



# Audit Committee Handbook

**Audit Committee Institute**

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Global



“An audit committee is essentially an oversight committee, for it is management who are responsible for the internal controls and the financial statements. The committee, however, has to satisfy itself, on behalf of the board and ultimately the shareholders that key controls are operating, that ethical practices are being reinforced, that key accounting estimates and judgements are being properly made and that internal and external audits are effective.”

Audit Committee Institute



# Audit Committee Handbook



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## About the Audit Committee Institute

The Audit Committee Institute (ACI) champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives in over 40 countries worldwide, ACI engages with directors and business leaders to help articulate their challenges and promote continuous improvement.

Drawing on insights from KPMG professionals and governance experts worldwide, ACI seeks to provide actionable thought leadership – on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more – all through a board lens.

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# Introduction

**This *Audit Committee Handbook* draws on insights and learnings from ACI's interaction with thousands of audit committee members, audit and governance professionals, and business leaders in over 40 countries worldwide over more than 10 years.**

Audit committees have, in many ways, run the gauntlet – through corporate accounting scandals at the start of the millennium and the expanding responsibilities, the dot-com bubble of the late 90s, the 2007–2008 financial crisis and the subsequent reforms throughout the world, corruption investigations in global companies, and the dramatic escalation and impact of cybersecurity attacks.

The insights gained and lessons learned have clearly set a high bar for audit committees (and boards), and the accelerating speed and complexity of doing business will, no doubt, keep pushing that bar higher. Technology and innovation, globalisation and geopolitical turbulence and other disruptive forces are shaping a risk and regulatory landscape that few could have envisioned 15, 10, or even five years ago.

By and large, we see audit committees adapting to these changes and challenges – refining their agendas and oversight processes and, in some cases, reassessing their skills and composition.

Keeping pace will require agendas that are, focusing on what is most important, allocating time for robust discussion and, perhaps most importantly, understanding the tone, culture, and rhythm of the organisation.

The *Audit Committee Handbook* is intended to be a practical, user-friendly reference for both new and seasoned audit committee members, and for management and audit teams that work with the audit committee. To that end, the *Audit Committee Handbook* covers the fundamentals – e.g., basic requirements and responsibilities and key areas of oversight – and offers insights into the current challenges and leading practices shaping audit committee effectiveness today. It is written to be relevant globally and to serve as a resource for both listed and unlisted companies in the private and public sectors.

Of course, no one size fits all; the practices discussed in this *Audit Committee Handbook* should be considered in the context of each country's and audit committee's needs and circumstances. Nevertheless, certain guiding principles underlie the effectiveness of every audit committee and the right principles can help to ensure that company specific practices are applied effectively.

Some of the issues covered in the *Audit Committee Handbook* – e.g., cybersecurity and the impact of emerging technologies, economic volatility and big data – are clearly matters that require the full board's attention. These and other broader issues are included, however, as the audit committee has an important role to play (at least as a catalyst) in helping to ensure that key issues – particularly those related to risk and compliance – are being addressed appropriately.

At the back of this book are a number of appendices that are intended to provide practical support to audit committees.

We hope this publication provides practical guidance to help audit committees identify and achieve their objectives and add value to the board, the organisation and its stakeholders.





## Chapter 1

# Guiding principles for audit committees

**The audit committee's 'core' duties – overseeing financial reporting and controls, as well as external and internal auditors – are a substantial undertaking and time commitment. In addition, many audit committees have oversight responsibilities for a range of other risks that have become increasingly complex and challenging in the current business environment – from operational and compliance risks posed by globalisation and the extended organisation (partners, suppliers, vendors, etc.) to cybersecurity and other risks related to emerging technologies. Prioritising this heavy audit committee workload continues to be a challenge for most audit committees.**



Audit committees are meeting this oversight challenge by focusing on ways to improve their effectiveness and efficiency – refining their agendas and oversight processes and reassessing their skills and composition. This requires agendas that are manageable (what risk oversight responsibilities are realistic given the audit committee’s time and expertise?); focusing on what is most important (starting with financial reporting and audit quality); allocating time for robust discussion while taking care of ‘must do’ compliance activities; and, perhaps most importantly, understanding the tone, culture, and rhythm of the organisation by spending time outside of the boardroom – visiting company facilities, interacting with employees and customers, and hearing outside perspectives.

Yet, practices that work best for one organisation may not be ideal for another – especially in a corporate governance environment where corporate culture, financial reporting risks and governance needs can vary dramatically from entity to entity and from country to country. We believe, however, that certain guiding principles underlie the effectiveness of every audit committee. Even as specific oversight practices evolve to address changing risks, regulatory requirements and corporate governance needs, the right principles can help ensure that practices are applied effectively – that is, by the right people with the right information, processes and perspectives.

**One size does not fit all.** When delegating oversight responsibilities to the audit committee, each board should factor in the unique needs, dynamics and culture of the company and the board. The responsibilities of the audit committee should be clearly communicated and precisely defined. Once delegated, the activities of the audit committee – including appropriate management interaction – should have the ongoing support of the full board.

**De facto independence and financial literacy are fundamental.** Audit committees must be in a position to challenge management and draw sufficient attention to dubious practices – even in apparently successful companies. In essence, this means that they need to understand their businesses and the substance of complex transactions, and determine that the financial statements reflect fairly their understanding. Perhaps the most important characteristic of an effective audit committee member is a willingness to challenge management; this is the essence of independence.

**Focus on those few things with the greatest impact.** When delegating oversight responsibilities to the audit committee, the board needs to determine what really matters and make sure the committee focuses on those issues and devotes the proper time and attention to them. As one audit committee chair told us, “If you try to focus on everything equally, you will just get overwhelmed.” The audit committee should focus on the areas that are of most importance to the company.

**Make sure the committee is getting ‘information’ and not just data** – from business and functional leaders as well as internal and external auditors. Even where audit committees comprise vigorously independent directors, they will prove ineffective unless they have both access to, and understanding of, all the relevant information. With meaningful information, the committee will be in a position to discuss and provide insight regarding the critical issues facing the business, and probe whether everyone at the table understands the risks, how the risks are being mitigated, what controls are in place, and whether the controls are working.

**Consider how the committee might improve its efficiency and make the most of its meetings.** To streamline committee meetings – and allow more time for discussion and questions – insist on quality pre-meeting materials (and expect pre-read materials to be read) and limit management presentations and the use of extensive slide decks. Conclude (and sometimes begin) each meeting with an executive session so that members have an opportunity to discuss important matters privately.

**Understand that it cannot all be done at the formal committee meetings; ‘between meeting’ work is essential.** One of the biggest changes in audit committee service in recent years is the degree of engagement. Today, the depth and breadth of audit committee engagement has made oversight a much more time consuming job, particularly at larger, more complex, global companies. The audit committee needs to get up and out of the corporate headquarters, seeing things and talking to people in their own offices and workplaces. It is entirely appropriate and even desirable for audit committee members – particularly the chair – to meet with members

of management and the external auditor between regularly scheduled meetings, to have more in-depth discussions on some of the issues that are developing.

**Reinforce the right audit committee culture and dynamics.**

The audit committee's effectiveness hinges on a number of critical factors – including the knowledge, experience, commitment, and de facto independence of its members; the committee's dynamics and chemistry; the quality of the committee's interactions with management and auditors (internal and external); and perhaps most importantly, the committee's leadership. The signs of a healthy committee culture are easy enough to spot: The committee encourages open discussion and debate; committee members question and probe management; dissenting and contrarian views are encouraged and actively sought out; and committee members speak their minds, listen fully, and work toward consensus.

**Take a hard look at the audit committee's performance.** Effective self-assessments are not easy – but they are essential. For many audit committees, self-assessment processes have not been particularly productive, and there is work to be done to ensure that the process accomplishes its objectives. As a first step, get the buy-in of all committee members – a commitment to making the most of the self-assessment process. Then engage the necessary resources and expertise to develop a self-assessment process that works for the audit committee – and follow through.

**Continually reinforce the audit committee's direct responsibility for the external auditor**

– specifically overseeing the auditor's work and independence, and recommending on its appointment and remuneration to the board. To ensure the auditor's true independence from management, the audit committee's direct oversight responsibility for the auditor must be more than just words in the audit committee's terms of reference or items on its agenda. All parties – the audit committee, external auditor and senior management – must acknowledge and continually reinforce this direct reporting relationship between the audit committee and the external auditor in their everyday interactions, activities, communications and expectations.

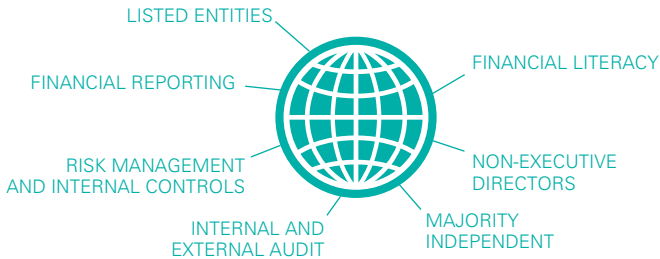


## Chapter 2

# The global regulatory landscape

**This chapter gives an overview of regulations and guidelines relevant for audit committees applicable around the world.**

## Key features of audit committees around the world



Audit committees are generally required for listed entities around the world – either mandated by law or prescribed by corporate governance codes. Although the specific requirements and features of audit committees may vary from jurisdiction to jurisdiction, the core DNA of audit committees is essentially the same all over the world.

An audit committee – usually a sub-committee of the board or the administrative body – is generally responsible for oversight of the financial reporting process, selection of the independent auditor, oversight of risk management and internal controls systems (as a minimum over financial reporting) and monitoring internal and external audit.

Specific key features and the legal requirements for an audit committee vary by country. In the European Union, specific regulations are in place and directives are applied through legislation at the country level. In the US, the main source of legislation for audit committees is generally rooted in the Sarbanes Oxley Act of 2002 and NYSE and/or NASDAQ listing rules, while the implementation of corporate governance rules – including the creation of an audit committee – in the Asia Pacific region operates generally through a ‘comply or explain’ approach.

The rules are regulations around composition of the audit committee differ from one jurisdiction to another but most of them prescribe that all members of the audit committee must be non-executive directors of which a majority has to be independent.

Also, most regulations and codes require a certain degree of financial expertise residing in the committee both on individual and committee level.

A more detailed overview of the regulatory frameworks and key features of audit committees around the world, can be found in **appendix 1**.



## Chapter 3

# Building and sustaining an audit committee

**Look at the governing structure of most large organisations and you are likely to find an audit committee. They are regarded as an important element of good governance, however, as many well publicised corporate governance failures have demonstrated, having an audit committee does not guarantee good governance.**

Audit committees are formed by the board of an organisation (when referring to the board we mean the wider terms to also include, governing body, council etc.) and, from a legal perspective, generally all decision-making remains within the collegial responsibility of the board.

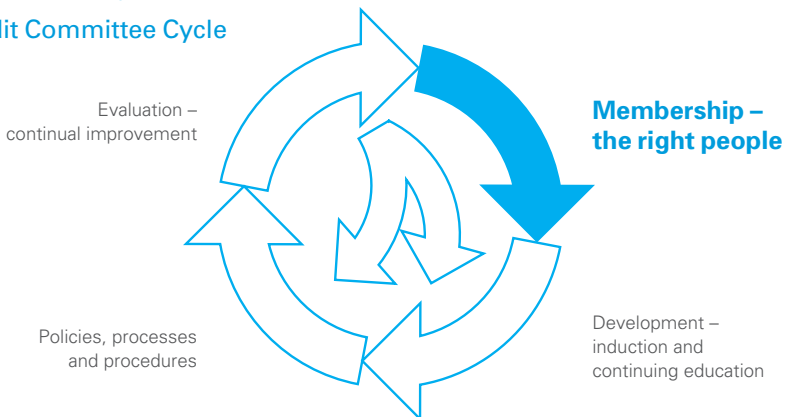
In the main, audit committees are constituted to help the board to discharge the board's responsibility for adequate and effective risk management, financial reporting, control and governance. How an audit committee fulfils this remit varies according to the abilities and behaviours of its members, the clarity of the committee's mission, and the tone set at the top of the governance structure. However, certain characteristics and practices mark a strong, effective audit committee. Audit committees should view these characteristics, not as elements carved in stone but, as components in a process that can and should be continually improved to enhance the committee's effectiveness.

