

Audit Committee News

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KPMG'S AUDIT COMMITTEE INSTITUTE

Editorial

Dear Readers

This issues of ACI News opens with a case study of Swiss Post to give you clear insight into how an internal control system (ICS) was implemented for this organization and what the concrete benefits are in addition to compliance with statutory requirements. Read more about it on page 2.

Discussion surrounding Corporate Tax Reform II has died down somewhat in the popular press following a close result in the February 2008 vote. However, it is likely to remain a hot topic for business owners and their shareholders. What are the specific consequences of Corporate Tax Reform II on tax planning for small and medium sized enterprises (SMEs)? You can find the answer to this starting on page 7.

The recent spring roundtable series focused on M&A in the board room. Guest speakers Lucas Grolimund, CEO of Cicor Technologies and Joseph R. Colleluori, Head of M&A for Lonza Group, gave insightful reports on their experiences and best practices pertaining to acquisitions. You will find a summary of this series on page 11.

Monitoring costs is an important task for the Audit Committee. What are the most important factors contributing to audit costs? You will find out more about these factors in the article "Audit costs – results of the study of the CFO Forum Schweiz" starting on page 12.

To mark the occasion of the five-year anniversary of KPMG's Audit Committee Institute we asked well-known ACI members to write about a topic currently being debated by the board and to give our readers an insight into best practices. We will present individual contributions to you from now until the end of 2008. The first entry begins on page 16.

Article on IFRS and US GAAP updates regarding the latest developments and trends in international accounting round off the latest issue of Audit Committee News.

I hope you find the report interesting and informative.



Günter Haag, Head of KPMG's Audit Committee Institute

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Success factors in the implementation of internal control systems

Practice report for Swiss Post

Sabrina Strugger-Thommen, MSc BA, internal control system specialist for Swiss Post

Checking for the existence of an internal control system (ICS) has been an integral part of the standard audit since January 2008, in accordance with the Swiss Code of Obligations. Companies have a great deal of freedom when implementing an ICS. The main responsibility in shaping the system lies with the Board of Directors. Swiss Post began the implementation of its ICS in 2007 in order to generate additional benefits for the company and fulfill statutory requirements.

Background

As a company of major economic importance, Swiss Post is subject to a standard audit pursuant to the revised Code of Obligations Article 728a and implements the requirements for an internal control system. In accordance with the revised Code of Obligations, Swiss Post limited its ICS to financial processes initially.

Benefits of implementing an ICS

Implementation of an ICS in accordance with the revised Code of Obligations involves considerable expense. Swiss Post set itself the goal of creating an ICS that would provide benefits for the company while fulfilling the statutory requirements.

Swiss Post anticipates that the main benefit will be the protection of corporate assets via target-oriented risk reduction through appropriate controls and the allocation of clear responsibilities in financial processes. The greatest challenge in the implementation of an ICS is the balance between benefit and expense as well as modifications in line with the company situation.

Scope and creation of the ICS at Swiss Post

The Board of Directors holds the main responsibility for shaping the ICS. Swiss Post rooted its ICS at board level in the organizational regulations. The Ex-

ecutive Board and the Board of Directors recorded the minimum requirements for Swiss Post's ICS in a manual entitled "ICS Finances". These requirements will be developed and implemented by the ICS competence center that is linked to the finance department at the group level. The manual will be fine tuned with customized "ICS Guidelines" per business division.

In their supervisory role the Board of Directors and the Executive Board have approved the ICS manual as an appendix to organizational guidelines. They will request a report on the ICS status at least once annually. Since the topic of ICS can be interpreted very broadly it is of central importance to determine the scope of the ICS before the start of the project. The scope of the Swiss Post ICS is determined by the area of consolidation. In the implementation phase it is limited to the five or ten most important financial processes per organizational unit. The relevant financial processes are determined based on the balance sheet and income statement for each unit.

Several accounts often can be covered by one process, as a business case typically occurs both in the balance sheet and statement of account. In addition to quantitative benchmarks to help identify the most important financial processes, it is important to in-

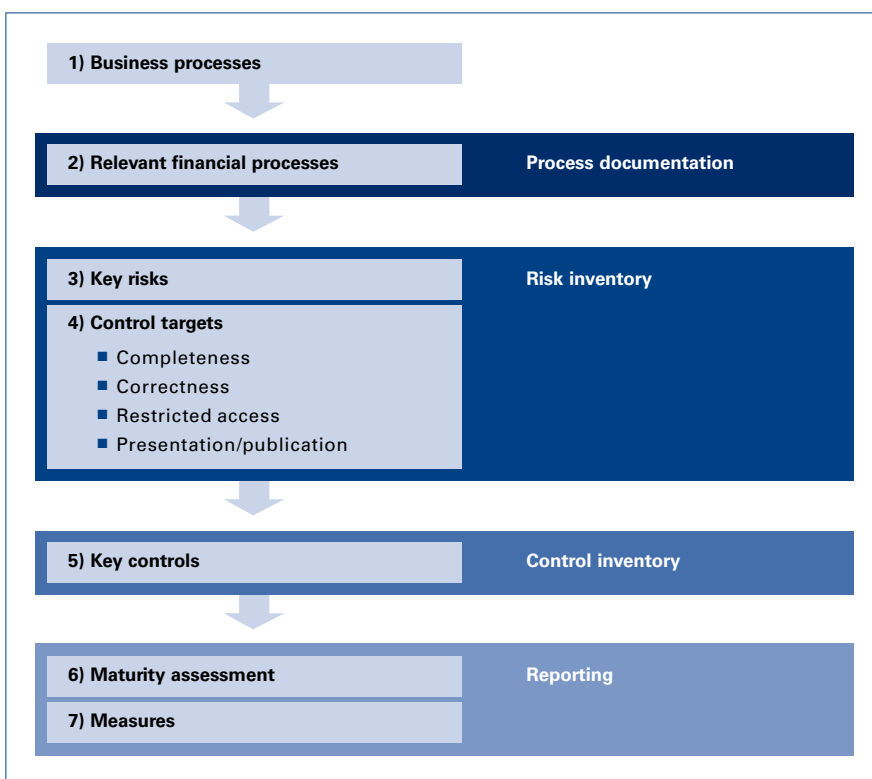


Figure 1

corporate the experience of the employees involved. The employees in Finance and the heads of Finance in the individual areas know their own processes best. From daily business experience as well as feedback from past audits, these people often know extremely well which processes carry the greatest risks.

The topic of ICS is not so new. Every successful company already has an

ICS, which is often documented on a very cursory level. For this reason it is essential from the beginning of an ICS project to obtain all documentation available. The need for action is based on defined deviations from the target situation.

Risk and control inventory

At Swiss Post the ICS has a risk-oriented structure. The risks identified in the relevant financial processes are de-

scribed in the risk inventory and categorized according to the following control goals:

- Completeness
- Correctness
- Restricted access
- Presentation/publication

The assessment of risks in accordance with probability and scope of damage provides the basis for prioritization (see Figure 1).

