

ENHANCED DISCLOSURE WORKING GROUP

GUIDELINES FOR ENHANCED DISCLOSURE

**TO ASSIST DIRECTORS, AUDIT COMMITTEES, SHAREOWNERS AND
INVESTORS**

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The Working Group would welcome any views and feedback. Please e-mail us at enhanceddisclosure@standardlife.com

PREFACE

The Global Auditor Investor Dialogue¹ recognises the need to restore confidence in the current economic climate and sees enhanced disclosures relating to accounting, audit and risk controls as having a pivotal role in achieving this. Accordingly, certain Dialogue members agreed to convene an independent working group to develop guidelines, which would focus primarily on disclosure and be capable of general application on a global basis, to assist not only boards and audit committees in fulfilling their responsibilities, but also investors and shareowners in their evaluation of annual reports and constructive engagement with companies on audit, risk and control matters. Members' intent is that the guidelines should compliment and support the contributions in this area by regulators and others. It is important to emphasise that they are guidelines not standards, and should be used as such, with flexibility and professional discretion.

The guidelines are intended to provide a practical tool, which should be tailored to circumstances of each company – for example, whether a company has a one-tier or two-tier board structures. Although the guidelines focus on companies with a one-tier board structure, it is recognised that in a two-tier structure many of the guideline provisions fall within the remit of the management board. Therefore, it is intended that the supervisory board would exercise appropriate oversight to monitor compliance.

Whilst early consideration and implementation of the guidelines is encouraged, the Working Group is very mindful of the increasing burden of responsibilities on boards, in general, and audit committees, in particular. That said, it is hoped that companies, directors, investors and shareowners will find the guidelines to be helpful and useful in respect of annual reports published in 2009 and beyond.

The Working Group is indebted to those who gave of their time to contribute their views during the development of the guidelines – their views helped to highlight deficiencies, temper the tone and otherwise bring valuable insights to bear.

Last but not least, the Working Group values greatly the endorsement of the organisations listed in Appendix I. Their support is invaluable and was never taken for granted and never will be. If others wish to give their endorsement, they would be very welcome².

¹ The Global Auditor Investor Dialogue is an informal forum whose members comprise the major global auditing networks and leading global investors and share owners. These guidelines may or may not represent the views of the individual Dialogue members.

² Any organisation wishing to endorse these guidelines is invited to send details to enhanceddisclosure@standardlife.com

Information Flows to the Audit Committee

An audit committee's effectiveness is conditioned by the quality of information it receives from management in order to reach informed judgements on key risks and issues. This is especially important in the credit crunch environment in respect of information relating to cash flow, debtors, asset valuation and impairment testing. Management has a responsibility to ensure that it fairly presents to the audit committee all material information that might influence its decisions and it should confirm to the committee and the board that it has done so. In the event that there are significant areas for improvement that the audit committee has asked management to address then it would be useful if this were disclosed.

The audit committee members should enhance their understanding of the information it receives by visiting relevant areas of the company where appropriate.

Guideline #1

The audit committee should identify the information it needs to enable it to fulfil its responsibilities, which should be reviewed and analysed with an independent mindset, so that the committee is confident as to the completeness and integrity of the information it receives. The information should be provided to it in a timely manner and in a format which is complete, understandable and reliable.

The audit committee should confirm to shareowners and investors that it has received sufficient, reliable, and timely information from management to enable it to fulfil its responsibilities.

Risk & Internal Controls

Many companies provide a comprehensive description of their risk management and internal control systems, including whistle-blowing policies. In this regard, shareowners and investors find it useful to have a summary of the principal risks, especially when their potential impact is quantified. Also, they are concerned to know that the audit committee (or other relevant board committee) considers that the risk management and internal control systems are adequate and are operating properly. In making its assessment it is particularly important that the audit committee properly understands any financial instruments and structured products held by the company, in order to be able to identify the corresponding risks. Shareowners and investors are mindful of the considerable resource which has to be committed by independent non-executive directors to fulfil this responsibility but wish to be assured, without prejudicing the commercial interests of the company, that the responsible committee has the right blend of skills to identify and prioritise the most relevant risks and exercise effective oversight.

Guideline #2

The board, audit committee, or other relevant board committee should disclose what steps it has taken to satisfy itself that the risk and control framework and processes are operating, and have operated, properly. It should disclose a summary of the process it has applied (directly or through relevant committees) in reviewing the operation of the system of internal control and confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. The scope should encompass business model, financial, operational and behavioural risks and incentives which impact on the achievement and evaluation of appropriate key performance indicators (KPIs).

