

EUROPEAN AUDIT COMMITTEE CHAIRMAN'S FORUM

Perspectives

Paris 13 November 2008

In conjunction with the KPMG's Audit Committee Institute

March 2009

The members of the Forum participating in the meeting were:

Prof. Dr. Klaus Pohle (Host) Sanofi Aventis
Drs. Jan de Jong Heineken
Ewald Kist Philips
Max Dietrich Kley BASF
Kurt Anker Nielsen StatoilHydro
Dan O'Connor AIB
Murray Stuart Veolia
Tom de Waard STMicroelectronics
Russell Walls Aviva
Bernd Voss Continental

Also in attendance for all or part of the meeting:

Joachim Schindler KPMG
Thomas Mannsdorfer American International Group (AIG)
Prof. Dr. Peter Hommelhoff KPMG
Patrick Petit KPMG
Didier de Menonville KPMG
Timothy Copnell KPMG
Daniela Mattheus KPMG

Gérard de la Martinière, audit committee chairman at Air Liquide, joined the group for dinner in the evening.

European Audit Committee Chairman's Forum

The European Audit Committee Chairman's Forum provides audit committee chairmen from some of the most respected organisations in Europe with the opportunity to debate issues of concern with their peers and to develop practical ways in which to enhance both audit committee effectiveness and the functioning of the capital markets.

Membership is by invitation only and limited to a select group of audit committee chairmen drawn from the 100 or so largest companies in Europe. The Forum meets once or twice a year in major European cities. Each meeting is hosted by a member of the Forum. KPMG's Audit Committee Institute act as organisers and facilitators, providing the timetable and framework for each event and any associated material.

The Forum held its fourth meeting at the offices of Sanofi Aventis in Paris on 13 November 2008. The meeting was hosted by Prof. Dr. Klaus Pohle, audit committee chairman at Sanofi Aventis. The speakers were Prof. Dr. Peter Hommelhoff (KPMG), Joachim Schindler (KPMG) and Thomas Mannsdorfer (Regional Manager, Financial Lines, American International Group AIG). Prof. Dr. Peter Hommelhoff, reflected on the duties, responsibilities and associated liabilities of audit committee members. Joachim Schindler led a conversation around the impact of the credit crunch and economic crisis on the audit committee agenda; and Thomas Mannsdorfer shared his thoughts on developments in directors and officers (D&O) liability insurance.

The duties, responsibilities and associated liability of audit committee members

The explosion of corporate governance regulation and recommendations in the last few years has dramatically increased the responsibilities placed upon audit committee members. In particular, the EU 8th Company Law Directive (the Statutory Audit Directive) imposes, for the first time in many jurisdictions, a statutory duty on certain companies to have an audit committee (or similar body) responsible for the discharge of specific duties around the oversight of financial reporting processes, audit, internal control and risk management.

Some regulators (for example the SEC) have set out that their intention was not to subject audit committee members to increased liability. Nevertheless, studies such as the recent Audit Committee Institute survey of audit committee members show that a large proportion (around 75%) of audit committee members believe that they face greater personal risk and legal obligations than other board/supervisory board members.

Prof. Dr. Hommelhoff raised a number of interesting questions which were subsequently debated.

Who is responsible for establishing the audit committee and setting its terms of reference, agenda and work plan?

The Forum agreed that, in the absence of legal or regulatory requirements, the full board/supervisory board should be responsible for deciding whether an audit committee should be established. Similarly, the Forum considered that the precise role for an audit committee was for the board/supervisory board to decide, and will necessarily vary according to the company's needs, the skills and experience of the committee's members and the tone set at the top of the governance structure. It was noted, however, that boards and supervisory boards "*would be well advised not to impose an excessively detailed narrow regime on the audit committee. Audit committees need space to act flexibly if they are to carry out their remit effectively.*"

Traditionally audit committees have not had decision making powers per se. They have been 'advisory' committees established to assist the board/supervisory board in discharging its governance responsibilities. As a result, to the extent that an audit committee undertakes tasks on behalf of a board/supervisory board, the results of their deliberations should be reported to, and considered by, the board/supervisory board. In doing so, "*the committee should highlight any matters where it considers that actions or improvements are needed, and make recommendations as to the steps to be taken.*"

The important thing is that all board or supervisory board members understand what the audit committee has done.