The top risks are categorized as key risks and covered by corresponding key controls. Risks that are not defined as key risks within the evaluation are not dealt with further. This selection ensures that resources for the construction and management of the ICS are implemented in a targeted fashion for the key controls.

Every key control must be described unambiguously in the control inventory. Control responsibility must be expressly allocated to one employee per control. This ensures that it is clear to every employee which controls they are responsible for in a process that often has many levels and is cross functional.

Reporting

To assess the maturity of the ICS, a self-assessment of the areas is car-

ried out at least once annually based on a questionnaire. The ICS Competence Center consolidates the results and provides the Executive Board and Board of Directors with a corresponding report. Swiss Post's ICS goals are auditability, effectiveness, and efficiency. Swiss Post is particularly keen to generate added value in the area of efficiency by means of the ICS, which can be achieved through better controls.

In order to make reliable statements regarding the aforementioned criteria, it is not sufficient to carry out a maturity assessment at the process level. Since Swiss Post would like to manage and improve controls and the ICS on an ongoing basis, the assessment must be made on the basis of the individual controls. This procedure ensures that any improvement potential is recognized and corresponding measures can be taken.

The questionnaire is divided into two main categories. In the first part questions are asked on the documented ICS process as a whole. These so-called process questions are answered once per ICS process. In the second part of the questionnaire questions are asked at control level. The control questions are divided into three categories: auditability, effectiveness, and efficiency. Each of these questions must be answered per control. Thus the assess-

ment of an ICS process consists of a questionnaire on the process as well as several questionnaires on the controls. To facilitate this assessment, these questionnaires are shown in an IT tool and can be completed electronically. There is no weighting of individual questions. In addition to the self-assessment there is an assessment of the ICS by Internal and External Audit (KPMG).

Measures to improve the ICS

The annual report to the Executive Board and the Board of Directors illustrates the implementation of the Swiss Post ICS manual and related compliance with statutory principles. Swiss Post is keen to identify any gaps in the ICS and to make appropriate improvement measures. Based on the detailed maturity assessment at the control level any improvement potential is easily identifiable. The ICS report to the Executive Board and the Board of Directors includes measures that have been taken to improve the ICS so that the recipients of the report can make strategic decisions and take charge when necessary. Every measure must be allocated to a control or a process. It must be clearly described and also allocated with a person responsible for that measure (see Figure 2).

Depending on the scope of the measure, either one deadline or a sched-

ule with several milestones are specified. The multi-level reporting process by the individual control officers via the ICS officers and the heads of Finance to the department heads – and finally the consolidation in the Group ICS Competence Center with reporting to the Executive Board and the Board of Directors – promotes understanding of the ICS across all levels of the company. In addition, this reporting process ensures that appropriate measures to improve processes can be implemented at the different levels.

Communication

Good communication is extremely important for the standardized introduction of an ICS throughout the company. The ICS competence center uses an interactive dialogue platform to support communication. This platform supports central filing for the exchange of information. In addition to the intranet platform there is a newsletter, which is sent electronically at least once per quarter to all Swiss Post employees involved in the ICS process. It contains information on the latest ICS developments and modifications to the ICS process.

This communication ensures that the ICS remains a subject of topical interest and conversation. The implementation of an ICS has no value if it is only updated once annually. All employees

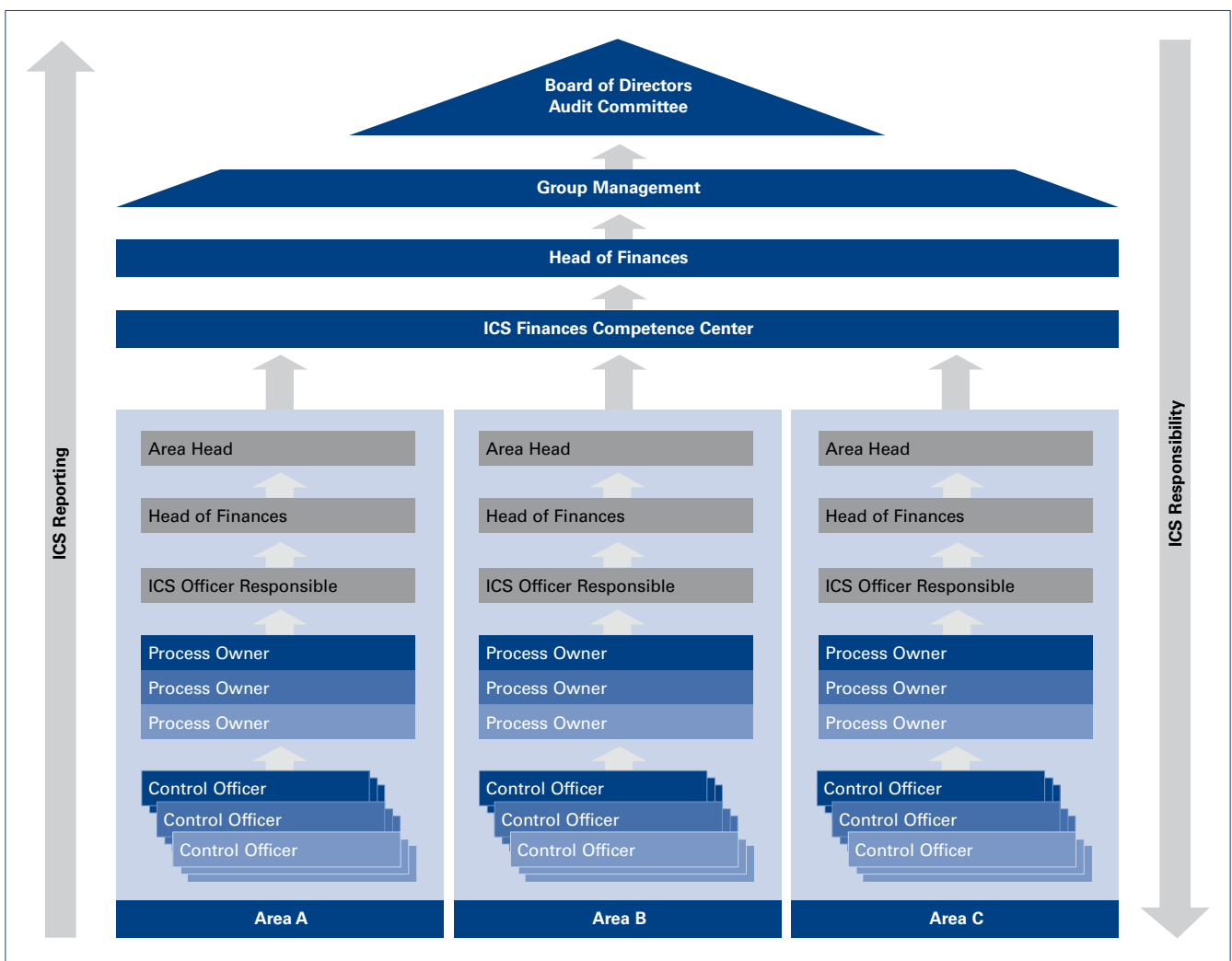


Figure 2

must be cognizant of the ICS and live up to the the goals specified in the manual. The Swiss Post ICS Competence Center wants to achieve these goals by means of active communication.

