

The newsletter for Audit Committee members in Thailand

# On Board\*

Issue 1: October 2005

## In this issue

Financial Reporting -  
To consolidate or not  
to consolidate?

Risk Management -  
Addressing risk in  
business strategy &  
planning

Corporate Governance -  
Enhancing disclosure to  
meet expectations

Internal Audit -  
Using risk-focussed plans  
to deliver value added  
results

# Editors comments

Welcome to this first edition of the PricewaterhouseCoopers Audit Committee newsletter.

As corporate financial reporting and corporate behaviour in general comes under greater scrutiny from regulators, institutional investors, analysts and others, so Audit Committees are placed more in the spotlight. With growing obligations and expectations, comes a greater workload. As a result, many Audit Committees are becoming concerned about the time and effort needed to keep up to date and to carry out their duties effectively and with appropriate care.

In this challenging environment, this newsletter is intended to assist Audit Committees by providing topical articles on matters of importance to them. Over the forthcoming issues, we will cover hot topics of the day and good practices, procedures, and insights gathered from leading Audit Committee members and PwC professionals.

We hope you will find the newsletters helpful and interesting and welcome any feedback from you on ways in which the newsletter might be improved.

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## Contributors



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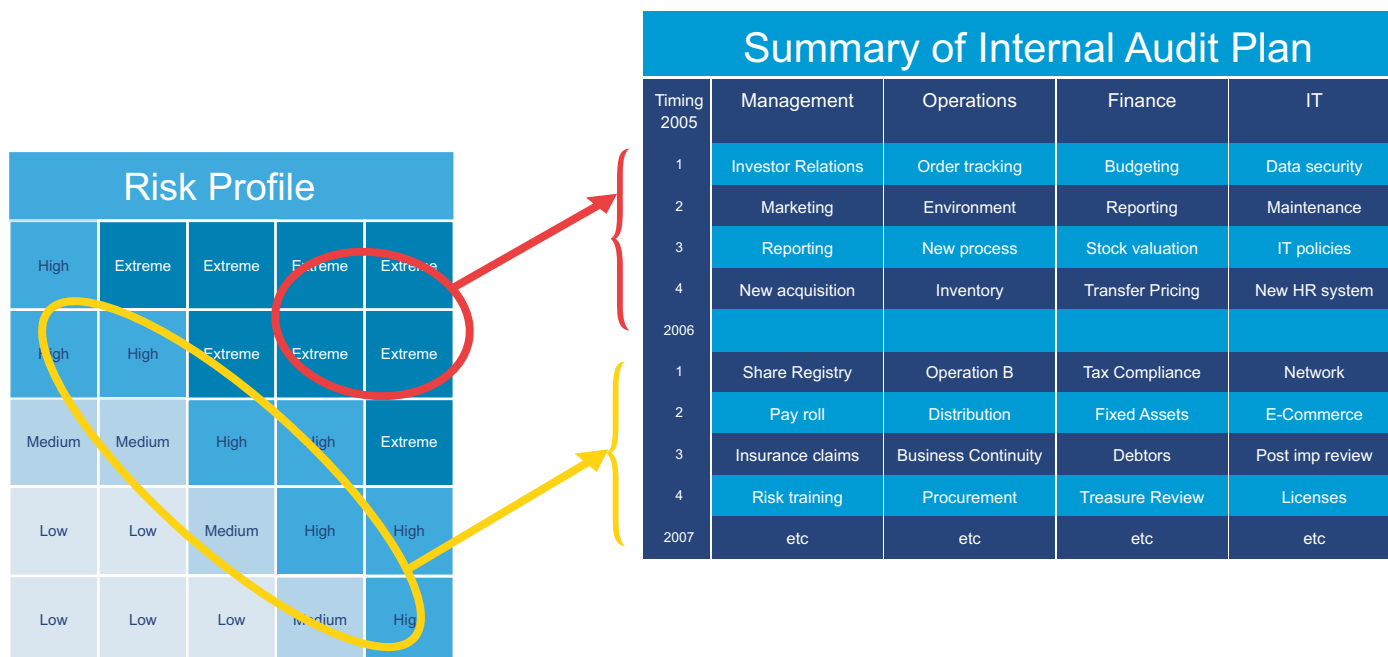


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## Assessing Risk Provides Focus

A key role of internal audit functions is to assist Audit Committees in meeting their responsibilities, particularly in respect of determining the adequacy of an organisation's system of internal control. To be effective, internal audit should have a clear plan of the processes and/or business units to be audited each year. The plan should be prepared based on sound rationale and clearly linked to an assessment of the organisation's risks.