Forum members did not really recognise a practical difference between the two-tier and unitary board approach in this respect. As one member commented, “the important thing is that all board or supervisory board members understand what the audit committee has done. They [the board/supervisory board] must form their own opinions as they are the body accountable to shareholders.”

There was some discussion as to whether the new requirements introduced by the Statutory Audit Directive (Directive 2006/43/EC) would change the status quo. The Directive clearly tasks the audit committee with the duty to monitor the financial reporting process; the effectiveness of internal control and risk management systems; and the statutory and internal audit. This might suggest to some that the audit committee has some degree of ‘preparatory’ responsibility, though the Directive does stress that the tasks assigned to the audit committee are without prejudice to the responsibility of the members of the board or supervisory and management boards; and that the such tasks may be carried out by a body performing equivalent functions to an audit committee if not an audit committee itself. There was general agreement among Forum members that, irrespective of the new legislation, the audit committee role was one of oversight – an ‘advisory’ role, not a ‘preparatory’ role. One member said *“we need to be cautious of adopting a too narrow and prescriptive approach. If the audit committee is preparatory rather than advisory it diminishes its stature. Instead we should be looking to strengthen the audit committee and make its processes more robust.”*

Forum members were also in agreement that the board/supervisory board was the appropriate body to monitor the audit committee’s performance and the value the committee brings to the company. In practice, many audit committees regularly undertake an assessment of their own performance and report their conclusions and proposed action plans to the board/supervisory board after discussion with the chairman of the board/supervisory board. One member stated that “if the relationship between the audit committee and the board/supervisory board is to work properly, then the chairman of the board/supervisory board should not be a member of the audit committee.” This is a widely held view and a feature of several European corporate governance codes. However, *“some companies, particularly smaller listed companies, have found it difficult to maintain the appropriate level of expertise on the audit committee without the presence of the board/supervisory board chairman.”*

Forum members were united in their call for greater transparency about how an audit committee discharges its duty, however, they were concerned by what appears to be a proliferation of audit committed related rules. Although there is a single EU Directive, the manner in which it is being adopted by Member States is throwing up subtle differences in both meaning and interpretation. *“This is increasing the potential for conflict when companies are listed in a number of different countries – an issue exacerbated if one of those countries is outside the EU.”*

Codes and ‘soft legislation’ was looked upon more favourably by Forum members. One member noted, *“laws might differ but the guidance within the codes proposed by Higgs, Cromme, Tabaksplat and others is well thought out; and it is converging.”*

What knowledge and expertise should audit committee members possess and is there a role for members with limited financial expertise.

Many corporate governance codes recommend that audit committees include one or more members with some form of financial expertise. The Statutory Audit Directive also contains an 'expertise' requirement in that at least one member of the audit committee must have competence in accounting and/or auditing.

It was suggested that there is no place for 'non-experts' on the audit committee because each member should have the knowledge necessary to enable them to discharge the tasks assigned to the committee by the Directive. However this view was not held by the majority of Forum members. *"They don't all have to be experts, but you do need at least one with financial expertise."* There are, of course, very practical considerations associated with the suggestion that all committee members be financial experts. One such consideration is the availability of appropriately qualified non-executive directors. As one member commented *"there can't be too many financial experts – where would they all come from?"*

A number of members thought it important to recognise that all audit committee members should possess a degree of understanding that goes beyond a passing knowledge of finance and basic familiarity with financial statements. They must understand the principles that underpin the preparation of financial statements, why critical accounting policies are chosen, how they are applied, and satisfy themselves that the end result fairly reflects their understanding. However, this doesn't necessarily mean that every audit committee member need be an expert – a term that implies a degree of specialist knowledge and understanding, perhaps a formal finance or accounting qualification or experience gained through a CFO role.