“Do not only look at the people who made it to the top, but also at the people who have yet to make it. Supervision, like management, is all about people.”

Belgian Audit Committee Chair

## Membership

### Audit Committee Cycle





### Terms of appointment

The terms of appointment of an audit committee member should be clearly set out at the time of appointment. All members of the audit committee should have a clear understanding of:

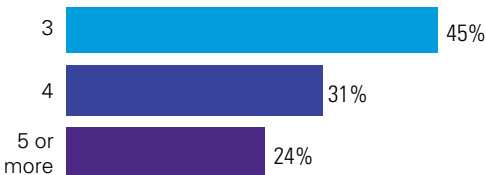
- what will be expected of them in their role, including time commitment;
- how their individual performance will be appraised (including a clear understanding of what would be regarded as unsatisfactory performance and the criteria that would indicate the termination of membership); and
- the duration of their appointment and how often it may be renewed.

### How many members?

The size of the audit committee will vary depending on the needs and culture of the organisation and the extent of responsibilities delegated to the committee by the board. Too many members may stifle discussion and debate. Too few may not allow the audit committee chair to draw on sufficient expertise and perspectives to make informed decisions.

The objective is to allow the committee to function efficiently, encourage all members to participate and to ensure that there is an appropriate level of diversity of skill, knowledge and experience.

#### Number of audit committee members:



Source: ACI's Global Audit Committee Survey 2015

### Rotation policy

Rotation of audit committee members can provide a practical way to refresh and introduce new perspectives to audit committee processes. Rotation also creates the opportunity for more members of the board to gain a greater and first-hand understanding of the important issues dealt with by the audit committee, thus contributing to greater understanding on the board. However, given the complex nature of the audit committee's role, rotation needs to be balanced with the desire to have members who possess the necessary skills and experience to be effective as a committee.

## Independence

Independence is one of the cornerstones of the committee's effectiveness, particularly when overseeing areas where judgements and estimates are significant. Full de facto independence of mind is crucial for every audit committee member, on top of any legally enforced independence requirements. Audit committee members must be adept at communicating with management and the auditors and be ready to challenge and ask probing questions about the company's risk management and control systems, accounting and corporate reporting. Put differently, de facto independence is crucial to achieve audit committee effectiveness.

It is up to the board to assess the integrity and independence of an audit committee candidate, so every member's appointment is an occasion for careful deliberation. The board should have a strong understanding of the relevant definitions of independence and how a lack of independence occurs and is interpreted in practice. Independence issues are often most prevalent with respect to business relations. The board should also be cognisant and mindful of situations in which the pure definition of independence is met; yet perceived conflicts of interest may still arise.

When determining the independence of an audit committee member, the board should consider – as a minimum – whether any material relationships or circumstances are likely or could appear to affect the person's judgement. Such relationships and circumstances may occur if the individual has, for example:

- been an employee of the organisation or group within (say) the last five years;
- had within (say) the last three years, a material business relationship with the organisation either directly, or indirectly as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- received or receives additional remuneration from the organisation apart from a director's fee, participates in the company's share option or a performance related pay scheme, or is a member of the company's pension scheme;
- close family ties with any of the organisation's advisers, directors or senior employees;
- cross directorships or has significant links with other directors through involvement in other organisations;
- a significant shareholding; or
- served on the board for more than (say) nine years from the date of their first election.

- has been a partner or employee of the current or former external auditor of the company or a related company or person within the last three years;
- is an executive director of another company in which an executive director of the company is a non-executive member of the board, and having other significant links with executive directors of the company through involvement in other companies or bodies; or
- is a spouse, legal partner or close family member to the second degree of a director or member of the legal management committee or person entrusted with the daily management or employee of the senior management in the company or a related company or person or of the persons referred to in the above.

“Legal independence requirements are mere minimum requirements and mainly focused on ‘financial’ independence. The board’s focus in assessing independence should go much further. Independence of mind is a crucial element for any independent audit committee member”

Luxembourg Board Chair

### Financial expertise

In most jurisdictions, at least one member of the audit committee should have competence in finance, accounting and/or auditing.

What constitutes such experience will, of course, vary from organisation to organisation, and each board should determine its own criteria referring to appropriate regulation. In many cases it must go beyond basic familiarity with financial statements. Members must be able to understand the rules and, more importantly, the principles underpinning the preparation of the financial statements and the auditor’s judgements. They must be prepared to invest the time necessary to understand why critical accounting policies are chosen and how they are applied, and satisfy themselves that the end result fairly reflects their understanding. In practice this is generally achieved by having directors on the audit committee that have a professional experience as CFO or equivalent or that have a qualification from a professional accountancy/auditing body.

While financial literacy is a great asset for an audit committee member, not every member needs to have relevant expertise in finance, accounting and/or auditing. Indeed, there is great value in having committee members from diverse backgrounds who are not afraid to ask simple questions such as ‘Why is that the case?’, ‘What would one expect to see?’ and ‘Tell me again because I still don’t understand.’ These are good, simple questions that can often be overlooked by more financially literate audit committee members. Nevertheless, the committee as a whole must possess sufficient financial acumen to be fully effective.

### Collective experience vs individual experience

While corporate governance rules usually stipulate that at least one member of the audit committee must possess the requisite accounting and auditing experience, most companies also rely on the collective experience of the audit committee as a whole. This raises the question of who has what experience? Does each committee member have a particular area of expertise, such that it is only when they come together as a whole that they have the necessary recent and relevant experience in accounting, auditing and finance? Or, by stating that they rely on the collective experience of the audit committee, are they ensuring that no one director can be held more liable than another by virtue of experience and knowledge?

Meeting attendance is also relevant to the financial expert debate. If an audit committee relies on its collective experience then what happens if one member does not attend a meeting? Does this mean that they do not have the requisite experience to operate? Equally, those audit committees that have identified one member as having the recommended experience need to be cautious of holding meetings when that individual is not in attendance. It is perhaps not surprising that companies commonly identify the audit committee chairman as the ‘financial expert’.

### Other skills, experience and personal attributes

In determining the composition of the audit committee, it is important to balance formal qualifications with consideration of personal qualities and relevant experience. What has been highlighted over recent years, is that there should be an appropriate balance of skills and experience on the board (and by implication its committees) to enable the board to discharge its duties effectively.

Generally, an audit committee member should possess certain attributes such as:

- integrity and high ethical standards;
- strong interpersonal skills;

- sound judgement;
- the ability and willingness to challenge and probe; and
- the time and personal commitment to perform effectively.

“Probably the most important point for an audit committee member to remember is never to assume that others understand something you cannot fathom. Always ask for an explanation and persevere until you do understand. You will be surprised how often your colleagues find the answer illuminating and adding to their knowledge.”

UK Audit Committee Chair

Boards and audit committees should satisfy themselves that audit committee members have an appropriate level of expertise and specifically experience relevant to the sector in which the company operates. It is reasonable to expect that such considerations become an important part of both the annual audit committee assessment exercise and board succession planning. When making appointments to the audit committee the board should consider the overall knowledge and experience of the committee in order to achieve sectoral competence.

A committee’s effectiveness in performing its mission is certainly enhanced by, and is often dependent upon, the member’s experience, knowledge and competence in business matters, financial reporting, and internal control and auditing. It is important that the audit committee is not reliant solely on management to provide it with such experience.

### Conflicts of interest

Audit committee members should declare any matter in which they have an interest. Normally, the process for recording declarations of conflicts of

interests in the audit committee should mirror that used by the board. Each member of the committee should take personal responsibility for declaring proactively, at the outset of each meeting, any potential conflict of interest relating to business arising on the committee's agenda or from changes in the member's personal circumstances. The chair of the audit committee should then determine an appropriate course of action with the member. For example, the member might simply be asked to leave while a particular item of business is taken, or in more extreme cases the member could be asked to step down from the committee.

If it is the chair that has a conflict of interest, the board should ask another member of the committee to lead in determining the appropriate course of action. A key factor in determining the course of action is the likely duration of the conflict of interest: a conflict likely to endure for a long time is more likely to indicate that the member should step down from the committee.

### The audit committee chair

Effectiveness and true independence often hinge on the chair's effectiveness. The essential characteristics of a strong chair are often personal attributes. The chair should be recognised for his or her leadership and vision, and be perceived by other committee members and management as able to set and manage the audit committee's agenda. The chair should be acknowledged as having the personal courage to raise and deal with tough issues and support other members to do the same.

Formal meetings of the audit committee are at the heart of its work. They are not, however, its only point of contact with the company. The audit committee chair and, to a lesser extent, the other audit committee members, need to keep in touch with key audit committee stakeholders such as the board chair, chief executive officer, chief financial officer, chief risk officer, the external audit partner and the chief internal auditor. In many companies, the audit committee chair meets regularly with each of these individuals as part of the process of developing the meeting agenda and preparing for each meeting. A successful audit committee chair should not only understand the importance of the audit committee's relationship with these individuals but also have the interpersonal skills to build and maintain effective working relationships.

“There are two extremes of corporate environment for the audit committee chair role. The mature, well resourced company with good systems, which is on top of the ever evolving governance environment and the relatively under resourced company, which tends to be behind the curve in terms of evolving governance. The former requires authoritative leadership to keep everything sharp and value adding whereas the latter can require quite exhaustive mentoring.”

UK Audit Committee Chair

The characteristics of an effective audit committee chair might include being:

- An independent proactive leader with confidence and integrity;
- A highly respected and experienced board member, who possesses strong financial literacy skills and time available to develop and closely monitor the committee agenda;
- A person with an excellent working knowledge of an audit committee’s functions and risk management frameworks;
- A good listener and communicator who can facilitate successfully;
- Able to champion open and frank discussion with discipline; and
- Tenacious and prepared to ask the tough questions.

The audit committee chair should play a proactive leadership role in:

- Setting the tone: dedicated, informed, probing, and independent – willing to challenge management, when appropriate;
- Keeping the committee focused on what is important – starting with financial reporting risk;
- Making sure the audit committee has the information, resources, and support to do its job;
- Periodically reviewing and refining the audit committee’s charter, including working with the board chair and committee chairs to reallocate responsibilities if the audit committee’s workload is out of balance;



- Ensuring that all committee members are engaged;
- Promoting communications – both formal and informal – between audit committee members;
- Spending time between meetings working with management and auditors to ensure that all relevant issues are identified and addressed by the committee;
- Supporting the CFO/finance organisation’s focus on long-term performance; and
- Setting clear expectations for external and internal auditors.

It is extremely unlikely that an audit committee would hold a meeting without its chair present. This is why it is sometimes suggested that the audit committee member with the highest level of financial acumen should chair the committee. Of course, this need not be the case, although it could be argued that as the chair may have more perceived authority it would make sense. The chair’s role is not to do all the work; rather, the chair should engage other members in the work of the committee by asking them to take responsibility for specific aspects and recognise their contribution.