The diagram below illustrates a linkage between an organisation's assessed risks, as depicted in a Risk Profile, and the Internal Audit Plan. To the extent that the risks are deemed suitable for attention by internal audit, high or extreme risk areas receive a greater priority for audit.



Thus, the Audit Committee should have a basic understanding of how the internal audit function develops its strategic internal audit plan. The basic concepts behind developing a strategic internal audit plan are illustrated in diagrams above:

The auditor must understand the organisation's business and risks in the context of the industry in which it operates and the key business objectives. Any information relating to the business risks that can be obtained from the organisation's Enterprise Risk Management activities should provide an input into the development of the audit plan. Internal audit should confirm their understanding of business objectives, corporate risks and the audit universe through discussions with senior management.

In the start up year of an internal audit function, companies typically do not have a formal baseline from which to evaluate the effectiveness of control activities. As such, the initial risk assessment and audit plan are developed primarily at an inherent risk level, i.e. the level of risk that is intrinsic in an activity before the planned or actual implementation of any controls by management to reduce the level of risk.

As internal audit's baseline knowledge of the internal controls develops, future risk assessments may also consider the past effectiveness of these controls in reducing the inherent business risks. Based on this knowledge, the priority attached to the audit of some risks may be revised. However, even in areas where controls are thought to be effective, internal audit may wish to periodically test these controls to ensure they continue to help mitigate the critical risks.

The results of the process described above will enable internal audit plans to be developed that address both a broad spectrum of risks across the organisation and attach a priority for the focus of internal audit. Once the internal audit plan has been developed, the head of internal audit should work with the Audit Committee and senior management to address high-priority risks and key stakeholder needs.

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# Greater Disclosure Benefits Stakeholders

What are the key themes coming out of recent surveys, studies and assessment of governance practices in Thai companies? In this section we highlight some of the areas where Boards, with an appropriate balance of support and challenge from the Audit Committee, can enhance their disclosure.

We have focussed on disclosure because it is an area where tangible changes can be made in time for the 2005 year end reporting season. Increased disclosure does not usually require significant changes in structure or practices - it only requires a commitment to provide relevant and valuable information to stakeholders. Many leading companies, particularly those who have slipped up in matters of good governance, are realising the benefits of straight talking to stakeholders, even when the news is less than positive - it is better to highlight plans for improvement than to stay silent. Comprehensive disclosure shows leadership and, perhaps contrary to intuition, an open culture can become a source of competitive advantage. Specific areas where we believe improvement can be made include:

- **Corporate governance policy.** Ensure that you have a documented policy on corporate governance and that it is communicated across the organisation. Disclose its key elements. A company that states it has a policy but has not yet documented it is unlikely to have successfully communicated and embedded good governance practices in its organisation. Use the annual report to disclose the key elements, including credible reasons for non-compliance in any area. Companies are increasingly establishing Corporate Governance Committees with a specific mandate to oversee the development, implementation and compliance of governance principles and policies.
- **Disclose more non-financial data.** Stakeholders need more than just financial based disclosures. Seek to present information that will also enable stakeholders to really understand the company's strategies, market conditions and outlook (especially over the longer term), including specific value creating activities.
- **Risk management practices** - Risk management is a hot topic. Smart companies are focusing more time on understanding how to formalise this discipline, and build risk management into business planning and operations. Risk management disclosure should cover details of the risk management framework but for real value add, it should highlight the risk issues facing the business, and how management will address these through specific actions.
- **Directors independence** - With the ever increasing expectations of more independent Boards, many companies, particularly those that are family controlled, are asking themselves two key questions. Firstly, how do we open our company up to include a greater proportion of independent directors at Board and Committee level and second, how do we find truly independent directors with the appropriate degree of business knowledge and experience? There is no quick solution here but we consider that a detailed statement of the current situation, including comments on the status of individual directors, together with the plans to introduce a greater proportion of independent directors, will be welcomed by the market place.
- **Director's remuneration** - Whilst acknowledging this is a relatively sensitive area, demands for full disclosure of individual director's remuneration, including all benefits and incentive schemes, will only increase. This disclosure is more valuable when it is overseen by a Remuneration Committee responsible for the assessment and review of executive remuneration packages.
- **Board and Committee meetings** - A good test of an organisation's commitment to best practices is to look at the number of meetings held for the main Board and its sub-committees, together with the attendance record of each director. Effective governance needs commitment and participation from all directors. Use the annual report to highlight the number of meetings held, and each director's attendance record. If the current position falls short of expectations, explain how it will be improved.
- **Evaluating board performance** - Leading companies are increasingly introducing more formal mechanisms to evaluate the performance of the Board and individual directors, usually on an annual basis. While the results are unlikely to be disclosed in detail, they should be used as a basis for performance improvement plans linked to clear objectives. Introducing and disclosing the process for performance evaluations is another message to the market that the company is aiming for greater transparency over its Board operations.