Success factors in ICS implementation

Swiss Post identified several success factors for a successful ICS in the first implementation phase. The support of

top management is essential in order to create a standardized ICS throughout the company in accordance with the corporate governance guidelines. It is also important to win the trust of

the employees. ICS will only be successful if all employees in all organizational units are aware of it.

Swiss Post also discovered the usefulness of external information sources. However, it is important to adjust this information to the situation of the company and to have the help of internal support for successful ICS implementation. Specialists from Internal Audit and Risk Management can help link new elements in the ICS with existing corporate concepts. For example, Swiss Post was able to continue using Risk Management's existing risk assessment scale for the ICS. By creating such connections, the ICS will be integrated better into existing company processes and understanding of the process will be increased.

Creating an ICS can take up a lot of resources. Therefore, it is important to limit the scope of the ICS implementation in order to deploy financial and human resources in a targeted manner. Limiting the Swiss Post ICS to a few important financial processes and their key risks guarantees that the ICS can be managed and further developed in the coming years. If the scope of the project is too large from the beginning there is always the danger that the interrelations will be lost and the system will no longer be modifiable if necessary.

Swiss Post was able to begin the implementation of its ICS with a good cost/benefit ratio and therefore will be able to generate additional benefits in the years to come while fulfilling statutory requirements.

Summary

With the implementation of an internal control system in accordance with the Swiss Code of Obligations, companies enjoy a great deal of freedom. If it is possible to link an ICS to existing concepts, further goals can be reached beyond compliance with statutory requirements. In the course of structuring its ICS, Swiss Post identified various success factors, which include support of top management, including employees in the process, sharing expertise, and limiting the project scope.

Source: Extract from the Master's dissertation entitled "Implementierung eines Internen Kontrollsystems bei der Schweizerischen Post" by Sabrina Strugger, University of Berne.

Corporate tax reform II

Overview and impact on tax planning

Andreas Schorno
Tax

Discussion surrounding Corporate Tax Reform II has died down somewhat in the popular press following a close result in the February 2008 vote. However, it is likely to remain a hot topic for business owners and their shareholders. On 1 January 2009, part of the revised provisions will enter into force. The new regulations that focus on partial taxation of dividends and contain a variety of supplementary measures will relieve the tax burden for small and medium sized enterprises (SMEs) and their owners. Greater flexibility in company financing is also based on the newly legislated capital investment principle. However, some execution questions regarding this topic are still open. Additional impetus comes from other related measures. The new provisions invite discussion on the changed framework conditions with regard to tax planning.

Overview of new regulations

Corporate tax reform was adopted by Swiss voters on 24 February 2008 after a fiercely fought battle. The Swiss Federal Council decided to enforce the first set of changes in the law as of 1 January 2009. Other provisions will follow at two year intervals.

The key element of Corporate Tax Reform II is concessions for dividends resulting from partial taxation. Additional positive tax framework conditions for SMEs will be created through peripheral measures, which include a change from the nominal value principle to the capital investment principle and various concessions for owners of partnerships (individual companies or partnerships) with regard to succession planning, inheritance, and liquidation.

In addition, tax-neutral procurement of replacement items will be standardized and expanded for re-investment. Other interesting points for stock corporations are an increase in the participation deduction and the option to have corporate profit tax calculated with the tax on capital (as in the cantons of Aargau, Thurgau, Schaffhausen, and St. Gallen).

Finally, disclosed or undisclosed restructurings to eliminate losses or to restore former nominal capital are

now deducted from stamp duty (approval procedure no longer necessary).

In addition to the federal legislators, various cantonal legislators have shown a desire to introduce reform. In many cantons the tax rates for legal entities and natural persons (individuals) are to be reduced, in some cases considerably. In the case of stock corporations, cantons such as Appenzell Ausserrhoden (6%), Obwalden (6%), Nidwalden (9%), Lucerne (planned: 4.5 – 6.5%) or even Uri (10%) are vying for the top places in the tax burden ranking. Some cantons are equally competitive with their income and wealth tax rates. The following extracts give insight into the most important elements of the corporate tax reform and its effects.

Relief for shareholders in stock corporations

a) Partial taxation of dividends

In partial taxation, dividends from qualified investments (10% of the share capital or company capital) will be added to taxable income only up to a specified amount.

For ownership of business assets up to 50% and private assets up to 60% the cantons are free to decide whether and to what degree they wish to eliminate double taxation by means of partial taxation of dividends. How-

ever, they are still bound by the minimum investment amount of 10%. Various cantons have already introduced tax relief measures for dividends. These are mainly implemented via the tariff: the dividends are calculated in full with taxable income but a lower rate is applied. The cantons of Basel City, Geneva, Jura, Neuchâtel, Fribourg, Valais, and Ticino are continuing with the regime of double taxation.

Dividends include ordinary and extraordinary profit distributions, bonus shares, bonus increases in nominal value, monetary benefits based on the participation structure, or payment of liquidation assets. The tax law perspective, not commercial law, is decisive in this (for example, repurchase of shares treated for tax purposes as a partial liquidation). Equities, capital contributions, and share certificates in Swiss and foreign companies are deemed to be investments. Profit-sharing certificates, loans, bonds, and hybrid financing instruments are not considered to be investments (whereas they would be under foreign legal systems, such as in the Netherlands). In the case of foreign equity rights, investment qualification requires the presentation of the typical characteristics that are in accordance with Swiss law.

Relieving tax on dividends does not eliminate the double taxation of prof-

its, but it does reduce it. Without any measures to relieve double taxation, a corporate profit tax rate of 20% and an income tax rate of 30% results in an overall rate of 44% on income from equity and/or investment capital. If the federal government and canton introduce partial taxation of 60%, overall taxation then sinks to 34.4%. (According to the regulations in the cantons this could be even lower.) In comparison, income from capital that has been made available to the company in the form of a long-term interest-bearing loan is merely burdened with 16% overall taxation (including tax effect for the company).

The incentive to keep investment capital at a low level and to issue loans instead or to make available investment assets will continue even after the implementation of Corporate Tax Reform II.

Moreover, the tax rules place limits on loan financing through undisclosed share capital and require a certain minimum amount of equity. In addition, tax-optimized interest is also subject to certain tax limits (2008: 5.5% for retail and manufacturing companies).

Owners working for the company may draw part of the profit in the form of a salary. The owner salary thus de-

termined may not be markedly above the salary that an independent third party would earn in the same position. In addition to income tax, social security contributions of around 12% must be included in the calculations. Taking into account the aforementioned interest rates, all effects and the social security rate, in our example under the "Salary" option we come up with a total burden of around 30%. In this option it is possible to take into account higher investments in the second pillar, which significantly reduces the tax burden.