<b>Eight steps to chairing the audit committee effectively</b>	
<b>1. Get the committee membership ‘right’</b>	<ul style="list-style-type: none"> <li>— Ensure the skills, knowledge and experience of committee members is appropriately diverse and up to the task</li> <li>— Do not dismiss so-called soft skills</li> <li>— Ensure appropriate succession plans are in place for the chair and committee members</li> </ul>
<b>2. Ensure committee members (and the committee as a whole) are ‘up-to-speed’</b>	<ul style="list-style-type: none"> <li>— Identify learning needs and knowledge gaps</li> <li>— Ensure each member has a tailored professional development plan</li> <li>— Ensure the committee has access to outside experts and other specialists</li> </ul>
<b>3. Ensure the committee has constructive relationships with management, auditors and other advisors</b>	<ul style="list-style-type: none"> <li>— Engage in informal meetings/dialogue with management, auditors and advisors to build empathy</li> <li>— Make full use of the ‘in camera’ private sessions at each audit committee meeting by planning ahead</li> <li>— Attend ‘away days’ and use social functions constructively to deepen relationships</li> <li>— Attend meetings in the business to deepen understanding of issues and provide context for committee meetings</li> <li>— Ensure key management (operational heads, individuals responsible for key risks, etc) attend and are present at meetings</li> <li>— Ensure the ‘marzipan layer’ of management (i.e. those below the executive tier) is appropriately engaged</li> </ul>

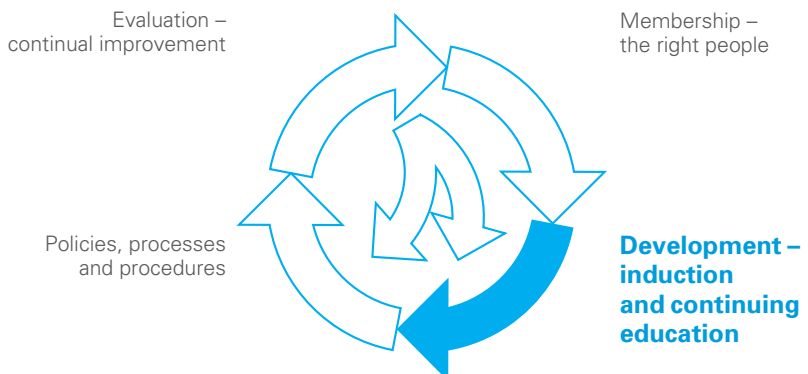
<b>Eight steps to chairing the audit committee effectively</b>	
<b>4. Create solid ground rules for meetings</b>	<ul style="list-style-type: none"> <li>— Address issues, not personalities. Focus on what is right – not who is wrong</li> <li>— Do not use the audit committee meeting to address matters that should be raised in board or management meetings</li> <li>— Avoid the use of ‘jargon’ and keep to the point – be clear and stick to the topic being discussed</li> <li>— Do not use audit committee meetings to demonstrate superior intellect, knowledge or excellence</li> <li>— Be positive and constructive – only disagree by making a constructive suggestion</li> </ul>
<b>5. Ensure the committee has access to the ‘right’ information</b>	<ul style="list-style-type: none"> <li>— Work with members to ensure committee papers, access to management and other information flows are appropriate</li> <li>— Ensure papers:               <ul style="list-style-type: none"> <li>— are timely</li> <li>— prioritise the key issues</li> <li>— are well signposted</li> <li>— include appropriate benchmarking and trend data</li> <li>— understandable – i.e. not overly long or complex</li> </ul> </li> </ul>
<b>6. Ensure the right conversation around the audit committee table</b>	<ul style="list-style-type: none"> <li>— Plan the style and content of the audit committee conversations ahead of time</li> <li>— Ensure every conversation has ‘clarity of purpose’</li> <li>— Make time for both ‘hard’ and ‘soft’ subjects, for decision and reflection, for introspection and evaluation</li> <li>— Ensure the routine business of the audit committee does not crowd out the critical issues</li> <li>— Ensure the overall agenda is not so tight that it cannot adjust to include ‘special business’ or matters raised by individual audit committee members</li> </ul>
<b>7. Ensure the committee is exposed to broad external perspectives</b>	<ul style="list-style-type: none"> <li>— Use external experts to present/discuss specific risk, business or macroeconomic issues</li> <li>— Ensure investor views on management, the organisation and the sector are understood</li> </ul>
<b>8. Evaluate performance on an on-going basis as well as formal periodic reviews</b>	<ul style="list-style-type: none"> <li>— Observe, question and resolve as required</li> <li>— Engage in one-to-one sessions with members and committee attendees</li> <li>— Consider to use an independent third party to evaluate committee performance</li> </ul>

“Whatever the environment, the audit committee is the pinnacle of constructive top down pressure that goes to support professionalism in a complex multi faceted business environment. A key aspect of which lies with the authority that the committee chair conveys in the handling of the committee and its agenda and how it communicates to both management and the board what it has reviewed and its conclusions and recommendations relating thereto.”

UK Audit Committee Chair

## Development – induction and continuing education

### Audit Committee Cycle



In the current business environment, the skills, experience and continuing education of board directors has come under the spotlight more than ever. Does an individual director contribute to the effectiveness of the audit committee? Do they have the skills, experience and personal characteristics to discharge their role competently?

## Induction

For any new director, but particularly when joining the audit committee – a learning curve comes with the territory. Just how steep that learning curve is, however, and how quickly a new director is able to contribute meaningfully to the work of the board and its committees, can hinge directly on the quality of the induction programme.

Understanding the business – its operations, strategies, risks, and management team – as well as the responsibilities and culture of the board and its committees takes time. But a structured induction programme – including essential information and briefing materials, quality discussions with key people, and a ‘roadmap’ for getting up to speed – can greatly accelerate a new director’s integration and contribution to the board’s work.

For new audit committee members, induction presents an added layer of complexity, given the intricacy and scope of the financial reporting/ accounting and legal/ regulatory compliance issues on the audit committee’s plate – not to mention the expectations of regulators, particularly in the financial services sector. The chair and/or secretary to the committee should ensure that the programme is tailored to suit the individual’s specific needs, and that it at least covers the audit committee’s terms of reference and an overview of the company’s internal control organisation and risk management systems.

“When I joined the board, the chair asked me to join the audit committee. He said it would be hard work but it would be the best and fastest way to find out how the company worked. He was right on both counts.”

UK Audit Committee Member

The terms of appointment of an audit committee member should be clearly set out at the time of appointment. All members of the audit committee should have a clear understanding of:

- What will be expected of them in the role, including the time commitment

- How their individual performance will be appraised
- The duration of their appointment and how often it may be renewed
- Induction programmes help to ensure audit committee members understand their responsibilities, current issues and the intricacies of the particular company.

At least the following should be considered when developing an induction programme:

- Provide tailored suggested reading for the new audit committee member, such as corporate documents and other briefing materials;
- Have an initial orientation session; and
- Have follow-up one-on-one meetings with key people in the company to develop a deeper understanding of the business, its key governance and control processes, and its leaders.

For pre-reading, the following may be provided:

- the committee's terms of reference and recent committee minutes and presentations to the board;
- relevant company policies, including the code of conduct and whistleblowing policy;
- the most recent annual and interim reports to shareholders;
- a summary risk register;
- any internal reporting on the effectiveness of internal control over financial reporting;
- recent press releases and correspondence with any securities regulatory authorities or other regulatory bodies;
- the internal audit terms of reference, work plan and recent reports to the audit committee; and
- the external auditor's work plan, the most recent year-end report to the audit committee and the most recent management letter.

Written materials should support oral presentations so that the new audit committee member has appropriate reference materials and tools as a result of the induction programme.

“The economic world has a changing nature, with more unknowns than certainties, in which learning the new and unlearning the old is crucial to be sustainable. This also applies to the audit committee.”

Argentina Audit Committee Chair

Regardless of whether it is part of a formal or structured orientation process, a new audit committee member will want to have one-on-one discussions with a number of key leaders in the business to gain a better understanding of the company – the culture, strategy, key risks, strengths, areas of concern, etc. – and to get to know the leaders outside the formality of the boardroom.

Initially, it may be helpful to get the ‘lay of the land’ by meeting separately with the company secretary and/or legal counsel and the head of internal audit, each of whom can be valuable sources of information and insight. What are the hot-button issues facing the company? What issues have management and the board been spending the most time on? What governance processes work well—or not so well? What is the culture of the company – and of the board?

The company secretary and/or legal counsel can provide information about the board from a legal and process point of view, including the committee structure, the role of each committee, and how the committees coordinate and communicate about oversight activities. The the company secretary and/or legal counsel also can provide an update on litigation or investigations that could have an impact on the company’s financial statements, disclosures, and legal/ regulatory compliance.

With internal and external audit increasingly playing a larger role in many businesses, the head of internal audit and the lead external audit partner should also have important insights to offer regarding the effectiveness of the organisation’s risk management processes, system of internal control, and governance processes.

### Ongoing professional development

The one thing that organisations can be certain of is that change is constant – not only in the area of financial reporting but also in regulatory compliance, technology and business risk. The board chair, committee chair and individual directors are all responsible for monitoring professional development requirements. A robust audit committee evaluation process should also highlight development needs of individual directors or of the audit committee as a whole.

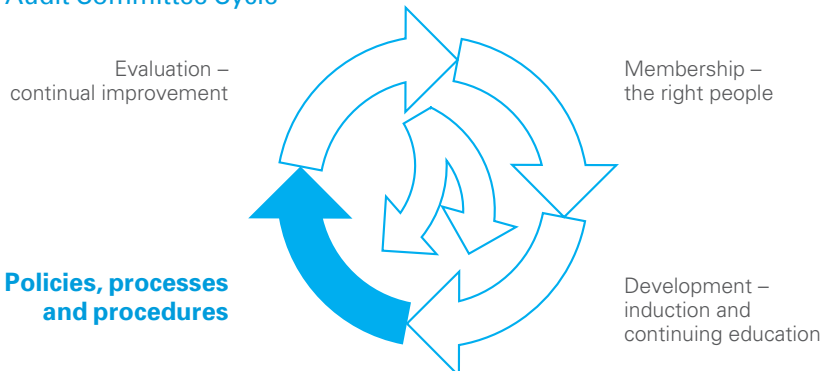
All members should seek periodic continuing professional education both inside and outside of the audit committee. The secretary to the committee might be tasked with ensuring the appropriate training opportunities are made available to audit committee members, whether in-house briefings or externally organised seminars. The most common means of updating the audit committee is through briefings by internal and external audit, the audit committee chair, the company secretary and the chief financial officer. In addition, many members attend external courses and conferences.

**“To be truly effective as an audit committee, its members, and especially the chair, must have sound enthusiasm and curiosity in and for their job.”**

Taiwanese Audit Committee Chair

## Policies, processes and procedures

### Audit Committee Cycle





### Terms of reference

The audit committee terms of reference should set out the main role and responsibilities of the committee. In terms of responsibilities, most audit committees would assume the following:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to monitor the effectiveness of the company's internal controls and risk management systems;
- to monitor the effectiveness of the company's internal audit function;
- to make recommendations to the board in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements; and
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

The audit committee's terms of reference should be clear on the scope of the committee's responsibilities and how these should be discharged to the board. It is essential for the audit committee to be independent, have sufficient authority and resources to form an opinion and report on the organisation's risk management, control and governance arrangements.