Forum members recognised the value in having members of the audit committee from diverse backgrounds. One member commented *"people with commercial or retail experience can make a very important contribution."* Often those with the least financial acumen are the members most able to ask the 'obvious' questions which others have taken for granted. Another member noted that *"behaviour is sometimes as important as knowledge."* Certainly sound judgement, integrity and high ethical standards; strong interpersonal skills; and the ability and willingness to challenge and probe are all attributes of an effective audit committee member.

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The forum noted that the degree of financial expertise on the audit committee or at least the perception of such expertise was of interest to external parties. One member discussed the role of financial analysts and drew the Forum's attention to the fact that *"some analysts were circulating reports that drew conclusions as to the quality of board oversight based on a very simplistic analysis of the perceived financial expertise of audit committee members."*

The expertise of audit committee members and liability concerns are understandably closely connected. The question arose as to whether audit committee members have greater liability exposure than other non-executive directors or supervisory board members. This proved a difficult question to answer because the requirements of the Statutory Audit Directive are relatively new and untested; and perhaps more significantly because the legal regimes differ across the various EU Member States (and elsewhere too). *"In Germany, Supervisory board members who don't sit on the audit committee need only consider the 'plausibility' of the auditors report whereas audit committee members have more liability."* By contrast, the UK Companies Acts do not recognise the differentiation between executive and non-executive directors. However, when questioning whether reasonable skill care and diligence has been exercised by a director, the

courts would consider the director's actual knowledge skill and experience as well as that which could reasonably be expected from a person carrying out that director's functions. "The bottom line is how judges might interpret the liability question in practice."

To what extent do the audit committee and its members bear responsibility for the 'proper' performance by the auditor of their duties?

In some countries the Statutory Audit Directive has greatly expanded the role of the audit committee. One attendee went so far as to suggest *"the Directive gives the audit committee and its member's co-responsibility for the proper conduct of the audit"* and that *"this is logical because it is on the audit committee's recommendation that the full board or supervisory board and ultimately the shareholders depend for the selection of the auditor."* This view was not unanimously held by Forum members. However Forum members did agree that the audit committee does not, and cannot, guarantee that the work of the auditor is completely free of error. *"The audit committee role is one of oversight – the audit committee should be seeking informed assurance from the auditor; taking as a base the committee's existing understanding of the business and the risks it faces."*

The maximum number of hours at the audit committee's disposal is very limited. Nevertheless, the audit committee has to find time to understand the audit approach in terms of risk, scope and coverage.

The Statutory Audit Directive requires that the audit committee, or body carrying out an equivalent function, monitors the statutory audit of the annual and consolidated accounts. Members were adamant that this did not mean an independent, parallel audit of the accounts by the audit committee alongside that of the auditor. If that were the case there would be meaningless duplication of effort by the auditor, the audit committee or both. *"The audit committee should be seeking informed assurance from the auditor, but this does not imply that the depth of enquiry should be such that the audit committee expresses its own independent opinion."*

One Forum member noted that *"the maximum number of hours at the audit committee's disposal is very limited. Nevertheless, the audit committee has to find time to understand the audit approach in terms of risk, scope and coverage; and make sure proper attention is being paid to any areas over which the committee has concerns."* As another member put it, "it is completely inappropriate for the audit committee to, for example, review audit files."

Getting the scope right is very important. *"Who's fault is it if something goes wrong - is it management, the auditor or the audit committee?"* Audit committee members need to understand where the external auditors are focusing their efforts and do their utmost to not only *"ensure that the audit is focused on areas of significant risk, but also that the auditor isn't minimising its approach due to (say) fee pressures."*

The session closed with Forum members reiterating their concern about regulation preventing audit committees from conducting their business effectively. *"Over regulation may have the unintended consequence of reducing the ability of the audit committee to carry out effective oversight. What we need is better coordination between regulators, not more legislation."*

Current market problems

While opinions may vary about the magnitude or length of the current economic downturn, it is clear that the ongoing financial crisis has a huge impact on the audit committee agenda. Audit committees need to understand how the credit crunch and economic downturn has affected their company's business and may need to address the system in place to manage financial risks – such as liquidity, access to capital, valuation of assets and cash management – as well as strategic, operational, and third-party risks such as reliance on suppliers and other business partners.