Valuation of Assets and Liabilities

The increased use of fair value accounting and its pervasive significance have presented challenging issues for issuers, auditors and users of audited financial statements. The Working Group believes that the role of the audit committee is of critical importance to ensuring that a robust and appropriate approach is taken to the valuation of assets and liabilities (including contingent and off balance sheet items), and that adequate and appropriate disclosure, including a description of the inherent financial risks, is provided in the financial statements and the notes thereto. The audit committee should consider using independent experts to scrutinise the fair values which are proposed by management.

Guideline #3

The audit committee should provide reasonable assurance that the significant assumptions used for determining fair values have been scrutinised and, where appropriate, challenged by the audit committee. In addition, the audit committee should confirm that they have satisfied themselves that the markets and/or models to which the valuations are marked have liquidity and transaction profiles that are adequate and sufficiently robust for enabling reliable and relevant valuations to be determined. Also, that they are satisfied that there is meaningful disclosure of critical judgements and key estimates.

Where values deviate from available market values, the audit committee should minute its general considerations, the information which provided the basis thereof, and its final endorsement. Periodically, these considerations can and should undergo a careful ex-post examination. The audit committee should ensure that shareowners and investors are provided with an unbiased explanation

of the factors which account for any significant deviation from previously reported values.

Write-Downs and Impairment Provisions

In addition to determining the primary valuation of assets and liabilities, management – and auditors – make significant judgements on write-down and impairment charges. The board and its audit committee have oversight responsibility to determine whether the process for write-downs and impairment provisions is adequate and appropriate. In particular, in respect of goodwill and other intangible assets, the audit committee should ensure that the process for determining the valuation takes into consideration the prevailing economic conditions.

Guideline #4

The audit committee should provide a brief, informative discussion of the factors which they have taken into account and the considerations they have made when fulfilling their responsibilities in respect of endorsing material write-downs and impairment provisions.

The audit committee, and ultimately the board, should carefully weigh other factors that might have influenced management’s proposed write-downs and provisions with a view to satisfying itself that management’s proposals are consistent with a true and fair presentation, free from bias, and take into consideration prevailing economic conditions.

Securitisation, Off-Balance Sheet and Contingent Liabilities

Investors and shareowners expect that there will be fair and unbiased disclosure of securitisation and off-balance sheet vehicles,³ and contingent liabilities in the audited financial statements, since these vehicles and liabilities can be material to a company’s financial position and, when appropriate, applicable regulatory capital ratios. Notwithstanding audit committees sometimes fail to give these items and their disclosure adequate attention, which can have serious adverse financial consequences.

Guideline #5

³ Fundamentally, investors and share-owners do not encourage off-balance sheet vehicles and other such arrangements and expect them to be kept to a minimum.

The audit committee should satisfy itself that all material securitisation arrangements, off-balance sheet liabilities and contingent liabilities have been identified for financial reporting purposes and that they are disclosed in sufficient detail in the financial statements, in accordance with any applicable accounting standards. The audit committee should critically assess and, when appropriate, challenge the valuations ascribed to these liabilities, and the methodologies used to determine them, to satisfy itself that the valuations used are fair and reasonable. The audit committee report should contain a meaningful description of the work it has undertaken in this regard.

Internal and External Auditors

It is critical to the integrity of audited financial information that both the internal and external audit functions are evaluated effectively at least annually. In the current climate, shareowners and investors need to be assured that the audit functions are effective and have been robustly evaluated; the evaluations should encompass a review of audit quality. In this context, it is recognised that the internal audit function has finite resources. It should focus on its principal responsibilities which are different from those of the external auditors, whose role is to express an opinion on the financial statements.

In addition, on a continuing basis, the audit committee must satisfy itself as to the independence of the external auditors and as to the adequacy of disclosures and analysis of non audit fees.

Guideline #6

The audit committee should disclose when and how periodic formal evaluations of the internal and external auditors were undertaken and of the key conclusions arising therefrom⁴. The external auditors should be subject to annual evaluation and the audit committee should provide a convincing, informative and non boiler plate explanation which supports its choice of auditor.

If the external auditor should change, the board or the audit committee, as appropriate, should promptly disclose the change and provide an informative explanation of the reasons for it.

Executive Compensation & Risk

⁴ A number of professional bodies publish review checklists such as the Institute of Chartered Accountants of Scotland's publication "Appraising your Auditors".