**“Focus on the processes supporting the adequacy of the risk management framework, the internal control environment and the integrity of reporting. Resist ‘mission creep’ into using the outputs of these processes, as that is the full board’s role.”**

UK Audit Committee Chair

An audit committee's terms of reference should be tailored to the company's specific needs and should clearly outline the committee's duties and responsibilities; and the structure, process and membership requirements of the committee. Ideally, it should describe the background and experience requirements for committee members and set guidelines for the committee's relationship with management, the internal and external auditors, and others.

In addition, the audit committee's terms of reference should be co-ordinated with the responsibilities of other committees in the organisation – remuneration committee, risk management committee, and other committees focused on a particular risk (e.g. cybersecurity committee or investment committee). These committees may be required to consider the same issue from different perspectives. Care should be taken to define clearly the roles and responsibilities of each committee, when collaboration is required, whether cross-membership is allowed, and whether the audit committee chair or members might attend other committee meetings as an observer (and vice versa).

The terms of reference should be detailed enough to clarify roles and responsibilities and include items that can be reasonably accomplished. However, audit committees should be mindful of the potential implications of increased workload and make sure they are not undertaking so many responsibilities that cannot be reasonably achieved, or that may subject committee members to future liability. Audit committees should guard against becoming the 'dumping ground' for new responsibilities. They should be mindful of accepting responsibilities that rightfully reside with the board as a whole. It should be remembered that the audit committee is not a body that makes binding decisions in its own right: the committee exists exclusively to assist the board in discharging its responsibilities.

To help ensure that the audit committee's effectiveness is not impaired by an increased workload, it is crucial that the audit committee – and indeed the board – regularly and robustly review the terms of reference. This assessment should highlight any changes to the organisation's circumstances and any new regulations or leading practices that may affect the committee's remit. The review may be incorporated into the self-evaluation process that the audit committee undertakes.

**Appendix 2** includes an example audit committee terms of reference. Our intention is not to advocate an exhaustive terms of reference. Rather, the example is intended to help audit committees and boards of directors in evaluating the completeness of their terms of reference for their specific circumstances. It should serve as a guide in establishing the audit committee work plan and meeting agendas.

### Setting the meeting agendas

A detailed agenda is vital for keeping the committee focused. Effective agendas are set with input from the CEO, CFO, CRO and the internal and external auditors. The audit committee chair however should maintain accountability for the agenda and should not allow management to dictate the content.

Meeting agendas ultimately drive the work the audit committee does. For this reason audit committee agendas should be closely linked to the committee's terms of reference. The audit committee agenda for the year should ideally originate from a detailed work plan. A wide ranging work plan helps members focus on their job. However, the nature of audit committee responsibilities and the ever-changing environment in which companies operate make it difficult to determine a fixed agenda of topics for each meeting. The committee should assess what is currently important and develop its agenda accordingly.

The detailed work plan would originate from the terms of reference.

**Appendix 3** includes an example of audit committee agenda topics that should be considered when developing detailed audit committee agendas for the year. An example audit committee agenda for the year is presented as **Appendix 4**.

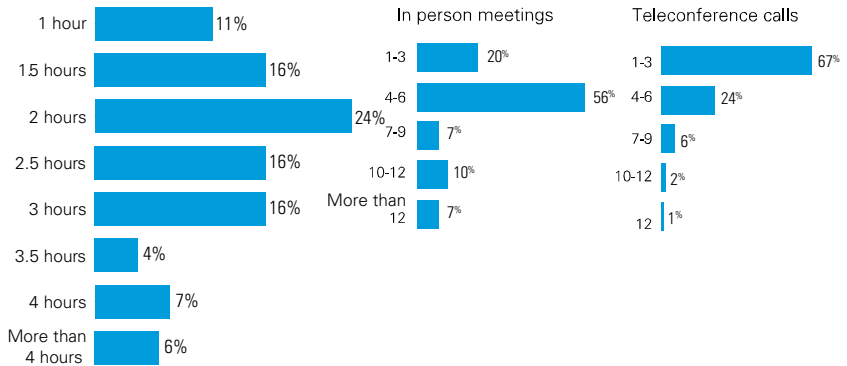
The secretary to the audit committee should ensure that the committee receives the meeting agenda and supporting materials in a timely manner, to enable committee members to give full and proper consideration to the issues. This would usually be at least one week prior to the meeting.

### Frequency and timing of meetings

The audit committee should meet as often as its role and responsibilities require.

Timing meetings to coincide with key dates within the financial reporting and audit cycle enables the audit committee to make timely and influential decisions. Equally, having sufficient time available at each meeting is critical. The committee must be able to cover all agenda items, hold as full a discussion as is required, and enable all parties to ask questions or provide input. There should also be sufficient time for audit committee members to discuss issues, without others being present (private session), at each meeting.

### Duration and number of audit committee meetings



Source: ACI's Global Audit Committee Survey 2015

An appropriate interval should be allowed between audit committee meetings and other related meetings (such as main board meetings) to allow any work arising from the audit committee meeting to be carried out and reported on as appropriate.

The most important issue is that audit committee members hold effective meetings. The quality and timeliness of pre-meeting materials, an appropriate balance between discussion/debate and listening to presentations, and better prioritisation of issues all help drive the effectiveness and efficiency of audit committee meetings. Allocate oversight duties to each audit committee member, rather than relying on the audit committee chair to shoulder most of the work.

**“Timely and high-quality information combined with in-depth advance preparation should guarantee informed and challenging debates, the essence of a well functioning audit committee.”**

Belgian Audit, Risk & Compliance Committee Chair

## Audit committee effectiveness

Consider how the committee might improve its efficiency and make the most of its meetings. To streamline committee meetings – and allow more time for discussion and questions – insist on quality pre-meeting materials (and expect pre-read materials to be read) and limit management presentations and the use of slide decks. Conclude (and sometimes begin) each meeting with an executive session so that members have an opportunity to discuss important matters privately.

Spread the committee's workload. Allocate oversight duties to each audit committee member, rather than relying on the audit committee chair to shoulder most of the work.

**“In many instances the only person who seems to be running at light speed is the audit committee chair. We really need to utilise the entire committee...for deep dives into particular areas of interest or concern.”**

US Audit Committee Chair

An effective audit committee is one that successfully supports the organisation in fulfilling its responsibilities relating to corporate reporting, risk management, control and governance. This goes beyond simply carrying out the tasks set out in the audit committee's own terms of reference.

Understand that it cannot all be done at the formal committee meetings; 'between meeting' work is essential. One of the biggest changes in audit committee service in recent years is the degree of engagement. Today, the depth and breadth of audit committee engagement has made oversight a much more time consuming job, particularly at larger, more complex, global companies. To be fully effective, the audit committee needs to get up and out of the corporate headquarters, seeing things and talking to people in their own offices and workplaces. It is entirely appropriate and even desirable for audit committee members – particularly the chair – to meet with members of management and the outside auditor between regularly scheduled meetings, to have more in-depth discussions on some of the issues that are developing.

While the structure and operations of audit committees may vary by country (and company), in summary, audit committee effectiveness, ultimately hinges on getting these things right:

*Clear role for the audit committee* – Operating in an environment where committee members and others within the organisation have a common understanding of the committee’s role.

*Membership* – Ensuring that the audit committee has the expertise and experience to provide robust oversight of financial reporting, audit quality, and other risks on the committee’s agenda.

*Driving the audit committee’s agenda* – The audit committee must shape its own agenda to ensure that it’s risk-based, focused, and manageable.

*Active involvement* – In-depth knowledge of the company gained from (pro)active engagement and genuine interest in the company (beyond the boardroom).

*Effective communication* – Open lines of communication with senior and middle management, internal and external auditors, and the full board based on mutual trust and constructive debate.

*Getting the right information* – Information provided to the audit committee must be relevant, concise, and timely.

*Informal meetings* – Informal and ad-hoc meetings (in between regularly scheduled meetings) are essential to stay fully informed.

*Tone at the top* – Sensitivity to the tone at the top of the company – and, indeed, throughout the organisation.

*Leadership* – The attitude, skill set, and engagement of the audit committee chair are essential to achieving all of the above – which collectively drive audit committee effectiveness.

### **Improving the quality of audit committee ‘conversations’**

The whole subject of chairing audit committee meetings deserves careful thought as getting the ‘right conversation’ around the audit committee table is an essential component of audit committee effectiveness. ACI’s research and experience indicate that many audit committees could significantly improve their oversight capabilities and therefore their effectiveness through greater consideration of the style and content of the conversations

they have. There are some important overarching considerations when preparing for audit committee meetings:

- Arranging the space available in the audit committee calendar for all the subject matter that should be covered involves mapping out the agenda. It is important to make time available for both ‘hard’ and ‘soft’ subjects, for decision and reflection, for introspection and evaluation. It is important that the routine business of the audit committee does not crowd out the critical issues, and that the overall agenda is not so tight that it cannot adjust to include ‘special business’ or matters raised by individual audit committee members.
- Every conversation needs framing. Whether challenge, debate or ‘for information’, every audit committee ‘conversation’ needs clarity of purpose so that all audit committee members have the appropriate information available before the conversation takes place. Conversations need clear purpose and outcome (whether a decision or an agreed position or simply being better informed), and follow-up.

**“It’s not about asking nasty questions, but to be truly interested.”**

Belgian Audit Committee Chair

Where ‘conversations’ around the audit committee table are not as effective as they might be, consideration of the following might be helpful. The tables below indicate a number of common issues and their likely symptoms, together with suggestions for the role that the audit committee chair and members might play in addressing these concerns.





**Issue: There are dominant personalities or groups in the audit committee meetings controlling the debate**

<b>'Red flags'</b>	<b>Audit committee chair's response</b>	<b>Audit committee member's response</b>	<b>Management's response</b>
<p><b>Dissenting voices marginalised</b></p> <p><b>Difficult issues not sufficiently discussed</b></p> <p><b>Debate becomes personalised not issue focused</b></p> <p><b>Special insights not used</b></p> <p><b>Individuals reticent to speak up</b></p> <p><b>Third parties stereotyped as out of touch</b></p> <p><b>Management team is defensive or aggressive</b></p>	<p>Build trust and respect with all members. Speak with them ahead of meetings and make sure they are sufficiently briefed to contribute effectively</p> <p>Give weight to the views raised</p> <p>Demonstrate by own behaviour that uncertainty and questioning of assumptions is appropriate</p> <p>Engineer a counter case in the debate</p> <p>Encourage and give 'air cover' to new committee members</p> <p>Address directly with the chair of the board if dominance continues</p>	<p>Speak up but don't hog airtime</p> <p>Ensure that you are fully briefed</p> <p>Add value by adding fresh insight</p> <p>Build relationships with other members and 'rehearse' difficult questions or concerns before the audit committee meeting</p>	<p>Recognise the different knowledge levels amongst the committee members and address member's areas of discomfort</p> <p>Consciously ask for input and advice</p> <p>Seek input from specific directors outside board meeting</p>

**Issue: The audit committee is being 'managed' by the executive team in attendance**

<b>'Red flags'</b>	<b>Audit committee chair's response</b>	<b>Audit committee member's response</b>	<b>Management's response</b>
<p><b>Executive's don't provide the committee with different viewpoints – all proposals appear to be a fait accompli</b></p> <p><b>Insufficient focus on the big picture/ too much focus on operational matters</b></p> <p><b>Probing challenge not welcomed by the executive team</b></p> <p><b>Insufficient emphasis on risk</b></p> <p><b>Papers not tailored to board needs</b></p>	<p>Use the company secretary actively in preparation of papers</p> <p>Pre agree with relevant executives how particular issues should be presented to the committee</p> <p>Personally demonstrate behaviour required by querying judgements and assumptions</p> <p>Insist on meeting relevant executives ahead of papers coming to committee</p>	<p>Respect the executive need for 'instant decisions', but 'push back' in the discussion</p> <p>Get to know the business and people below the top executive team – the 'marzipan' layer</p> <p>Be active conduits to the external world</p>	<p>Use scenarios to show the range of uncertainty</p> <p>Use 'reverse stress testing' to demonstrate risk awareness and control</p> <p>Show willingness to suspend own assumptions</p>