Following the implementation of partial taxation of dividends on qualified investments, companies now have a broader range of planning tools open to them. Within certain limits? they can choose to draw income from their investment of capital and work as interest, dividends, or salary. This invites business owners to come to grips with a balanced financing, salary, and dividend policies within the new framework.

b) Capital investment principle

The introduction of the capital investment principle means a real change of direction for the tax regime. Under the nominal value principle, it was unattractive for the shareholder to provide the company with funds via premiums, subsidies, or investments

Nominal value principle		Capital investment principle	
Repayment		Repayment	
Reserves (legal and free)	taxable	Reserves (legal and free)	taxable
Disclosed capital investments	taxable	Disclosed capital investments	tax free
Premiums	taxable	Premiums	tax free
Share capital	tax free	Share capital	tax free

Figure 1: Corporate Tax Reform II – introduction of the capital investment principle

as these would lead to a potential tax base. Following the revised provisions, in the future (i.e., from 2011) all capital investments made by shareholders will be returned to them free of tax (see Figure 1).

The capital investment principle refers to disclosed capital investments. These are shown under the reported reserves in the tax and trade balance sheet. Investments that are not disclosed and therefore remain hidden still remain subject to distribution tax. Thus, for example, in the case of the conversion of a partnership to a stock corporation, a hidden capital investment takes place within the scope of the tax-neutral, undisclosed reserves that are transferred to the company. These undisclosed reserves remain subject to a deferred distribution tax as well as to a deferred corporate profit tax. If the blocking period is violated, the post-taxed reserves will also be published in the balance sheet of the stock corporation, thereby changing from an undisclosed to a disclosed capital investment. If disclosed capital investments are made due to the transfer of company or investment assets, and if these are later written down, the tax-free capital investment to be repaid is not reduced. If, however, the reserves from disclosed capital investments are eliminated in the balance sheet as loss-

es due to write downs, they are not reinstated once the company later generates profits and builds reserves.

The capital investment principle is applied to all disclosed investments that were made after the 31 December 1996. Since in the future (as of 2011) these must be reported in the tax and trade balance sheet, it is recommended that the corresponding papers and documentation recording the receipt of these investments are kept. In another future development disclosed capital investments will be treated the same as paid-up nominal capital from a tax point of view. From the perspective of commercial law they are therefore easier to execute. In particular, no publicly notarized resolutions or further commercial law documentation is required. The return of disclosed capital investments to shareholders is made in accordance with the rules governing the distribution of dividends.

Beginning in 2011 dividends or monetary benefits to shareholders will be distinguished according to whether or not they are repayments of capital investments or dividends (taxwise). In the case of monetary benefits in the form of undisclosed profit distributions, it must be expected that the tax authorities will only permit a declaration as a repayment of capital

if it is disclosed, i.e., it is made to the debit of corresponding reserves.

Changes at corporate level

a) Replacement purchase

Previously, hidden reserves on sold company goods could only be transferred to the replacement object tax neutrally if this was operationally necessary and fulfilled the same function. In the future, a transfer of reserves for operationally useful reinvestments is possible. Hidden reserves on operational real estate are excluded; they cannot be transferred to moveable investment goods. Also, in the case of sold holdings for stock corporations, a tax neutral replacement purchase is possible through another holding. The sold and replacement equity rights must equal 10% of share or company capital.

b) Concessions in the case of participation deduction

The investment deduction introduced in Corporate Tax Reform I at federal level has been extended: the understanding of investment has been expanded by a reduction in quantitative limits. Instead of a quota of 20% or a market value of two million francs, in the future (as of 2011) the “key values” of 10% or one million francs will apply. With regard to the participation deduction on capital gains, the period of ownership has been reduced

Example of profit before tax with 1 million Swiss francs		
Profit: 1 million Swiss francs	Previously	Partial taxation 60%
Profit before tax	1'000	1'000
Tax on corporate profits (20%)	-200	-200
Distribution	800	800
Taxed distribution	800	480
Income tax (30%)	-240	-144
Remaining profit	660	656
Total tax burden	44%	34.4%

Figure 2: Corporate Tax Reform II – partial taxation

to one year. In the case of staggered sales, the final sale of “remaining stock” may fall below the 10% quota as long as its market value exceeded one million francs on the last tax balance sheet date. In addition, holders of dividend-right certificates with a 10% share may also claim the investment deduction. Quantitative criteria must be in place at the time of the distribution and/or sale. The current market value for listed equity rights is calculated according to the market price and for non-listed equity rights according to a recognized valuation method (see Figure 2).

Lowering the limit to one million francs in current market value means that the equity rights in securities could also qualify for the investment deduction. Whether or not this will encourage people to transfer their equity rights from private assets to a holding company is uncertain. Transposition limitations for investment quotas of more than 5% must be taken into account, which will lead to the creation of premium reserves. These reserves will continue to be ineligible for the implementation of the capital investment principle. When combined with price increases, they will be a significant deferred tax burden.

Concessions for owners of partnerships

Partnerships often have significant deferred taxes in their hidden reserves that can be a burden of 40% or more, including social security contributions of 10%. The tax consequences have now been mitigated in certain circumstances. When liquidating one’s assets from a company from the age of 55 or for health reasons a less stringent rate will apply in the future; with regard to retirement provision. The heirs of a deceased business owner can also request the application of this lower rate if they liquidate the business before a specific date. The tax due on the hidden reserves realized during the distribution of an estate can also on request be deferred. This simplifies the division of an estate where a business is not taken over by all the heirs. A tax deferral on the increase in value can be requested if real estate is withdrawn from the non-current assets and transferred to the private assets (transfer to own private assets or as part of the division of an estate). These options make it easier to settle the company succession.

Summary

Federal legislators have made the economic environment for SMEs and their owners more attractive through corporate tax reform. At the same time, changes in tax rates are also taking place in many cantons. Furthermore, by extending the range of tax concessions there is also new momentum in tax planning.

KPMG's Audit Committee Institute Roundtable: M&A in the board room

Spring 2008 roundtable events – key findings

Last fall the topic of IT governance was hotly debated as part of the roundtable series. In the roundtable discussions in the spring the focus was M&A in the board room. Guest speakers, Lucas Grolimund, CEO of Cicor Technologies, and Joseph R. Colleluori, Head of M&A for Lonza Group, gave insightful reports on their experiences and best practices regarding acquisitions.

For Lucas Grolimund, solid preparation prior to an acquisition is essential. In his opinion, careful analysis of the synergies and valuation model underlying the acquisition are part of this preparation. Particular care is needed for DCF valuation models as the final value can equate to 80% or 90% of the current value.