In summary, best practice recommends that Boards ensure governance practices are under continuous review. The Audit Committee can play a significant role in this regard. Through its objectivity and influence, it can encourage the Board to enhance areas of less than robust practice. So why not use this coming year-end to achieve as many "quick wins" as possible?

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## A Question of Consolidation

The external reporting responsibilities for company directors are extensive and growing. As a result, appropriately qualified Audit Committees are now typically required to support the Board by overseeing the preparation of the published financial statements. This requires the Committee, along with many other tasks, to ensure that the financial statements both comply with appropriate accounting standards and make all the necessary disclosures.

This is not an easy task as recognised by governance codes such as Sarbanes Oxley, which now requires Audit Committees to have at least one financial expert as a member to ensure complex accounting matters receive the appropriate degree of review and challenge.

One of the hottest issues in recent months in Thailand has been the SEC exercising its power to investigate and request restatement in instances where financial statements lodged with the SET do not meet listing requirements. One recurring issue which deserves specific attention relates to subsidiaries and whether a subsidiary company should be consolidated within the Consolidated Financial Statements. The SEC's main concern is that the exclusion of a subsidiary could result in a misleading financial result and/or position.

To provide guidance on this matter, the SEC issued Re: The Preparation of the Consolidated Financial Statements in December 2004. In preparing consolidated financial statements, the SEC requires Thai companies to comply with Thai Accounting Standards. The current Thai Accounting Standard No. 44 Re: Consolidated Financial Statements and Accounting for Investments in Subsidiaries, focuses on the concept of the power to control in determining whether a parent/subsidiary relationship exists. Control exists when the parent has the ability to govern the financial and operating policies of a subsidiary. Examples of control given in the Standard include such instances where the parent has power...

- derived from more than 50% of the voting rights by virtue of agreement with other investors.
- to govern the financial and operating policies of the enterprise by statute or under an agreement.
- to appoint or remove a majority of members of the board of directors.
- to cast a majority of votes at meetings of the board of directors.

In practice, control is usually assumed to exist when the parent can exercise more than half (e.g. holds more than 50% of paid-capital) of the voting power of the subsidiaries, since it is easy to justify. However, there are circumstances when the parent may own only a minority of the ordinary shares but will still control the financial and operating



policies of the subsidiary. To assist listed companies and auditors in preparing consolidated financial statements, the SEC has provided guidelines / indicators for the consideration of control, even though the equity interest is less than 50%, which include the following:

- The company is a major financial resource of the enterprise e.g. lending more than 50% of total assets or liabilities of the enterprise, providing guarantee to other lenders
- The company is responsible for the losses or major risks of the operations of the enterprise e.g. being the sole/major customer

High-quality financial reporting is vital to capital markets and the reputation of the reporting entity. At the end of the day, Audit Committees cannot escape their primary responsibilities - overseeing financial reporting. The Audit Committee should have enough time to understand business transactions and to conduct its review of the financial statements. The final draft of the financial statements should be received by the Audit Committee in time for any changes to be made.

As part of the overall review, the Committee should pay particular attention to the impact of new reporting standards, complex or unusual transactions, judgemental areas, significant related party transactions and the appropriateness of the basis of consolidated financial statements. It is also important to hear the external auditors perspective on these matters - requesting comments from the external auditors on such topics would certainly be helpful.