### Issue: 'Groupthink' - The audit committee lacks diversity of thought

<b>'Red flags'</b>	<b>Audit committee chair's response</b>	<b>Audit committee member's response</b>	<b>Management's response</b>
<p><b>Constant drive to get through the agenda and 'move on' to next topic</b></p> <p><b>Scenarios rarely used</b></p> <p><b>Lack of any external input or challenge</b></p> <p><b>Assumptions not tabled openly</b></p> <p><b>Different options not presented or evaluated</b></p> <p><b>'Out of the box' thinking discouraged</b></p>	<p>Use a facilitative style to manage the debate</p> <p>Use third party briefings etc to increase insight, drive debate and facilitate opposing views</p> <p>Review the committee membership</p> <p>Review the style and effectiveness of the boardroom conversation</p>	<p>Use 'intelligent naivety' to ask the 'non-obvious questions'</p> <p>Keep asking questions in different ways until satisfied</p> <p>Suspend prevailing assumptions</p> <p>Change the angle of debate</p>	<p>Present options and alternatives rather than a fait accompli</p> <p>Actively request debate and introduce difficult issues as 'finely balanced'</p> <p>Overtly welcome the committee's views</p> <p>Ensure the committee has all the relevant information</p>

### Issue: Low commitment, engagement or capability of some audit committee members

<b>'Red flags'</b>	<b>Audit committee chair's response</b>	<b>Audit committee member's response</b>	<b>Management's response</b>
<p><b>Attendance in person but not in spirit</b></p> <p><b>Lack of preparation</b></p> <p><b>Consistent lack of contribution</b></p> <p><b>Focus narrowly on 'own world view'</b></p> <p><b>Too much 'shooting from the hip'</b></p>	<p>Get to know each member by spending time with them outside formal committee meetings</p> <p>Be clear with members about the contribution required</p> <p>Demand brains are switched on and mobiles switched off</p> <p>Change the committee's constitution if appropriate</p>	<p>Raise any issues promptly with the audit committee chair</p> <p>'Move on' if not able to contribute</p>	<p>Be sensitive to committee members feeling out of depth or marginalised</p> <p>Discuss offline and encourage greater contribution, even in areas outside their domain specialisation</p> <p>Share own 'thinking journey' with committee members</p>

**Issue: The audit committee is overly focused on process**

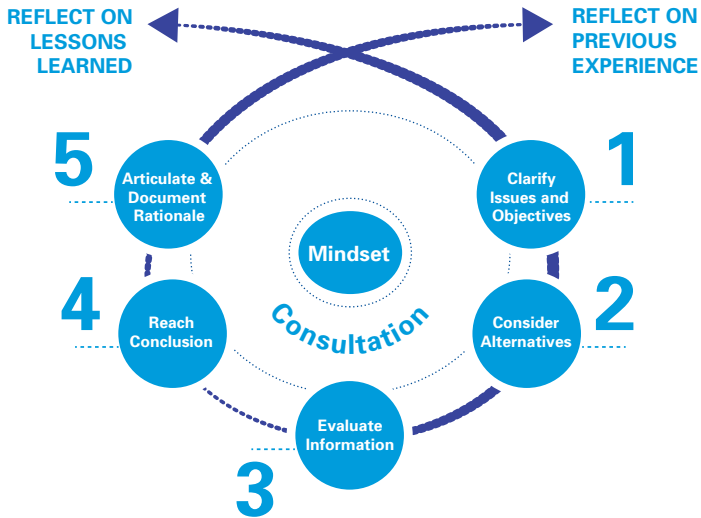
'Red flags'	Audit committee chair's response	Audit committee member's response	Management's response
<p><b>Overemphasis on 'ticking the boxes' at the expense of 'proper' debate</b></p> <p><b>Inappropriate allocation of time to critical issues</b></p> <p><b>Sense of pressure to get through the agenda</b></p> <p><b>Failure to stand back and look at the big picture</b></p> <p><b>Unwillingness to challenge 'the way we do things here'</b></p>	<p>Involve multiple inputs when setting the agenda</p> <p>Differentiate agenda items by importance</p> <p>Listen hard for signals of discomfort</p> <p>Don't be afraid to park items for further review where necessary</p> <p>Be prepared to call additional meetings where necessary</p>	<p>Raise concern either in meeting or offline with the audit committee chair</p> <p>Offer to lead the discussion on a specific upcoming issue</p> <p>Specifically cover during the annual evaluation process</p>	<p>Ensure committee members are properly briefed on critical issues and audit committee priorities</p> <p>Provide meaningful and constructive feedback if asked to contribute to the evaluation process</p> <p>Proactively volunteer constructive thoughts from 'outside the committee'</p>

**Issue: Lack of reflection time about the committee's own performance and style**

'Red flags'	Audit committee chair's response	Audit committee member's response	Management's response
<p><b>Little discussion on how debate could be improved</b></p> <p><b>No opportunities to consider 'what might be done differently next time'</b></p> <p><b>Process suggestions derided</b></p> <p><b>Annual committee evaluation does not get to the real issues</b></p>	<p>Encourage occasional wide ranging discussion on 'meeting craft' at (say) post meeting dinners.</p> <p>Meet with each director to gather their views on the quality of conversation/ debate and get their suggestions for improvement</p>	<p>Insist on the maintenance of high standards</p> <p>Use external experience to support behavioural change</p>	<p>Provide meaningful and constructive feedback if asked to contribute to the evaluation process</p> <p>Proactively volunteer constructive thoughts from 'outside the committee'</p>

## Applying sound judgement

Audit committees should consider the use of a formal judgement process, like KPMG's Professional Judgement Framework<sup>1</sup>. A sound understanding of this five-step process – when correctly used – can help identify whether judgements by an audit committee are threatened by predictable, systematic judgement traps and biases.



The five-step approach is divided into the following stages:

### 1. Define the problem and identify fundamental objectives:

- Ensure the appropriate issue and objective are identified.
- Clarify objectives to understand the problem, and set expectations for the possible solutions. This also helps to better communicate and explain the problem to others.

*Key questions for audit committees to consider include: What problem needs to be solved? Is the issue stated clearly? How does the issue relate to overall objectives?*

<sup>1</sup> As also published in the thought paper *Enhancing Board Oversight: Avoiding Judgement Traps and Biases* published by the Committee of Sponsoring Organisations of the Treadway Commission (COSO).

## 2. Consider alternatives:

- When more alternatives are considered, judgement may improve.
- Take time to generate as many alternatives as reasonably possible.
- Consider all points of view to help identify alternatives.

*Key questions for audit committees to consider include: What are the possible courses of action? Is the decision influenced by external factors? Has opposing information been considered for each point of view?*

## 3. Gather and evaluate information:

- Derive the sense of the facts within the context of the obtained information.
- Draw inferences from the available evidence.
- Gather additional information as needed.
- Weigh and prioritise competing interests, rules, evidence, assessments and likely consequences.

*Key questions for audit committees to consider include: What subjective assumptions are embedded in the information obtained? Are inferences supported by objective facts, or supportable when based on other information obtained? Has attention been paid to both the negative and positive implications of the facts? Has sufficient information been obtained?*

## 4. Reach a conclusion:

- Make a preliminary choice of one of the alternatives.
- Consider some hard tradeoffs between alternatives to reach a conclusion.
- Make a final judgement, based on an evaluation of all aspects of the issue and objective.

*Key questions for audit committees to consider include: Does the conclusion make sense in the context of the issue and the obtained information?*

### 5. Articulate and document the rationale:

- Spell out the facts and reasons supporting the judgement.
- Double-check the validity of the decision to further protect against irrelevant influence.
- Document the decision in accordance with firm and professional requirements.
- Use this documentation as a means of confirming that the conclusion is fully justified in terms of the best available evidence and the controlling rules, principles and precedents.

*Key questions for audit committees to consider include: Is the reasoning sound? Have all relevant factors that were considered been documented? Does the conclusion make sense after it was documented?*

### Meeting attendees

No one other than the audit committee members should be entitled to attend any meeting of the audit committee. It is the audit committee itself that should decide who should attend any particular meetings (or part of it).

Circulating the meeting agenda to the board chair may generate interest from other independent directors and the chair. The audit committee may also choose to invite specific directors or members of other board committees because of their knowledge and perspective on the issue being discussed.

Many audit committees regularly invite the CFO, CRO, CIO, the external audit partner, chief internal auditor, and perhaps the CEO to attend committee meetings. The CEO often has valuable insights to share, but the chair of the audit committee should make sure that the CEO does not inhibit open discussion at the meeting. In addressing a significant and complex issue, some audit committees choose to invite all directors – essentially operating as a ‘committee of the whole’ with the meeting chaired by the audit committee chair. This approach enables all directors to understand and apply their knowledge to an important issue.

### In camera or private meetings

Many audit committees hold meetings (or parts thereof) with only the formal committee members present. Holding such meetings in camera gives the members a good opportunity to discuss any issues or concerns among themselves, and positions them to better understand and challenge management and the auditor at the audit committee meeting.

It is also good practice to hold separate in camera meetings with the internal and external auditors. Frequently, such sessions are held at the end of the scheduled audit committee meeting. The executives are asked to leave, and the committee then invites comments from, and asks questions of, the representatives from internal and external audit.

A private session where management is not present arguably reinforces the independence of the audit committee and allows it to ask questions on matters that might not have been specifically addressed as part of the audit. It allows auditors to provide candid, often confidential, comments to the audit committee on such matters. However, the audit committee chair should manage such private sessions carefully as they introduce a lack of transparency, in that executives do not hear about any problems or issues first hand and may not be given an opportunity to respond. This in turn may cause them to feel excluded and even defensive. Introducing such sessions as part of the regular process might alleviate some of these tensions.

Typically, there should be few such items to discuss in camera. Nevertheless, it is useful to have a process in place should issues arise. All key matters related to risk management, financial reporting and internal control should usually be reviewed in a candid, robust manner with executives, audit committees and auditor during the audit committee meeting. The audit committee can use the private session as a follow up if members are not satisfied with the answers given at the committee meeting, or if they thought the discussions were too guarded or uneasy. However, it is preferable to air such matters fully at the audit committee meeting, so they do not need to be readdressed in the private session.

**Appendix 5**, provides a detailed discussion of the private session with the external auditor together with a framework for conducting such meetings and a list of questions that audit committee members might ask of the auditor.

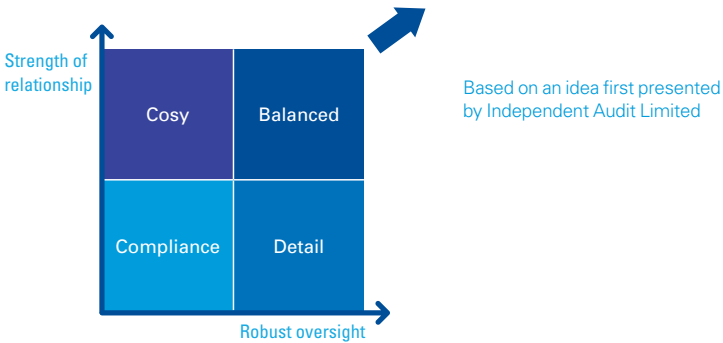
### Relationships

Audit committees work more effectively when all board members have a clear understanding of what responsibilities are devolved to the committee (and conversely what responsibilities are not devolved to the committee). Each need to determine their own ways of working together, but of paramount importance is a strong relationship between board members, audit committee members and those working with them such as auditors, risk functions and executive management.