Throughout the M&A process close collaboration between the CEO, CFO, and the board of directors is essential. Tangible positive changes within a short period following the acquisition are also important because they are expected by the workforce. However, the most critical point in a successful integration is the cultural fit, which determines the merger's success or failure. Lucas Grolimund illustrated the positive and negative aspects of the M&A process in his presentation using clear, expressive examples.

During his portion of the presentation, Joseph R. Colleluori elaborated on particular acquisition challenges using specific examples from Lonza. A successful acquisition requires a related strategy, which one can extract from Lonza's key competencies. Once an acquisition target has been identified, five main questions must be asked:

- What is the target?
- How does the target complement

the findings from the SWOT analysis of the acquirer (in this case Lonza Group)?

- What synergies and added value could be achieved?
- What is the timetable for the integration?
- What evaluation process will be used and what are its advantages/disadvantages?

It is important to provide the board of directors with regular updates on M&A activities. Also, lessons learned from previous transactions must not be ignored.

Following the presentations numerous questions and shared experiences from the audience took center stage.

It was clear from the liveliness of the debate that the M&A process presents many members of the board with a particular challenge. The topic that engaged members at their tables was the development of the commodities markets and scarcity of resources. Clearly M&A topics more relevant than ever for board members.



Audit costs – results of the study by the CFO Forum Schweiz

The CFO Forum Schweiz (CFOs) has taken the first detailed inventory of audit costs for Swiss companies

Hans-Ulrich Pfyffer
Advisory

Monitoring audit costs is an important task for the Audit Committee. A summary of the findings from a study conducted by the CFO Forum Schweiz (CFOs) is presented below. The data, which was collected on a broad basis and carefully analyzed, enables objective statements to be made regarding the audit expenses of Swiss companies.

Aims of the study

The aim behind collecting and analyzing the data from the “CFOs Audit Cost Survey” was to make objective statements on audit costs and to provide increased transparency.

The study provides the first objective analysis of these costs and facilitates initial conclusions regarding the determining factors in the audit. It also illustrates trends in the cost structure for different industries/clusters.

Participating companies

The study was based on a questionnaire that was sent to 214 companies. Eighty-nine companies answered. The participants in the study come from diverse industries and are characterized by differences in complexity and size. The study excludes banks and insurance companies.

Findings from the study

Audit costs and size structure

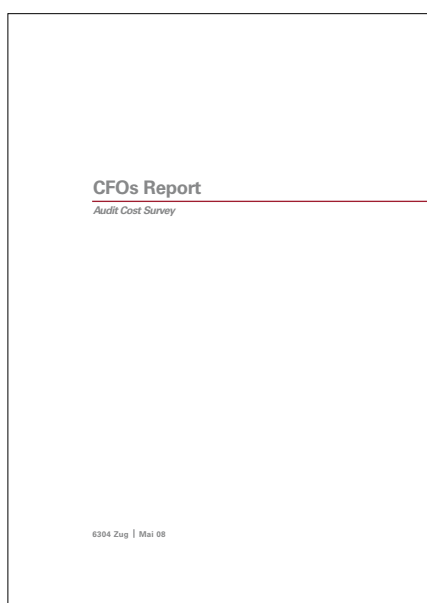
The companies that took part represent a reasonable number of medium-sized companies and multinationals. On average the audit costs of all participant companies equal 0.215% of their turnover. For smaller companies (< CHF 100 million turnover) this value equals 0.82% while for multinationals (> CHF 1000 million turnover) this value was “a mere” 0.068%. The reasons for these differences can be found

in the feasible economies of scale as well as in the definition of materiality – with companies of various sizes these are defined on a differentiated basis. The average audit costs for companies with a turnover of less than CHF 100 million are slightly distorted upward as a result of special situations (e.g., some completed IPOs). The following table provides an overview of the audit costs based on company size (see Figure 1, page 13).

Audit costs by industry

The study covers eleven different industries. Varying amounts of audit costs for each industry are obvious. Reasons for the differences are most likely stem from different risk situations and structural factors. The table in Figure 2 provides an overview of the audit costs by industry (see page 13).

At the top of the list we have the Chemicals & Health industry (skewed slightly upward due to the number of IPOs) followed closely by Media, Telecoms & Technology. Energy supply brings up the rear due to factors such as turnover distortion based on trading activities. It is notable that lower audit costs can be seen frequently in strictly regulated industries. The relatively high audit costs for real estate companies (in relation to turnover) must be assessed with caution. In this industry assets would be a more reliable benchmark.



Turnover volume of participants		Auditing costs/turnover in percent				
Size of company	UN	Minimum value	Maximum value	Median	Ø	Range
< 100 million in turnover ¹	14	0.083%	3.223%	0.398%	0.820%	3.140%
100 – 250 million in turnover	20	0.038%	0.976%	0.137%	0.193%	0.938%
250 – 500 million in turnover	17	0.035%	0.221%	0.124%	0.129%	0.186%
500 – 1000 million in turnover	15	0.022%	0.203%	0.091%	0.086%	0.181%
> 1000 million in turnover	23	0.015%	0.151%	0.052%	0.068%	0.135%
Total sample turnover	89	0.015%	3.223%	0.111%	0.215%	3.208%

Figure 1

Parameters for audit costs

Audit costs are determined primarily by company size, which is not surprising. Additional factors are the category of the auditors (i.e., Big Four or national company), accounting standards, and complexity of company activities. On average, the Big Four (i.e., Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers) charge higher audit fees. According to the study this is due to the higher level of product differentiation and the inherently higher fees for services. In relation to complexity, the statistics prove that internationally active companies have higher auditing costs than national companies. It is interesting that audit costs correlate positively with the level of consultancy services. This trend is particularly surprising given that regulations increasingly limit the provision of consultancy services by auditors.

Applying IFRS or US GAAP results in higher audit costs. The companies audited in compliance with US GAAP have on average 12.5% higher audit costs than those using IFRS. This may be the reason why IFRS seems to be winning the worldwide competition with US GAAP.

The study also shows that the number of companies involved in an audit has no significant influence on the audit costs. The use of a single auditor (One Auditor Concept) simplifies coordination and leads to a redistribution of fees with a corresponding reduction in price. However, country-specific price advantages cannot be exploited. The contrary effect seems to compensate for this.

Change in audit costs

Over time audit costs show a certain

stability. Larger fluctuations are found when framework conditions change. The following list shows the most important factors that lead to a change (usually an increase) in audit costs (in order of descending value):

- Acquisition
- Regulatory provisions
- Change in scope
- Change in accounting standards
- Selling part of a company
- Growth
- Issue of securities
- Inflation
- Change of auditor
- Withdrawal from the market

¹ **Note on interpretation:** The cluster with < 100 million turnover does not include any exceptions but does include companies in special situations (e.g., IPO companies with low turnover volumes). A reliable interpretation is provided by the median values.