Attendees at the forum discussed a number of issues relating to the economic downturn and the impact on the audit committee's role. The key areas are discussed below.

Five year strategic plans may have been developed well before the current recessionary outlook was anticipated. Strategic plans may need revising or even rescinding.

Understanding the impact of the financial crisis/recession on the company

Forum members considered it essential that the audit committee understands the impact of the recession on the company's earnings, cash flow, liquidity, and compliance with debt covenants. Furthermore the committee should focus on financial forecasts and early warning indicators; ensure that management are monitoring the impact of the crisis on a 'real-time' basis, and developing (and stress-testing) worst-case scenarios. One member said *"the supervisory board and/or audit committee needs to understand what scenario planning and stress testing has been done. It may be necessary to push the scenario planning to its limits as the company may not just lose (say) one or two major customers, but three or four!"*

Forecasts must be realistic and relevant. As one member pointed out *"five year strategic plans may have been developed well before the current recessionary outlook was anticipated. Audit committees can not let management plough ahead as if nothing has happened. Strategic plans may need revising or even rescinding."*

Similarly, the audit committee should - with the benefit of hindsight and 'lessons' from the financial crisis to date - consider the adequacy and effectiveness of the company's processes for managing risk. One member commented that *"the audit committee can be a catalyst in helping to pose the right questions."* Such questions might include: can management provide a holistic view of the company's major risks - both on and off the balance sheet? Is the risk information up-to-date? Are the top risks facing the company understood and agreed upon? How rigorously does management stress-test key risk assumptions? Are the board's information sources sufficiently varied and objective? How does culture - including remuneration and other incentive arrangements - impact the company's risk profile?

It is important to talk to the banks early though that is no guarantee that difficulties will not arise. It's all about damage control.

Assessing the company's exposure to third parties in financial distress

The Forum thought that audit committees should ensure management is monitoring the impact of the financial crisis on the key customers, suppliers, insurers, partners, banks, underwriters, and other third parties that may be experiencing financial difficulties. As one attendee put it, *"an accurate and up-to-date understanding of the company's potential exposure to third parties is essential – some banks are expecting a huge number of businesses to go bankrupt."*

For many companies, their relationship with the banks is particularly important. Audit committees should consider challenging management's understanding as companies are increasingly finding that long-term banking relationships and drawdown facilities can not be relied upon. One member recounted the story where *"a company with a large unsecured facility proposed entering into a cash raising transaction in order to increase its liquidity. On hearing of the potential disposal, the company's banker threatened to withdraw their facility – with no renewal on any terms."* Another member said, *"it is important to talk to the banks early though that is no guarantee that difficulties will not arise. It's all about damage control. The audit committee must ensure management is well prepared in advance of any negotiations and all board members must be kept apprised of what's happening."*

Understanding the impact of the financial crisis on the company's financial reports

Forum members considered it important that audit committees should seek to ensure that management has identified potential impairments that should be reflected in the financial statements and that fair values determined by management and valuation experts are reasonable. This might include valuation/impairment of the company's investment portfolio as well as goodwill, deferred taxes, patents, and other intangibles. Some Forum members noted the audit committee's role is *"helping ensure management have properly assessed how changes in the financial markets have impacted the valuation of pension plan assets and funding requirements."* Other Forum members highlighted the need to *"understand the company's disclosure processes for fair value accounting and liquidity issues; and how the application and impact of fair value accounting is described in the narrative reporting and other periodic reports."*

Going concern

Many of the issues above are relevant to management's consideration of the going concern assumption. In more benign market conditions this has been a relatively easy exercise. However, with the speed of events over recent months, Forum members believed it to be important that *"the audit committee should challenge management as to whether current market conditions have resulted in material uncertainties that cast significant doubt over the company's ability to continue as a going concern."* Examples of such uncertainties that were discussed include:

- Inability of lending banks to honour existing facilities;
- Undue reliance on hitherto strong relationships with lending banks;
- Difficulties with re-financing when existing facilities mature - automatic renewals should not be assumed;
- Difficulties with re-financing after covenant breaches triggered by not meeting financial statement measures or other tests;

Audit committees should challenge the assumptions used by management in the cash flow forecasting models and the validity of the models used for the forecasts.