When addressing the financial crisis, many regulators, commentators and others have called into question executive compensation policies and practices which may incentivise executive behaviour that has been counter-productive to maintaining a well controlled, sustainable enterprise. Although determining compensation and remuneration policies and practices is primarily the responsibility of compensation and remuneration committees, the audit committee has an important role to assist these committees in ensuring that compensation policies and practices are consistent with an effective control environment. In particular, the board and/or the audit committee should satisfy itself that key finance, control and risk management personnel do not have inappropriate performance incentives – and only appropriate ones. In fulfilling this responsibility, regard should be had to KPIs, as referred to in Guideline #2 (Risk and Internal Controls)

Guideline #7

The audit committee should provide (a) a brief but informative description of its interaction with the compensation or remuneration committee in respect of executive compensation policies and practices and (b) comfort that the compensation policies and practices for top executives, key business unit leaders and senior control and risk management personnel are, in its opinion, appropriate for maintaining a robust control environment, consistent with good stewardship, and the long-term objectives and risk appetite of the company.

Substance not Form

A persistent criticism of many audit committee reports is the use of boilerplate language that fails to reflect the breadth and depth of the important activities undertaken. This is a barrier to effective accountability and transparency. Far better that the audit committee provides a useful and engaging account of the activities it has undertaken.

Guideline #8

The audit committee should provide a non-boilerplate report that provides an useful and engaging account of its activities, giving informative emphasis to key audit issues and how they are managed. All members of the committee and particularly the chairman are encouraged to take an active role in writing the audit committee report.

Audit Committee Charter

Many companies make their audit committee charter available on their website or include it in their proxy statement. Investors and shareowners welcome such disclosure but they are concerned to ensure that the charter remains ‘fit for purpose’, especially in the current economic environment. Mindful of the inherent complexities of accounting and auditing standards, and the significance of the judgements that have to be made in implementing them, the charter should enable the audit committee, at its sole discretion, and when it reasonably believes it necessary to do so, to obtain external independent advice at the company’s expense so that it can fulfil its responsibilities with assured confidence.

Guideline #9

The board and audit committee should undertake annually a considered and in depth review of the audit committee charter, which should be disclosed on the company’s website and, where appropriate, be included in their proxy statement, and satisfy themselves that it provides the terms of reference to enable the audit committee to fulfil its responsibilities. The board and the audit committee should disclose that the charter has been reviewed and summarise any changes that have been made to enable the audit committee to fulfil its responsibilities.

The audit committee should confirm that its charter permits it to obtain independent external advice at the company’s expense and it should disclose whether or not it has obtained such advice. In addition, the audit committee should confirm that it has fulfilled its responsibilities under its charter.

Audit Committee Membership

Investors and shareowners want to be assured that the audit committee membership is reviewed at least annually. In addition, that it comprises one or more members – preferably one of whom is the chairman of the committee - who have relevant and recent financial expertise as well as relevant commercial experience. Furthermore, the independence of the committee is a cornerstone – indeed, investors generally prefer that all members of the audit committee are independent. It is vital that the committee members receive regular training to ensure they maintain their competence and credentials, and keep abreast of auditing, accounting, and relevant risk issues.

Special care and attention is required in these regards when addressing the membership of audit committees of financial services companies. Such companies often have complex activities involving complex products, for which the quality of auditing is essential and valuation is heavily dependent on applicable accounting practices as well as the ability to determine whether valuation data is relevant and robust – relevant commercial expertise is invaluable in this context. It would be a matter of significant concern if the audit committee of a financial services company

did not have at least two experts, one of whom should have accounting expertise in financial services.

Also, it is important the board itself has the skill sets and competencies which will enable a knowledgeable discussion and exchange of views on the matters raised by the audit committee for the board's consideration.

Guideline #10

The board should disclose that it has reviewed the audit committee's composition during the year, and that it is satisfied that the audit committee has the expertise and resource to fulfil effectively its responsibilities, including those relating to any risk and controls.

Furthermore, the board should provide a convincing and informative explanation to support its opinion that the audit committee has not only recent and relevant financial and audit experience but also the commercial, financial and audit expertise to help it assess effectively the complex accounting, audit and risk issues it has to address. Any changes to the composition of the audit committee should be promptly disclosed and explained.

APPENDIX I

ENDORISING ORGANISATIONS

The undernoted organisations have kindly endorsed the Guidelines for Enhanced Disclosure.

Asian Corporate Governance Association

Association of British Insurers

California Public Employees' Retirement System (CalPERS)

Eumedion

Hermes Equity Ownership Services

International Corporate Governance Network (ICGN)

Railpen Investments

Standard Life Investments

Any organisation wishing to endorse these guidelines is invited to send details to enhanceddisclosure@standardlife.com

APPENDIX II
WORKING GROUP MEMBERS

Kenneth Bertsch *	Morgan Stanley Investment Management
Gerben Everts *	APG Investments
Guy Jubb * (Convenor)	Standard Life Investments
Mary Hartman Morris *	California Public Employees' Retirement System (CalPERS)
Isabelle Santenac *	Ernst & Young

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