“Clearly, it is now vital, more than ever before, for the “CFO, audit committee chair and external auditor” to interact well and play their respective complementary, clearly-defined roles together, in harmony.”

French Audit Committee Chair

The ‘oversight and relationship’ paradox



Paradoxically, the balance between strong relationships and robust oversight is at the heart of the audit committee role. A committee that fails to understand the line between oversight and management can easily find itself in a poor relationship with executive management; and effective oversight is difficult to achieve where management sees the audit committee as nothing more than a necessary corporate governance burden. Equally, an overly cosy relationship is unlikely to lead to effective oversight as challenging questions are all too easily avoided in such circumstances. The ideal place to be is where those working with the audit committee (whether it be the CFO, CRO or auditors) look to the committee as a useful partner or sounding board. The exchange of information flourishes in such circumstances and as audit committees are only ever as good as the information they have access to, this naturally leads to better oversight.

“Trust is good. Trust with verification is better!”

UK Board Chair



### Identifying issues early

Questions of substance should not be raised for the first time at the year-end audit committee meeting. Serious problems may result if there are unexpected answers. If the year-end audit committee meeting is conducted effectively, the chair should be communicating with financial management as well as the internal and external auditors during the weeks before the meeting. The chair should also bring matters of potential concern to the attention of the audit committee members ahead of time. The relationship with the auditors should be such that any serious concerns are brought to the audit committee's attention promptly, but in a non-adversarial way.

**“In my view, the Audit Committee should actively develop and maintain a robust and open dialogue with not only the CFO but also the Partner responsible for the Audit and the Risk Manager/Senior Internal Auditor. This should ensure that emerging issues that require the attention of the Committee are communicated in good time.”**

UK Audit Committee Chair

An effective annual plan for meeting agendas can help the audit committee identify issues and discuss them as early as possible during the year. Management should be expected to discuss key accounting estimates and subjective adjustments for each accounting period. The external auditor should periodically discuss the appropriateness of accounting judgements and estimates, including any accounting alternative choices made by management.

### Responding to crises

Organisations may, from time to time, get into difficulty due to fraud, industrial action by employees, failure to meet a key piece of legislation or other reasons. On such occasions, the board acting through executive management is responsible for crisis management and any remedial action. Nevertheless, the audit committee is often ideally placed to advise, provide appropriate oversight and, in exceptional circumstances, deal with outside agencies.

The audit committee should consider the key processes and policies required to determine when to undertake an internal investigation, and ensure that any investigation is sufficient in scope and objective and is thorough.

Who would participate in the investigation? What disclosures would be required or advisable? Who would lead the investigation? How would an independent legal counsel or outside expert be selected? To what extent should the investigation be documented? These and other essential aspects of an internal investigation should form part of a robust action plan, which can be invaluable in guiding the investigation to a timely, credible and conclusive result – particularly when faced with time pressures.

Independent investigation may be required in the event of a major fraud or regulatory inquiry; or where, for example, an organisation is required to restate its accounts due to an error.

When the board (on the advice of the audit committee) determines that an independent investigation is required, the following factors can be essential to establishing credibility of the investigation:

- conducting the investigation in an objective and timely manner;
- employing outside experts – such as legal counsel and forensic accounting professionals – who are truly independent and appropriately qualified (such experts can help to define the scope of the investigation and ensure the immediate preservation of electronic and other evidence);
- considering external auditor involvement, including what communications and updates may be appropriate (the external auditor may conduct its own parallel or ‘shadow’ investigation);
- making timely and accurate disclosures to regulators and others, as appropriate or required;
- documenting key processes, findings and remedial actions taken (as recommended by legal counsel); and
- investigating the matter until the audit committee is fully satisfied that all relevant issues have been addressed.

Audit committees should also be regularly apprised of the legal and regulatory issues that arise during an investigation, including financial reporting deadlines and necessary disclosures.

Approaching accounting investigations in a proactive manner can offer important advantages. An internal corporate investigation can allow the organisation to ‘take control’ of a potentially negative situation and effectively manage the flow of information and the pace and direction of the investigation. A well managed internal investigation may also result in a shorter and less disruptive external inquiry.

### Resources for the audit committee

The audit committee should be provided with sufficient resources to undertake its duties and make effective use of its time.

Internal audit is likely to be the single most significant resource used by the audit committee in helping the governing body to discharge its responsibilities. The relationship between the audit committee and internal audit function is discussed in Chapter 7.

The audit committee should have a secretary – normally the secretary to the board or some other independent person. In determining the secretary to the committee, the board should consider whether the proposed secretary has significant financial or other senior management responsibilities that might impair, or be seen to impair, the independence of the individual.

The secretary should support the committee in all audit committee matters, including supporting the chair in planning the committee’s work and drawing up meeting agendas, maintaining minutes, drafting material about the committee’s activities for the annual report, co-ordinating the timely collection of supporting papers and distributing them, and other support as needed. As noted earlier, the chair must maintain the committee’s independence while securing the necessary input and support from management. The organisation via the board should also make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the committee reasonably believes it necessary to do so.

“Audit committees and indeed auditors should remember the Latin origin of their title, which is ‘listener’. ‘Listening’ is the prerequisite to balanced analysis, judgement and challenge ...”

Belgian Audit Committee Chair

## Communication and reporting

The audit committee chair should report to the board after every audit committee meeting, in sufficient depth to enable the board to fulfil its oversight responsibilities. The minutes of each audit committee meeting should be prepared on a timely basis and drafted in such a manner so as to clearly:

- summarise the work undertaken by the audit committee, explaining if necessary the importance of the work and any conclusions drawn or actions taken; and
- advise the chair of the board on any relevant matters, including any matter on which the audit committee believes the board should be taking action and the committee's recommendation thereon.

Practical difficulties can arise when the audit committee meeting and board meeting are held such that there is little time to prepare formal minutes. In such circumstances it is normal for the chair of the audit committee to report orally to the board with the formal report sent to board members at a later date.

Audit committee minutes are normally copied to the head of internal audit and the external audit partner. Further communications with internal and external audit are covered in Chapters 7 and 8.

## Audit committee remuneration

Whether an audit committee member is remunerated for services will depend on the sector the organisation operates within. So, for example, audit committee members in parts of the public and third sectors are sometimes unpaid volunteers, however, in the private sector audit committee members are usually remunerated for their services.

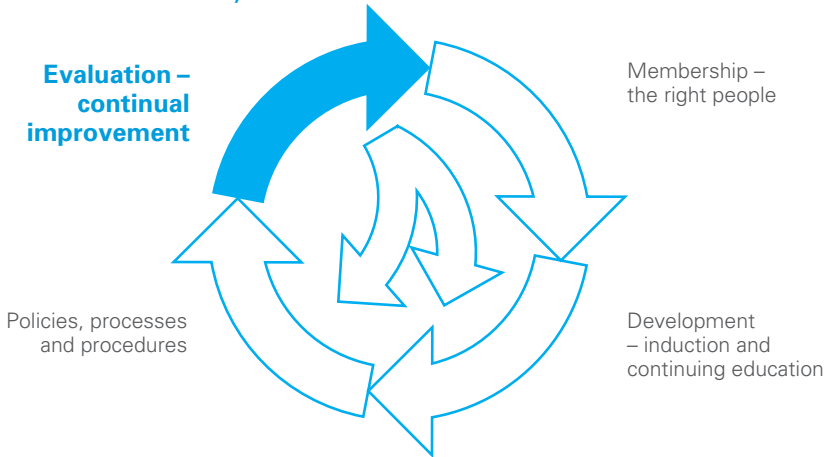
In publicly listed organisations, the quantum of remuneration paid to audit committee members (and the chair of the committee) is usually determined by the board. It is reasonably well established in practice that the committee chair receives more remuneration than other members, reflecting the time commitment and responsibilities of the role.

Consideration should be given to the time members are required to give to audit committee business, the skills they bring to bear and the onerous duties they take on, as well as the value to the company of their work.

Remuneration for non-executive service can sometimes pose a dilemma for both management and committee members. While compensation should be enough to recognise the time commitment required and the liabilities accepted in order to attract good and responsible directors, the amount should not be excessive such that independence may be perceived to be impaired.

## EVALUATION – CONTINUAL IMPROVEMENT

### Audit Committee Cycle



The audit committee should regularly assess its own effectiveness and the adequacy of its terms of reference, work plans, forums of discussion and communication. Regular assessment may identify areas in which the committee and its processes might be more effective, or may highlight skills and/or knowledge gaps in the committee. This may lead to a request for additional development (continuing education) or, in exceptional circumstances, require the chair to begin discussions on the possible recruitment of a new member. The audit committee needs to ensure that it has the requisite knowledge to discharge its duties at all times. For this to be achieved the audit committee chair, working with the nomination committee, should regularly review the status of succession to the audit committee and aim to ensure that there is continuous access to suitable candidates.

### What does effectiveness mean?

Agenda overload is not a new issue for audit committees, but our global survey work<sup>2</sup> continues to show that it is a major concern: 75 percent of the 1,500 audit committee members queried, said the amount of time required to carry out their audit committee responsibilities has increased moderately (51%) or significantly (24%) over the past two years. And 40% said it is becoming increasingly difficult to oversee all the major risks on its agenda given the committee's agenda time and expertise.

<sup>2</sup> ACI's Global Audit Committee Survey 2015

Based on ACI's interactions with audit committee members and business leaders worldwide, the following principles are essential to manage agenda overload and to "keep the eye on the ball":

*Learn to say no.* New issues and risks are often allocated to the audit committee by default, rather than by design. Be wary of 'mission creep,' and consistently question whether new and ongoing issues belong on the audit committee's agenda, given the time and resources required to oversee its core responsibilities.

*Face-time in the boardroom is precious.* Audit committee meetings should be well thought-out and structured in a way that allows the committee to make the most of its time together. Limit (or exclude) PowerPoint presentations in favour of quality discussion; expect pre-read materials to have been read before the meeting; reach a level of comfort with management and auditors so that financial reporting and compliance activities can be "process routine", freeing up time for more substantive issues facing the business; focus on the three or four most important matters that need attention.

*Spend time with management and auditors outside of the boardroom.* Informal meetings with the CFO, controller, auditors, and others outside of regularly scheduled meetings can help the audit committee chair (and the committee) stay up to speed and sharpen the committee's formal meeting agendas. You often get a much clearer picture of the issues.

*Tap all resources at the committee's disposal.* Internal auditors, external auditors, the C-suite, outside experts. The audit committee should fully leverage the array of resources and perspectives necessary to support the committee's work. The committee should always be asking itself whether it's getting the information and support it needs. Are we properly resourced? Are we hearing from those who have a point of view to offer?

*Spread the committee's workload.* Allocate oversight duties to each audit committee member, rather than relying on the audit committee chair to shoulder most of the work. As one audit committee chair told us: "In many instances the only person who seems to be running at light speed is the audit committee chair. We really need to utilise the entire committee...for deep dives into particular areas of interest or concern."

*Take a hard look at the board's risk oversight approach.* Does the allocation of risk oversight activities make sense in light of how the risk and regulatory environment has changed recently? Is there a need for another committee, additional expertise, or better communication and coordination on risk oversight among committees? Committee reports should be robust, and committee chairs should be communicating regularly to make sure they know what's going on in the other committees.

“Underpinning all ‘must-do’s’ is the requirement for the audit committee chair to have credible expertise that is relevant to the company.”