- Uncertainty as to future trading forecasts and projections on which re-financing plans are based;
- Dependency on future asset sales to stay within facilities (for example sales of property which cannot be assumed to happen as in the past);
- Dependency on a significant customer and the risk of such a customer terminating the arrangement where no long term contract is in place or it is no longer in a position to honour such a contract;
- Dependency on a significant supplier and the risk that they fail to meet their commitments endangering our clients business without a contingency plan in place;
- The range of variability of an estimate (e.g. a litigation claim) in difficult times may affect going concern; and
- Insurance company unable to meet claims.

Forum members considered that *“audit committees should challenge the assumptions used by management in the cash flow forecasting models and the validity of the models used for the forecasts.”* The accuracy of previous forecasts is also important as is ensuring the forecasts cover a period of at least twelve months from the date of approval of the financial statements.

Profit warnings

The audit committee's role with regard to annual and half-yearly financial statements is well understood, but the committee's role in respect of other financial information released by companies is less clear. Of particular concern in the current economic climate is the role the audit committee plays with respect to profit warnings. [It has been reported that profit warnings by UK listed firms hit a seven-year high in 2008 - 17 percent higher than in 2007. It is not unreasonable to suggest that similar conditions exist throughout Europe.]

Forum members were in general agreement that the audit committee does have a role in ensuring the probity of price sensitive information including profit warnings, but it was unreasonable to suggest that the audit committee should have 'hands-on' role - that role properly rests with executive management. The Forum considered that the audit committee (and/or the board/supervisory board) should ensure that proper processes exist to ensure profit warnings are as reliable as possible, timely and comply with relevant regulation and investor expectations. One member commented, *“if the situation is deviating from what the market expects, then you must give a profit warning.”* Other members suggested that companies might do well to look at the quality of their regular investor communications *“If macro economics is the reason companies are making profit warnings, then there is an argument that too little information was given in previous reports about the assumptions supporting any forecasts.”* Another Forum member said *“perhaps take the initiative by disclosing information that might stop the market jumping to conclusions.”*

Regulations differ with respect to the information that needs disclosing, but what is really different this year is the broad range of potential outcomes that directors face when making their forecasts. Forum members recognised this difficulty but noted that the whole market is subject to exceptional uncertainty and investors and analysts were aware of this.

The timing of profit warnings was debated – not least because certain regulators, for example the UK's Financial Services Authority, are probing companies over possible failure to disclose key trading data to the markets. It seems that regulators are acutely aware of the 'pressure' on boards to hold back bad news from the market, particularly when their survival is at stake. Members considered this to be a vexed issue and noted that *"boards and regulators may clash over what information should have been revealed and when - especially given the wider circumstances surrounding many decisions during the economic slowdown."*

Regulatory bodies generally require companies to ensure all information which is likely to have a significant effect on share price is made known to the market as soon as possible. However, as one Forum member noted, *"compliance with the requirements often involves fine judgments."* This is undoubtedly true as companies generally need only divulge information which is sufficiently precise, such as probable events and circumstances, and to judge whether such information would have a significant effect on the share price *"is not an easy decision at the best of times, but even less so in today's economic climate."* Another Forum member noted that *"directors need to consider their legal position as unnecessary disclosure that had an adverse effect on share price might lead to the directors being sued by shareholders for harming share value through needless or inaccurate statements."*



Directors and Officers (D&O) liability insurance

Thomas Mannsdorfer led the discussion on Directors and Officers (D&O) liability insurance. He noted that whilst D&O liability cover has been with us for some time, *“directors are facing unprecedented levels of scrutiny in the light of one of the toughest regulatory environments in living memory. Furthermore, achieving and maintaining compliance is time consuming and the penalties for failing to do so are severe.”* Mr Mannsdorfer went on to say that in the current environment there has been an increased regulatory burden placed on directors, a greater awareness of stakeholders’ rights and, for some, an increased likelihood of class actions. The latter point was illustrated with statistics showing a steady rise in the percentage of US Federal Securities class actions filed against non-US issuers over the period 1997 to 2008.