Sectors		Auditing costs/turnover in percent				
Sector	UN	Minimum value	Maximum value	Median	Ø	Range
Chemistry and health ²	12	0.030%	3.223%	0.134%	0.594%	3.194%
Construction & materials	6	0.044%	0.154%	0.053%	0.069%	0.110%
Industrial goods and services	33	0.022%	0.666%	0.113%	0.140%	0.644%
Media, telecoms & technology ³	12	0.015%	1.739%	0.149%	0.350%	1.723%
Food/drink, consumer and household goods	7	0.035%	0.182%	0.093%	0.084%	0.147%
Retail, travel and leisure	7	0.036%	0.154%	0.068%	0.087%	0.118%
Energy	6	0.018%	0.182%	0.030%	0.054%	0.164%
Real estate	6	0.025%	0.976%	0.224%	0.342%	0.951%
Total sample	89	0.015%	3.223%	0.111%	0.215%	3.208%

Figure 2

It may come as a surprise that the change of auditor figures so low on the list. However, this finding is corroborated by the fact that a change in the company auditor only results in short-term savings. The study reveals: “The audit costs following a change in auditor are significantly lower in the first three years following the change at most. After that, no cost advantage is discernible. This is probably an indication of the efficiency of the price structure for auditing services in the medium term. The price concessions made for the acquisition of audit engagements (i.e., time/expense calculations) therefore are not sustainable in terms of performance or expense. Tenders

are generally made under optimum conditions”. Another trend that can be identified is that flat-rate fee agreements lead to higher costs than variable cost models.

Added value of the audit

The statement that scarcely any added value can be discerned from the final annual audit should give the audit industry food for thought. Heads of finance see the benefits primarily in the fulfillment of statutory or regulatory requirements. However, this view forms a stark contrast to the sector’s own view of itself—that there is clearly an added value in its services. In this regard the opinion of Audit Committees,

who could also benefit from the additional “assurance” by the auditors, would also be of interest. The study determined that the primary benefit of an audit was the strengthening of investors’ confidence. Additional benefits can be seen in the feedback for Accounting & Reporting as well as with regard to the effectiveness and

² **Note on interpretation:** The cluster Chemicals and Health also includes companies in special situations (e.g., IPO companies with low turnover volumes).

³ **Note on interpretation:** The cluster Media, Telecoms & Technology also includes companies in special situations (e.g., IPO companies with low turnover volumes).

efficiency of the internal control system. The study makes the following comment: "It is the job of audit firms to report the spread of added value transparently in the future, to close the gaps in perception – or at least to re-think their own position and options."

Future expectations

Most companies expect audit costs to increase. This view is based on increasing requirements on the part of the legislators. The additional requirement for proof of an internal control system is given as an example (Article 728 SCO) as well as further regulatory costs. In addition, internally generated factors such as growth and acquisitions are mentioned. Inflation is also a factor. A further factor for price increases is the lack of competition between the audit firms. Representatives of the audit industry are bound to have a different opinion here as competition between the audit firms is regarded as intense. Nonetheless, 20% of the companies surveyed expect lower or stable audit costs due to the same or a narrower audit scope, improved collaboration between the company and auditor, simplified reporting and consolidation structure, or the merger of legal entities.

About the study

This study was issued by the CFO Forum Schweiz, Grafenauweg 10, 6304 Zug. It can be downloaded from

the web site www.cfos.ch. The authors are: Dr. Rudolf Huber, Chairman, Stephan Erni, Managing Director, Thomas Grimm, B.A. HSG, University of St. Gallen.

The CFO Forum Schweiz plans to conduct follow-up studies to further examine the factors that determine audit costs.

Summary

The study confirms its initial thesis that listed, globally active companies or companies that comply with US GAAP or IFRS have higher audit costs. The conclusions that company structure (holding vs. parent company) and number of auditors involved have no significant influence on audit costs are particularly interesting. In addition, the fact that companies with fixed cost models pay on average 7% higher audit costs in relation to companies with a variable cost model should come as a surprise. Furthermore, the statement that heads of finance can read scarcely any value added into the final annual audit must give pause for thought.

Generating added value

Collaboration of the Audit Committee with Internal Audit and the external auditor

Anton Felder
Member of the Board of Directors
of Nationale Suisse 2002 – 2007, and
Chairman of the Audit Committee

To mark the occasion of the five-year anniversary of KPMG's Audit Committee Institute we asked several well-known members to write on a topic currently being debated by the board and to give our readers an insight into their best practices. We compiled these articles in a 44-page anniversary publication entitled "Collected contributions for the ACI's fifth anniversary". We are delighted to present individual articles from this publication to you through the end of 2008, starting with this issue.*

An Audit Committee should generate added value for the company through its activities. To achieve this goal, optimum collaboration between Internal Audit and the external auditors is essential.

Internal Audit as an extension the Audit Committee

In view of legal and rapidly changing framework requirements as well as the increasing complexity and responsibilities of the Board of Directors, the Audit Committee depends on competent support from Internal Audit to complete its tasks in a professional manner.

To generate added value from this collaboration, clear requirements for Internal Audit must be drawn up by the Audit Committee and recorded in the Audit Charter. They include:

- Definition of roles along with goal setting, audit areas, and audit approach
- Conditions for advisory activities and collaborating in project teams (early inclusion of audit-relevant aspects must be central in this)
- Job profile for the auditors
- Requirements and assessment criteria with regard to objectivity and independence
- Guidelines for communication, including reporting

Internal Audit supports the chairman of the Board of Directors and the Audit

Committee in their duties and sees itself as a partner of the Executive Board. It focuses on monitoring the internal control system (ICS), identifying significant risk potential, and supporting the risk management process. As a rule it does not give any instructions and avoids conflicts of interest in its work. The Audit Committee must monitor compliance with the stated requirements.

For smaller and medium-sized companies, the question of whether or not Internal Audit services should be provided by in-house specialists or third parties is of considerable importance. In addition to this fundamental decision, placing partial, service-specific assignments with companies that demonstrate the necessary expertise can make sense, even for large companies. For example, this affects audit activities in the areas of IT, construction projects, or derivative financial instruments. The in-house development of specialist knowledge can be too expensive or take up too much time. The Audit Committee should make the necessary decisions in this regard.

In order to provide these demanding services professionally, auditors should match the defined job profile as closely as possible. An interdisciplinary team of auditors in larger organizations is ideal. The head of Internal Audit has to

* This publication can be ordered at auditcommittee@kpmg.ch

meet high expectations with regard to specialist, management, and social skills. The Audit Committee selects the person for this position.

The chair of the Audit Committee and the head of Internal Audit meet periodically for one-on-one discussions. To benefit from this exchange expectations must be clearly formulated and discussion topics need to be defined. The chair of the Audit Committee also ensures that Internal Audit is kept in the loop with regard to operational information flows.

The head of Internal Audit always participates in the meetings of the Audit Committee and provides input on the following topics: multi-year audit plan, annual audit plan, coordination with the external auditor, risk management, ICS assessments, special assignments, compliance, and personal requests. Furthermore, he or she is available to the Audit Committee to clarify or answer questions on Internal Audit's current report. In addition, the head of Internal Audit is expected to give input on further agenda items/questions. This platform forms an important basis for the exchange/provision of information for the Audit Committee.

