type of person to drive through the integration phase.

It pays to remain objective

While there will be an element of luck in making a deal work, you can significantly enhance the chance of success by adopting a structured approach, and learning from so many (well documented) failures.

Having said this, the problem with a deal environment is that its stakeholders have varying motivations and differing degrees of interest in making the deal happen. This can result in emotions getting in the way of straightforward, objective, and commercial decision making – not an easy one to manage.



www.pwc.com/th