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## Addressing Risk in Business Planning

Although still evolving as a discipline, 'enterprise risk management' now has the general support of CEO's and Boards around the world. A recent PwC survey of CEO's showed that over 75% of the respondents agreed or strongly agreed with the statement that enterprise risk management was a priority for the CEO and Board in their organisations.

Despite the many practical challenges involved, this and other similar PwC surveys reveal a 'strong or considerable positive impact' when risk management is integrated with strategic planning and other key decision making activities.

Every organisation faces uncertainty, and yet this fundamental topic is often not addressed particularly well when strategic and supporting tactical business plans are being developed. Enterprise risk management does not dictate which objectives management should choose. Rather it proposes that management has a process to align strategic objectives with the entity's mission and ensure the chosen strategy and related business objectives are consistent with the entity's risk appetite.

The seven questions and supporting commentary below are intended to stimulate ideas for Audit Committee members who want to understand how an organisation addresses the interface between risk and strategy.

### Q1. To what extent, and how, are sources of risk and uncertainty explicitly identified in the strategy setting process?

- Uncertainty around external macro factors such as economic growth rates, oil prices and politics are important and considered by most strategy setters. However, explicit consideration of industry trends or changes and their impact on industry and competitor behaviour is often more relevant for strategy setting purposes but is not covered so well.
- Analysis of trends and uncertainties begins with a good understanding of the industry, the organisation's value drivers and customers. Organisations should be wary of simply falling back on apparent trends and conventional wisdom when considering the future.
- Too often strategies are developed based on a single picture or estimate of the future. Tools such as scenario planning may be used to build up alternative, internally consistent scenarios which reflect how trends might develop. The variables considered and their underlying causes, the impact on industry structure and competitive behaviour, should be plausible and documented. Gaining early information about the future of each variable can have a high strategic value.
- Too few organisations document their strategic planning process well, or leave a clear trail supporting the rationale for their strategies.

### Q2 How well are alternative strategies considered in the light of uncertainty?

- Organisations should consider and evaluate alternative strategies in response to the scenarios that may occur. The Board and management should make a conscious selection of a preferred strategy or the key choices most critical to pursuing the overall corporate objectives and meeting stakeholder preferences.
- Michael E Porter highlights that the risk associated with each strategy is a function of factors such as:
  - Timing of resource commitment
  - The degree of inconsistency of strategies for alternate scenarios
  - Relative probability of scenarios
  - The cost of changing strategies once uncertainty is resolved.

Whilst and in-depth consideration of appropriate strategies from a risk perspective is beyond the scope of this article, the following are examples of risk related responses that might be associated with particular strategies:

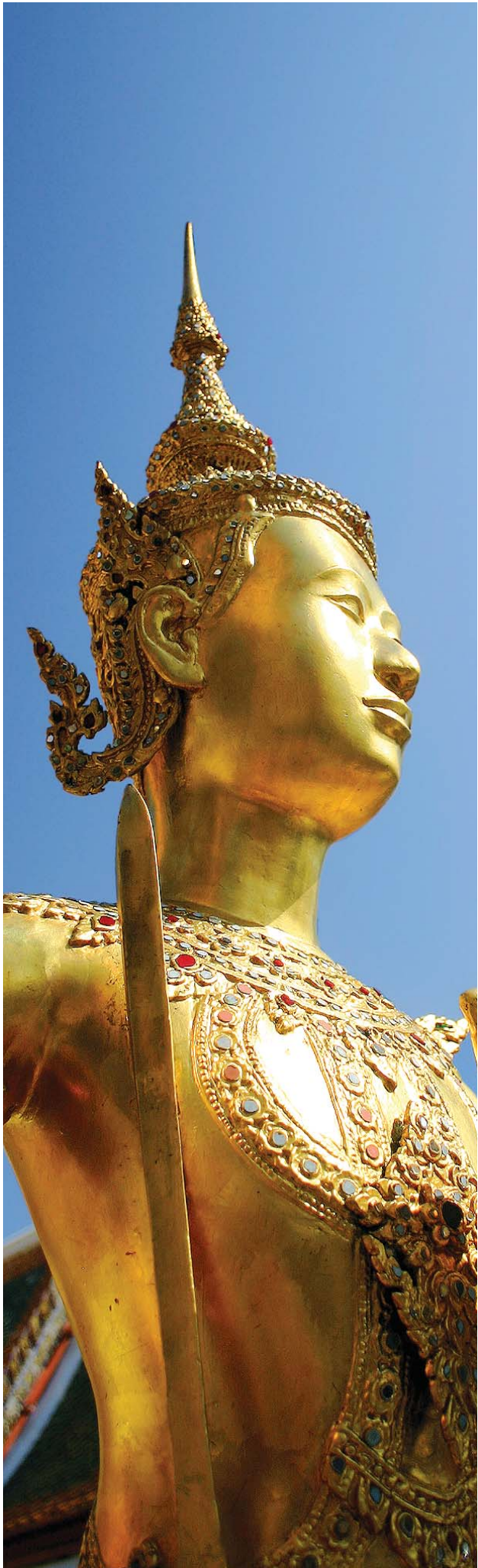
Strategy	Risk response
• Breakthroughs, innovation	• Take risk of investing in R&D and exploring growth opportunities
• Exploiting unique assets and growth options	• Price making and risk pricing
• Doing better with what we have	• Adopting risk-based capital allocation techniques and measuring risk adjusted performance
• Selection of defensive strategies in volatile times	• Earnings-at-risk modelling and resilience planning