Internal Audit reports should be: objective, clear, accurate, impartial, concise, comprehensible, and solution-oriented with agreed-on measures, pro-

tection of assets, and improvements in business processes. Internal Audit first discusses problem areas with the Executive Board and it informs the Audit Committee. Obvious exceptions to this rule include violations of the law by the Executive Board.

In assessing the activities of Internal Audit, the Audit Committee must have Internal Audit's activities periodically assessed by "clients" to supplement its opinion. This is carried out most effectively in the form of interviews. In addition, Internal Audit must be "X-rayed" by external auditors at intervals of around five years. The chair of the Audit Committee discusses the qualifications and assessment findings in an open and timely fashion with the head of Internal Audit. Corrective measures are also agreed on. Also, special attention must be paid to further training obligations with regard to future requirements and challenges.

Added value can be generated for the company through audit and advisory activities, as well as through open and constructive collaboration with the Audit Committee and Internal Audit.

External Audit provides additional benefits

External auditors elected by the general meeting of shareholders has the role of to check and report on whether

or not the financial statements and consolidated group accounts comply with statutory requirements, articles of association, and chosen rules. Recently the audit area has been expanded to include aspects of the internal control system (ICS) and risk reporting.

The Audit Committee supports external auditors and promotes open communication. External auditors are the contact point for applying accounting principles and structuring financial reporting. The scope for interpretation based on standards should be used in a client-oriented fashion by the external auditors and supported by arguments and facts.

As a rule, the Audit Committee meets two to three times annually with external auditors. The audit plan, audit results, and management letter are obligatory agenda items in these meetings. It is important to examine any differences in interpretation between the auditors and management in these meetings. These differences must be resolved by the Audit Committee and presented to the Board of Directors for a decision if necessary.

Many small, important tips that are to the benefit of the company can result from audit activities. The auditors should be urged to communicate any relevant findings. Additional benefits can

also be drawn from discussions between the Audit Committee and external auditors if the wealth of experience and specialist knowledge of these people is successfully tapped. This can be achieved in an open and respectful environment.

The quality control of external auditors is of particular relevance. Every three years or so the Audit Committee initiates a presentation on this and how it is put into practice. The Audit Committee to ensure annually that external auditors are qualified to do their tasks. They base their assessment on criteria such as: qualitative and quantitative completion of the assignment, flexibility on deadlines, team structure, justifications for important audit findings, communication style, image, independence, and fees. Findings must be discussed and supported by facts.

In terms of cost optimization it is required that the external auditors' fees be scrutinized. The amount of the fee, as well as the benefits from audit activities must be at the center of the assessment. A good audit should be compensated appropriately.

In addition, the fee amount alone should not form the basis for the external audit mandate tender. The Audit Committee is well advised to set clear

goals in advance. for the tender and criteria for assessing the offers.

The Audit Committee, Internal Audit and external auditors have the power to create added value for the company – added value that is also to the company's advantage. Therefore the Audit Committee is entrusted with the decisive role of catalyst.

IFRS Update

Current IASB developments

Thomas Schmid
Stefan Sieber
International Accounting & Reporting

In November 2006 the IASB published the IFRS 8 Operating Segments. This standard is part of the short-term convergence project that aims to harmonize IFRS and US GAAP regulations. It also brings IFRS regulations in line with those of SFAS 131, thereby replacing IAS 14 segment reporting. The new regulations must be applied to reporting for business years that begin on or after 1 January 2009. Since the previous year's information must be aligned accordingly, there is now a need for action by the affected companies.

IFRS 8 promotes the disclosure of information that allows the reader to assess the type and financial consequences of business activities as well as the economic environment in which a company operates.

IFRS 8 is based exclusively on the so-called management approach to reporting about the financial development of the operating segments. This article serves as a guide on to how implement this approach.

IFRS 8 Operating segments – management approach

The implementation of the management approach can be divided into five steps:

1. Identify key decision makers
2. Identify operational segments
3. Combine similar segments
4. Define the reporting requirements of the segments
5. Appendices

In the following we should particularly like toThis analysis focuses concentrate on steps 1 to 4.

Identify the mainkey decision makers

In order to identify operational segments it is vital to determine who are the key decision makers (i.e., Chief Operating Decision Maker, CODM). However, the CODM is to be understood as a function, not a person, for which the main task is to allocate resources to the operational segments and assess their performance for the company. Thus this role may be held by a person or group of people who decide together how to allocate resources and assess performance. As a rule, the CODM is usually the task of the highest level of management. In Switzerland it has to be decided if this function lies at the Board of Directors (BoD) level or if there should be a far-reach-

ing delegation to the Executive Board. This is because the responsibilities of the BoD of a Swiss company are not limited to supervision. They also include the non-transferrable overall management of the company.

How are operational segments identified?

An operational segment is deemed to be a sub-unit of the company and/or organization,

- the business activities of which could result in expenses or income,
- the operational results of which are regularly supervised by CODM,
- and for which separate financial figures are available.

Therefore it is not a question of whether the sub-unit incurs expenses or generates income. It is also not required that the income is earned through external clients. This means that operational segments can also be vertically integrated sub-units, even if these do not generate any turnover due to the lack of internal billing. It also means that even start-up areas that do not yet generate any income can be reported as separate operational segments. On the other hand, not every sub-unit in the company represents an operational segment. For example, central function areas such as the company head office do not constitute an operational

Example

A company has six business areas and produces three different products. Each product is produced and sold by a specific business area in Switzerland (areas A,B and C) and Italy (areas D,E and F). The CODM receives financial information for the individual areas A,B, and C but only joint data for Italy.

As the CODM does not receive any separate financial information on the individual sub-areas D, E and F, and it makes its decisions on resource allocation based on the joint data for Italy, these grouped together sub-areas are considered an operational segment. Should the individual sub-areas report non-aggregate data to the CODM, they would be identified as individual operational segments.

segment as they do not generate any income. Also, pension plans do not show any characteristics of an operational segment (see "Example").

Can similar segments be grouped together?

Operational segments can be grouped together in larger segments if they show similar financial characteristics and are expected to have a similar financial development. Any grouping must be in line with the basic principle of IFRS 8. In addition, the following homogeneity criteria must be fulfilled:

- Type of products and services
- Type of production processes
- Client structure
- Sales methods
- Standardized regulatory environment for the sub-unit (e.g., for banks, insurance companies or public utility companies)

How are reporting requirements of the segments determined?