Chinese Audit Committee Chair

### Assessing effectiveness

The precise method by which the board and audit committee assess the audit committee's effectiveness should be for the board and the audit committee to decide. It is common for the board and committees to self evaluate. However, it is good practice that organisations have externally facilitated board (and therefore board committee) evaluations. No single process will be appropriate for all organisations, nevertheless, the following guidelines are recommended:

- *Independence:* To be credible, the assessment process must be independent – and to be seen to be independent – of executive influence or authority. The audit committee chair should control the assessment process and criteria, albeit taking into consideration the views of the chair of the board, and other interested parties where appropriate.
- *Clearly established goals:* Clear goals for the assessment should be established. If the assessment of the audit committee is to be more than a box ticking exercise, it must be designed to encourage audit committee members to perform the inherently difficult task of candidly and constructively critiquing each other's performance as individuals as well as their collective performance as a committee.
- *Tailoring evaluations to the organisation:* Each evaluation process should be tailored to meet the needs of the organisation. The audit committee chair should establish a process and performance criteria that suit the individuals and the culture of the organisation.

- *Ensuring candour, confidentiality and trust:* The audit committee chair should encourage candour, openness, fairness and discretion in the assessment process while ensuring strict confidentiality with respect to each participant's input and feedback. Implementing a constructive assessment process depends on the committee's ability to develop a culture of frankness and mutual trust.
- *Regular review of the assessment process:* Any assessment process will be shaped by many forces, including the organisation's circumstances and performance, committee tenure and relationships between individual committee members. Consequently, the committee should periodically review its assessment practices and criteria to ensure their continued efficiency and appropriateness.
- *Feedback:* To ensure credibility, it is important that those involved in the evaluation process receive feedback.

The audit committee should regularly assess its own effectiveness and the adequacy of its terms of reference, work plans and forums of discussion and communication. In doing so, it should consider:

- ascertaining whether the board is satisfied with the committee's performance;
- comparing the committee's activities to any relevant guidelines or recommendations;
- comparing the committee's activities to leading practices in different sectors;
- comparing the committee's activities to any previously established criteria;
- comparing the committee's activities to any previously identified shortcomings; and
- comparing the committee's activities to the terms of reference, the committee's aspirations and any objectives set by the board.

The committee should also consider requesting feedback on its performance from management, auditors and other relevant stakeholders.

Questionnaires are one mechanism that audit committees can use in assessing their effectiveness. However, consultation and feedback is improved by face-to-face discussions where appropriate. Informal meetings with the auditors or in camera sessions during regular audit committee meetings can be employed for this purpose.



A suggested framework for an audit committee's review of its effectiveness and the adequacy of its terms of reference and work plans can be found at **Appendix 6**. The results of the evaluation and any action plans arising should be reported to the board after discussion with the chair. Any necessary changes should be recommended to the board.

The audit committee chair should also assess the performance of individual committee members as well as the performance of the committee as a whole. The performance evaluation of individual members might consider *inter alia*:

- expertise;
- enquiring attitude and independence;
- ability to take a tough constructive stand at meetings when necessary;
- understanding of the organisation;
- willingness to devote the time needed to prepare for and participate in committee meetings and deliberations; and
- approach to conflict and whether the person helps the committee to manage conflict constructively and productively.

The evaluation of the audit committee chair should be done by the chair of the board, based on similar criteria. The results should be reported to the board.

Evaluations which are well performed demonstrate the committee's intention and commitment to achieve its responsibilities in an effective, diligent manner. They should focus on:

- What is the committee for and what does success look like?
- Do others within the organisation understand what the audit committee is supposed to do?
- Outcomes rather than activities – not what the committee did, but how it did it.
- Is time spent on the right areas?
- What impact has the committee had? Has it added value to the governance process?

After completing the evaluation, the chair of the board and the audit committee chair should discuss the outcomes so that appropriate action can be taken. The audit committee chair should discuss with individual members the outcomes of the evaluations and any actions required.



## Chapter 4

# Monitoring the corporate reporting process

**Audit committees are generally responsible for reviewing, on behalf of the board, the significant financial reporting issues and judgements made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements.**

Audit committees can also review related information presented with the financial statements, including the operating and financial review, and corporate governance statement disclosures relating to the audit and to internal control and risk management systems. Similarly, where board approval is required for other statements containing financial information (for example, summary financial statements, significant financial returns to regulators and release of price sensitive information), whenever practicable, the board should consider asking the audit committee to review such statements first.

Sometimes the board might even ask the audit committee to fulfil a wider remit and carry out such oversight necessary to advise the board on whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the company's performance, business model and strategy.

Whatever the extent of the committee's remit, where following its review, the audit committee is not satisfied with any aspect of the proposed corporate reporting, it shall report its views to the board.

**“At the end of the day, financial integrity is our number one mission – and the only way to stay on top of that is to be actively engaged and really integrated into the rhythm of the organisation.”**

US Audit Committee Chair

## The financial statements

Organisations are generally required to prepare annual reports, including audited financial statements, and these are the mechanism by which boards report on the stewardship of the organisation and its assets to investors and/or other stakeholders. Annual reports then provide the underpinning to other communications by companies – such as interim management statements, market sensitive information, and investor presentations. Given the important role that they play in the corporate reporting framework, it is essential that annual reports are relevant and present an accurate, coherent and balanced picture of the business and its prospects.

## Responsibilities

While boards have overall responsibility for preparing annual reports that present a balanced and understandable assessment of the organisation's position and prospects, in practice this responsibility is delegated to management. Therefore, it is management, not the audit committee, that is accountable for preparing the annual report, including complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations.

The audit committee has an important oversight role in providing the board with assurance as to the propriety of the financial reporting process. It should consider significant accounting policies, any changes to them and any significant estimates and judgements. The management should inform the audit committee of the methods used to account for significant or unusual transactions where the accounting treatment is open to different approaches. Taking into account the external auditor's view, the audit committee should consider whether the organisation has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgements. The audit committee should review the clarity and completeness of disclosures in the financial statements and consider whether the disclosures made are set properly in context.

To perform their role effectively, the audit committee needs to understand the context for financial reporting, and in particular:

- management's responsibilities and their representations to the committee;
- management's remuneration, especially any incentive arrangements;
- the external auditor's responsibilities (under generally accepted auditing standards);
- the nature of critical accounting policies, judgements and estimates;
- any significant or unusual transactions where the accounting is open to different approaches;
- the impact of relevant accounting standards and rules and regulations;
- financial reporting developments; and
- the overall requirement that the financial statements present a 'true and fair' view.

Audit committees should be confident that they are being made aware of any relevant accounting policy or disclosure issues or changes, and that this information is communicated to them early enough to enable

appropriate action to be taken. A regular two-way dialogue between the audit committee and the CFO should take place though the audit committee should also look to the external auditor for support, using the auditor's insights to help to identify potential issues early and assist the committee to oversee the quality and reliability of financial information.

### **Accounting policies, judgements and estimates, complex transactions and transparency**

In fulfilling their oversight role, the audit committee should understand the process by which management ensure the timely and transparent delivery of meaningful information to investors and other users of financial statements. The audit committee should seek to ensure that such a process is both fit for purpose and working as intended.

The assessment of the appropriateness of the organisation's accounting policies, underlying judgements and estimates, and the transparency of the financial disclosures in reflecting financial performance, should be at the core of the audit committee's discussions with management and the external auditor.

### **Critical accounting policies, judgements and estimates**

The preparation of financial statements requires numerous judgements and estimates. Each judgement or estimate can significantly impact a company's financial statements and each estimate has a range of possible and supportable results. Understanding the company's business, as well as the industry in which it operates, will help the audit committee to focus on the appropriateness of the company's approach.

In order to properly understand and assess the appropriateness of critical accounting policies, judgements and estimates the audit committee should:

- Understand and evaluate the facts and economics of the transaction or group of transactions.
- Consider the appropriateness of management's selection of accounting principles and critical accounting policies. What were the alternatives? Have they changed in the current period? Why have they changed? How might the changes affect current and future financial statements?
- Assess management's judgements and critical accounting estimates. What are the key assumptions behind those estimates? How sensitive are current and future financial statements to changes in those assumptions?

- Question the degree of aggressiveness or conservatism surrounding management's judgements and estimates. Is there potential for management bias in developing the estimates?
- Consider the relevant accounting guidance and any alternative accounting treatments. What are other companies doing in similar circumstances?
- Ensure the external auditor is satisfied that management's accounting policies, judgements and estimates reflect an appropriate application of generally accepted accounting practice.

In practice, these steps may not be performed sequentially and are often combined due to the iterative nature of the decision process.

When considering the impact on the financial statements of any changes to accounting standards or generally accepted accounting practices, the audit committee should satisfy itself that:

- management has sufficient resources devoting appropriate attention to understanding recent developments in financial reporting; and
- the application of new requirements is appropriate in light of the nature of the organisation's operations and significant transactions.

Audit committees should understand the circumstances in which management may feel pressure to engage in inappropriate earnings management. It could be that: market expectations are unrealistic; targets are not being met; or management remuneration incentives are heavily weighted to earnings measures. The audit committee should recognise when these conditions are present and where necessary receive what they hear with professional scepticism.

### Unusual and complex transactions

The audit committee should assess the treatment of any unusual or complex transactions. In addition to the considerations with respect to critical accounting policies, judgements and estimates, the audit committee should understand:

- the business rationale for the transaction;
- how the transaction is disclosed in the financial statements and whether such disclosure is appropriate;
- the impact on the comparability of financial position and performance with respect to past and future periods; and
- any factors surrounding the accounting for any unusual transaction.

### Completeness, clarity and transparency

Overall, the audit committee needs to assess the completeness, clarity and transparency of the financial statements and related disclosures, by asking such questions as:

- Do the financial disclosures consistently reflect the organisation’s financial performance?
- How clear and complete are the financial statement note disclosures?
- What are equivalent organisations doing, based on publicly available information?

Management and the external auditor can greatly assist the audit committee in understanding and assessing these matters by providing the committee with clearly written communications, augmented with face-to-face discussions.

“Financial information provided to the market needs to be reliable – and this goes beyond the statutory accounts. It applies to all information reporting to the market, and any quality audit should factor in procedures on such financial information.”

Dutch Audit Committee Chair

### Going concern

Audit committees can be tasked by boards to provide confirmation that a robust going concern risk assessment has been made. In such circumstances, the audit committee should pay particular attention to management’s use of the going concern assumption in the preparation of the financial statements and should satisfy itself that:

- proper consideration has been given to cash flow forecasts prepared for at least, but not limited to, twelve months from the date of approval of the financial statements including an analysis of headroom against available facilities and that all available information about the future has been taken into account;
- consideration has been given to the need to extend the cash flow forecast exercise to evaluate issues that may arise after the end of the period covered by the initial budgets and forecasts;
- appropriate evidence has been obtained about the group’s ability to secure new or to renew existing funding commitments;

- an analysis of the terms of current banking facilities and covenants has been considered by management and that such an analysis would identify those risks that need to be addressed. If so, are plans in place to manage those risks; and
- full consideration has been given to guarantees, indemnities or liquidity facilities that have been provided to other entities that the group may be called on to honour. Has management considered whether the group has the resources to meet such obligations should they arise?

Boards should consider disclosing to shareholders in the annual report the role of the audit committee in confirming that a robust going concern risk assessment has been made together with information on the material risks to going concern that have been considered by the board/audit committee and, how they have been addressed.

### External audit differences

The audit committee should review the external auditor's recommended audit adjustments and disclosure changes, focusing on both the adjustments and changes made by management and those that management has not made.