### Q3 Are organisations making the best use of risk analysis tools and techniques when planning?

- The wide variety of available risk analysis tools and techniques are often not fully appreciated by organisations but these range from relatively simple qualitative techniques to more advanced, quantitative approaches.

### Q4 Who should be involved in the assessment of risks?

- Business unit managers are often in the best position to assess potential uncertainty and developments in the industry that they operate in. Their involvement in risk assessments is key as they are responsible for devising and implementing strategy. However, some managers may not have the necessary skills or experience to make a proper assessment of the risks.
- Assistance from others within the organisation including specialist corporate planning functions, and external specialists, can provide valuable input on macro and industry related issues.
- Responses to risks that affect more than one business unit may be better addressed at a Corporate or portfolio level.



**Q5 How often should scenario planning happen?**

- More frequent risk forecasting and planning should mean that material uncertainties are less likely to be disregarded. This may be particularly important in a volatile business environment. However, it may not be necessary for all business units to go through scenario planning every year.

**Q6 How well is risk appetite understood and communicated?**

- CEOs often complain that business managers do not take enough risks. An organisation's appetite for risk should be clearly articulated and linked to capital considerations. An organisation might wish, for example, to consider its risk appetite in terms of:

Level of risk appetite	Examples of when risk appetite may be applicable
High	Take increased risk by investing in areas for future sustainable growth
Little	Do not disturb status quo in mature areas of the business
None	Area outside of ethical boundaries or core business competencies.

**Q7 How can the risks threatening the achievement of the developed strategy be managed and monitored?**

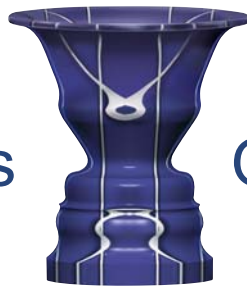
- Once strategic objectives and supporting business plans have been considered, the risks that they will not achieved should be identified and assessed. Many organisations now develop risk management plans as a mechanism to record and then monitor the key risks, their importance and any necessary actions needed to address them. These documents should be regularly monitored and updated.
- Risk and performance metrics should be established to enable real-time or continuous monitoring of variances to planned performance.

In summary, there is much to be gained from systematically identifying, assessing and subsequently monitoring risk as an integral part of the strategy setting and review process. Competitive advantage, sustainable and compliant business operations are all worthy goals to be sought from integrating risk into the planning process.

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Notes:  
 1 PricewaterhouseCoopers: 7th Annual Global CEO Survey - Managing Risk: An Assessment of CEO Preparedness, 2003  
 2 PricewaterhouseCoopers: Embedding risk management into the DNA of the business, 2004  
 3 Porter, Michael E. Competitive Advantage, Creating and Sustaining Superior Performance, New York, The Free Press, 1985

Your worlds



Our people\*