If case 1 takes half the cover and case 2 takes half the cover, there’s nothing left for case 3.

Forum members expressed concern that D&O cover can get exhausted very quickly and that cover is often not available for certain large amounts. *“If case 1 takes half the cover and case 2 takes half the cover, there’s nothing left for case 3.”* This is a particular problem for audit committee members if a plaintiff starts with the CEO and CFO then brings an action against the audit committee members at a later date.

Members also thought it was important to maintain policies that provide for the advancement of costs. It was suggested that this was not always the case and probably *“down to individual handlers if there wasn’t a clause in place.”* Some members thought that it was probably in the interests of the major insurers to advance costs where practicable simply as a reputational matter. The choice of defence lawyers available under some policies was also a concern.

A small amount of time was spent outlining the basics of D&O cover. Cover is normally structured in three layers or ‘sides’. Side A protects directors and officers from claims against them for wrongful acts in those situations where they are not indemnified by the company itself. This may be where the company is not permitted to indemnify the directors, where it chooses not to do so, or where it has insufficient funds (say) due to bankruptcy. Side B cover provides for corporate reimbursement where the company does indemnify its directors. Side C is for claims made directly against the company.

As companies struggle in the midst of a recession, they face a much tougher market for insuring directors against lawsuits.

The subprime and credit crises have already led to a higher number of securities class-action lawsuits – a big driver of D&O claims. [Up to 15 December], 210 law suits had been filed against corporations in 2008, compared with 177 for all of 2007 and 119 in 2006 according to the Securities Class Action Clearinghouse, a collaboration between Stanford Law School and Cornerstone Research. The financial sector has driven most of the lawsuits, making up 57% of the 110 filings in the first half of 2008, according to the clearinghouse. Most of the financial sector filings were related to the subprime crisis and credit crunch. *Charles Keenan, Bank Director Magazine, 2009*

It is too early to ascertain the full affect of the current financial crisis. Nevertheless, there are some interesting issues - not least because many companies are finding it difficult to refinance at acceptable rates, debt covenants are being broken and aggressive accounting practices are more difficult to disguise in a downturn. It was noted that while insurers have traditionally not had to pay out many losses under Side A policies, the current market turmoil and spate of failed companies may well change that and as a consequence this could have an impact on the cost and type of coverage available to directors going forward.

One Forum member commented *“as companies struggle in the midst of a recession, they face a much tougher market for insuring directors against lawsuits. As a result I am concerned that premiums for D&O insurance will rise and coverage may be narrowed as insurers look for ways to reduce risk.”*

This concern was echoed by another forum member who noted the importance of *“getting an update on the indemnification position. As board members we need to know that someone knowledgeable has reviewed the policies and understands what the coverage is.”* Directors might want to ask whoever is responsible for D&O cover to meet with the board to explain how much cover is needed and how much they have. Mr Mannsdorfer said that *“AIG were endeavouring to simplify their policies to make them clearer.”* *As for the required level of cover, “risk managers or general council can usually help and statistics about settlement amounts are in public domain.”*

Renewal time was considered by many to be especially important. Directors (and their advisors) need to be on the look out for revised terms – especially change of control provisions which are increasingly relevant in the wake of recent bank takeovers. In the current economic climate, acquisitions and mergers can take place very quickly so directors need to know what change of control triggers are in place and how they affect their cover – usually such provisions result in cover expiring.

Directors also need to be mindful of new exclusions. Are all areas of the business covered? Are extras like legal fees covered? Regulatory exclusions are also worthy of consideration. Such exclusions might absolve the insurer of paying claims in the event of enforcement actions, investigations or other fall out as a result of government oversight. Mr Mannsdorfer confirmed that *“it is important that exclusions are not hidden within the small print. Policies must be clear and understandable.”*

The next meeting

It was agreed that the fifth meeting of the European Audit Committee Chairman's Forum should be held in autumn 2009. The meeting will address topical matters which will be developed around eight weeks prior to the next meeting.

About the European Audit Committee Chairman's Forum

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Perspectives reflects the Forum's use of a adapted version of the Chatham House Rule whereby the names of members and guests and their company or firm affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals, companies or firms.

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