To determine the reporting requirements of the segments, IFRS 8 allows for the grouping of similar operational segments and promotes minimum reporting if the following quantitative thresholds are met:

- Segment income equals 10% or more when compared to total income (including the income between

the different segments)

- Segment results equal at least 10% of the cumulative results of all the operational segments, calculated as the greater total amount of all the operational segments with positive or negative results
- Segment assets equal at least 10% of total assets of all operational segments

If the total external income of the segments subject to reporting does not equal 75% of the total turnover, additional (smaller) operational segments are to be reported until this 75% limit is exceeded. All other segments not subject to reporting requirements are shown in a collective segment (i.e., all other segments). In contrast, joint activities (e.g., head office costs) must be shown separately from the joint statement as transitional positions in the transitional statement.

Determining the segment data

The segment data must be determined in line with the assessment methods used by Internal Audit. In principle this means that the data does not have to be in line with the balance sheet and valuation provisions of the IFRS either in the determination of the segments that are subject to the duty of reporting or in the illustration in the segment report. As mentioned above, this involves a transition statement

for the segments subject to the duty of reporting, which is compiled according to internal criteria for annual financial statements in accordance with IFRS.

IFRS 8 as a topic for the Audit Committee

Initial analyses show that there are potentially more segments subject to reporting requirements in accordance with IFRS 8 than under IAS 14. The reporting of previously non-illustrated segments therefore must be consistent with overall company communication. Because the changeover from IAS 14 to IFRS 8 requires certain decisions and preparatory work, this topic should appear on the Audit Committee's agenda sooner rather than later.

US GAAP Update

Overview of Current Developments in the United States

Doug Mullins

Jason Kies

US GAAP Accounting and Reporting

[The US Public Company Accounting Oversight Board \(PCAOB\) Adopts New Ethics and Independence Rules.](#)

[The Financial Accounting Standards Board \(FASB\) Issued a FASB Staff Position Regarding Convertible Debt.](#)

[The FASB Issued FASB Statement 161, Disclosures about Derivative Instruments and Hedging Activities, and FASB Statement 162, The Hierarchy of Generally Accepted Accounting Principles.](#)

[SEC Staff Suggests Disclosures about Fair Value Measurements.](#)

[XBRL US GAAP Taxonomies and Preparers Guide Completed and the SEC Issued a Proposal to Require its Usage.](#)

PCAOB Adopts New Ethics and Independence Rules

On April 22, 2008 the PCAOB voted to adopt Rule 3526, Communication with Audit Committees Concerning Independence, and an amendment to Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles.

Rule 3526 will require that a registered public accounting firm before accepting an initial audit engagement under PCAOB standards describe in writing to the audit committee all relationships between the firm or any of its affiliates and the issuer or persons in a financial reporting oversight role at the issuer that may reasonably be thought to bear on the firm's independence. This rule, if approved by the SEC, would become effective on the later of September 30, 2008 or 30 days after SEC approval.

The amendment to Rule 3523 excludes from the scope of the rule tax services provided during the portion of the audit period that precedes the beginning of the professional engagement. If approved by the SEC, the amendment to the Rule would become effective immediately.

FASB Staff Position Issued Regarding Convertible Debt

According to the FASB Staff Position (FSP) regarding Accounting Principles

Bulletin (APB) 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)", issuers of convertible debt that may be settled wholly or partly in cash must account for the debt and equity components separately.

Specifically, this FSP applies to any convertible instrument that upon conversion may be settled wholly or partly with cash, but is designed in particular to change the accounting for convertible debt that upon conversion is settled by repaying the principal amount in cash and paying the value related to the conversion feature (the conversion spread) in shares.

This FSP is to be applied retrospectively to previously issued convertible instruments as well as to new instruments, in current and comparative periods in fiscal years beginning after December 15, 2008.

FASB Statement 161, Disclosures about Derivative Instruments and Hedging Activities

Companies must disclose the fair value of derivative instruments and their gains or losses in tabular format and information about credit-risk-related contingent features in derivative agreements, counterparty credit risk, and

strategies and objectives for using derivative instruments, according to new Statement 161, which amends and expands Statement 133. The new Statement must be applied prospectively for interim periods and fiscal years beginning after November 15, 2008.

Statement 161 requires companies with derivative instruments to disclose information that should enable financial-statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133, and how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows.

FASB Statement 162, The Hierarchy of Generally Accepted Accounting Principles

The FASB adopted a hierarchy of authoritative accounting guidance for non-governmental entities, an action that is not expected to change practice, but is expected to facilitate designating the coming codification of accounting standards as authoritative. Statement 162 makes the hierarchy explicitly and directly applicable to preparers of financial statements, a step that recognizes preparers' responsibilities for selecting the accounting principles for their financial statements.

SEC Staff Suggests Disclosures about Fair Value Measurements

The SEC staff has expressed views on disclosures relating to fair value measurements that should be considered for inclusion in the management's Discussion and Analysis section.

The staff letter focuses on the requirements of Regulation S-K to disclose in MD&A any known trends, demands, commitments, events, or uncertainties that a company would reasonably expect to have a material favorable or unfavorable impact on results of its operations, liquidity, or capital resources.

While many of the disclosures cited in the letter are related to requirements in FASB Statement 157, Fair Value Measurements, the letter does not amend or interpret any of Statement 157's provisions. Specifically, the staff discusses disclosures about the use of unobservable inputs, including how the inputs were determined and how the resulting fair value amounts and possible changes in them affected or may affect future results of operations, liquidity, or capital. Additionally, the staff suggests disclosures about valuation techniques and processes used to validate those techniques.

XBRL US GAAP Taxonomies and Preparers Guide Completed

XBRL US, Inc., the nonprofit consorti-

um for XML business reporting standards, announced that it completed the collections of financial and business terms (taxonomies) for US GAAP requirements and common reporting practices in XBRL format, and the accompanying Preparers Guide. XBRL US developed the taxonomies under a contract with the SEC.

The SEC approved issuing a proposal that would require companies to submit XBRL-formatted financial statements as exhibits to their filed financial statements, phasing in the requirement over three years based on company size and whether the company uses US GAAP or IFRS as issued by the IASB. The requirement would apply to annual and quarterly reports, transition reports, and registration statements, and companies that maintain web sites would have to make the information available there. It will have a 60-day comment period after publication in the Federal Register.

Events organized by KPMG's Audit Committee Institute

As a KPMG Audit Committee Institute member you will receive invitations to the following events. Details and electronic registration forms will be posted on: www.auditcommittee.ch

Audit Committee Roundtables

KPMG's Audit Committee Institute will offer another series of roundtables in the German speaking region of Switzerland in autumn 2008. These roundtables are targeted to Board members of Swiss companies.

Address changes

Please send address changes to: auditcommittee@kpmg.ch, Fax 044 249 2166 or to KPMG AG, Heidi Ströbele, Badenerstrasse 172, 8026 Zurich

ACI Roundtables Autumn 2008

«Forensic»

■ October / November 2008

All ACI members will be invited to this event and informed about the different dates and locations at our earliest convenience.

www.auditcommittee.ch

All current information is posted on KPMG's Audit Committee Institute website.

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Contact us by phone if you have questions.



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