To establish a framework for these reviews, the audit committee should:

- tell the external auditor and management what audit differences the committee wants to hear about – material audit differences or a broader definition;
- convey its expectations that the external auditor will promptly identify, discuss with management and the audit committee, and recommend audit adjustments and disclosure changes;
- understand the reason behind any misstatements; and
- encourage management to adjust for all audit differences.

### The year-end timetable

If the audit committee is to make an effective contribution, it should review the final draft version of the annual financial statements prior to their approval by the board. An appropriate interval should be left between the audit committee meeting at which the committee recommends approval of the financial statements and the board meeting at which the financial statements are approved. This allows any work arising from the audit committee meeting to be carried out and reported as appropriate.

An example year-end timetable is given at **Appendix 7**.

Any delays in preparing and auditing the financial statements should be followed up by the audit committee, as they might indicate underlying problems within the finance function or external audit process.



## Narrative reporting and other corporate reports

All information published by organisations is potentially open to close scrutiny by the investment community and other stakeholders, and a company's share price may be significantly affected by investors' reactions to results announcements. Organisations also produce narrative reports, analyst briefings/investor presentations, half-year accounts and interim management statements; sustainability reports; and other financial and non-financial information posted on the corporate website.

It is not always appropriate for the audit committee (or the board) to review all corporate reporting, but management should have a process in place to ensure the relevance and probity of such information; and audit committees have a role to play in ensuring such processes are fit for purpose and working as intended. Audit committees (and boards) also have a role to play in ensuring the tone of reported information is appropriate. Indeed, there is an upcoming corporate governance trend suggesting that audit committees have an explicit role in advising the board on whether the whole annual report 'cover-to-cover' is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy. In such circumstances, the audit committee would potentially review, and report to the board on, the content of the annual report (including any narrative report) and the processes supporting the preparation of that information.

The factors an audit committee would consider when carrying out such an extended oversight role are, in many respects, very similar to those discussed above in the context of the financial statements. However, audit committees might specifically consider whether:

- stakeholders' needs are fully understood;
- the language used is precise and explains complex issues clearly;
- jargon and boilerplate are avoided;
- appropriate weight is given to the 'bad news' as well as the 'good news';
- the narrative in the front end is consistent with the financial statements in the back end; significant points in the financial statements are appropriately explained in the narrative report so that there are no hidden surprises;
- the description of the business model and strategy (and risk) is sufficiently specific that the reader can understand why they are important to the organisation;
- the disclosed business model and strategy accords with the committee's understanding;

- the disclosed business model and strategy is appropriately linked to disclosure of risk and performance;
- the disclosed risks are genuinely the principal risks that the board is concerned about. The links to accounting estimates and judgements are clear;
- highlighted or adjusted figures, key performance indicators (KPIs) and non GAAP measures are clearly reconciled to primary statement figures (IFRS) and any adjustments are clearly explained, together with the reasons why they are being made;
- important messages, policies and transactions are highlighted and supported with relevant context and are not obscured by immaterial detail. Cross-referencing is used effectively; repetition is avoided;
- issues are reported at an appropriate level of aggregation and tables of reconciliations are supported by, and consistent with, the accompanying narrative; and
- significant changes from the prior period, whether matters of policy or presentation, are properly explained.

Audit committees might also want to consider the assurance asymmetry between the financial statements and the rest of the annual report. Historically, the probity of the financial statements and the systems generating the information reported in the financial statements, receives a lot of attention from management, internal audit and external audit. The same is rarely true for some other elements of the annual report.



The audit committee should therefore consider the materiality of all information reported in the annual report and whether the assurance received over such information is appropriate in the circumstances. It is a reasonable assumption that if information is of value to stakeholders then it should be reported to them and, conversely, if an organisation reports information then it is on the basis that it believes that the information is of value to stakeholders. In either case there should be an expectation that such information is accurately reported and that it is not otherwise misleading. Independent assurance on such information therefore has the potential to provide value to stakeholders by increasing confidence in its accuracy.

### **Analyst briefings and investor presentation**

Practices regarding analyst briefings/investor presentations differ and whilst some audit committees review such presentations in advance of the analyst/investor meetings, many do not. Nevertheless, all audit committees should ensure that there is an appropriate process for the information's preparation and protocols for its review and release.

### **Subsidiaries**

The audit committee is primarily concerned with public reporting, and hence information relating to the consolidated group. The remit of some audit committees may, however, be extended to the financial reports of individual group companies. Alternatively, some companies set up separate audit committees for significant subsidiaries due to the importance of these operations. The audit committee terms of reference should reflect the role and responsibilities of the audit committee in these circumstances.



## Challenges arising from uncertain and volatile business environments

The current uncertain and volatile business environment and the complexity of financial reporting regulation are particularly difficult for management and continue to increase the risk that annual reports and accounts misreport facts and circumstances and contain uncorrected errors and omissions.

The following questions seek to identify issues that will be particularly relevant to the work of audit committees when organisations are facing uncertain economic conditions in one form or another.

### Assessing and communicating risk and uncertainties

Has the board set out in the annual report a fair review of the company's business including its principal risks and uncertainties? Are the risks clearly and simply stated? Are there many of them and if so, are they really principal risks? Is it clear how the risks might affect the company?

Has full consideration been given to how the business may have been changed to address the effects of the recession and the additional challenges, if any, posed by the forecast significant reduction in government expenditure?

Is it clear how the board is managing the risks? Are the processes used to manage risks supported by systems and internal controls that are effective in achieving their objectives?

Is the committee satisfied that the group has monitored the effects on the business of the continued volatility in the financial markets and reduced supply of credit, including its exposure to liquidity risk and customer and supplier default risk?

Has the committee considered whether the audited financial statements describe fairly all of the key judgements about the application of accounting policies and the estimation uncertainties inherent in the value of assets and liabilities?

Have all relevant issues that have concerned management during the year and that have been drawn to the attention of the board and/or the audit committee been considered for disclosure?

### Assessing audit quality and creating the right environment for constructive challenge

Has the audit committee discussed the outcome of the prior year review of the effectiveness of the annual audit with the auditor and does the audit strategy and plan appropriately address the issues raised?

Where an internal audit function exists, has the committee considered whether it wishes internal audit to conduct additional work up to or at the year-end? For example, to look at new or amended products and services? Is the committee comfortable with the boundary between internal and external audit?

Has the audit committee discussed business and financial risks with the auditor and is the committee satisfied that the auditor has properly addressed risk in their audit?

strategy and plan? Is the committee satisfied that the external auditor has allocated sufficient additional and experienced resources to address heightened risks and, if not, are negotiations scheduled to secure additional commitments? Has management exerted undue pressure on the level of audit fees such that it creates a risk to audit work being conducted effectively?

Has consideration been given to any recommendations for improvement in prior year annual reports or audit from the press or regulatory agencies?

Have arrangements been agreed with the auditor to ensure they express any concerns they have about estimates, assumptions and forecasts without undue influence by management?

## Reliance on estimates assumptions and forecasts

Has the audit committee considered the processes in place to generate forecasts of cash flow and accounting valuation information, including the choice and consistent use of key assumptions?

Are the forecasts and valuation processes supported by appropriate internal controls and reasonableness checks and have those internal controls been tested by internal and/or external audit?

Has consideration been given to the need for changes in the approach to valuations and key assumptions underlying forecasts since last year and are those changes consistent with external events and circumstances? Have last year's key forecasts and valuations been compared to actual outcomes and have any lessons been fed into the current year process?

Do models and key assumptions adequately address low probability but high impact events? Has management considered which combination of scenarios could conspire to be the most challenging for the company?

Is the audit committee satisfied that appropriate sensitivity analysis has been conducted to flex assumptions to identify how robust the model outputs are in practice and that the assumptions are free from bias?

Are the assumptions that underlie valuations, including any impairment tests, consistent with internal budgets and forecasts and with how the prospects for the business have been described in the narrative sections of the annual report and accounts?

Have the auditors been asked for a written summary of their views on the assumptions that underlie cash flow forecasts and other estimation techniques used to value assets and liabilities? Is the committee satisfied that any material concerns have been properly addressed by management?

## Earnings management

The audit committee must remain alert to inappropriate earnings management. Inappropriate practices might include questionable revenue recognition; inappropriate deferral of expenses; misuse of the materiality concept; and misconstrued recognition, reversal or use of provisions and allowances without events or circumstances to justify such actions.

Accounting standards do not produce financial statements that are 'right' in the sense that there is only one possible answer; application of the standards can sometimes produce a range of possible answers. For example, valuations and estimates – which inevitably require judgement – are needed for many elements of the financial statements, particularly for transactions that span the year-end or several years (such as retirement benefits and major capital projects). The audit committee should enquire about the basis used by management when making significant judgements.

Estimates in accounting are required because of the uncertainty inherent in many transactions. No matter how carefully estimates are made, revisions to some of them may prove necessary from time to time. Revisions should be based on new developments, subsequent experience or new information. The audit committee should enquire into changes in estimates to ascertain the degree to which management bias (if any) is evident.



## Areas of potential concern

Specific areas of accounting warrant special attention. They are particularly vulnerable to interpretations that may obscure financial volatility and adversely affect the quality of reported earnings:

*Revenue recognition* – Recognising sales revenue before a sale is complete, or at a time when the customer still has options to terminate, void or delay the sale, has attracted great attention in recent years. This area is particularly important for companies where the focus is on revenue rather than profit.

*Changing estimates* – Changing estimates to make the numbers is another frequently used method for managing earnings. While changes to estimates may be perfectly acceptable when supported by real economic facts, all too often estimates are altered when the underlying economics of the business do not support the change, and without any disclosure to investors. Investors end up having to make investment decisions based on numbers that lack transparency, consistency and comparability.

*Abuse of the materiality concept* – Errors may be intentionally recorded under the assertion that their impact on the bottom line is not significant. However, given the market's reaction to even small changes in earnings per share, what is and is not significant may not always be clear.

*Capitalisation and deferral of expenses* – Costs that should be accounted for as a cost of the period may be capitalised or deferred. The capitalising and deferring of such costs can occur through, for example, ambiguously defined capitalisation criteria for property, plant and equipment and intangible assets, unreasonable amortization periods, or the capitalisation of costs for which future economic benefits are not reasonably assured.

*Non-GAAP measures* – Some companies use non-GAAP measures to disseminate an idealised version of their performance that excludes any number of costs and expenses yet still suggests reliability and comparability. In effect, spinning straw into gold! Often, undue emphasis is placed on results before unusual items; start-up operations; earnings before interest, tax and depreciation and amortisation (EBITDA); and even marketing expenses, as if some costs were capable of being ignored.

## Recognising and avoiding inappropriate interpretations

Understanding the company's business, as well as the industry in which it operates will help the audit committee to focus on the appropriateness of management's approach. However, audit committees must also be aware of the circumstances in which management may feel pressure to engage in inappropriate earnings management. It could be that:

- market expectations are unrealistic;
- targets are not being met; or
- management's remuneration incentives are heavily weighted to earnings measures.

The pressure to achieve earnings targets can place a heavy burden on senior management, in terms of both job security and remuneration. Unfortunately, this pressure can lead to the consideration of biased, aggressive, and sometimes incorrect or inappropriate financial reporting interpretations.

Audit committee members need to know enough about their company to recognise when these conditions are present. In such cases, they need to receive what they hear with some scepticism. If the audit committee is not alert and sceptical, many of the improvements in the quality and reliability of financial reporting in recent years will be undermined just when they are most needed. Audit committee members therefore need to ensure their knowledge of the business remains up to date.

Auditors must also play their part. The traditional audit qualities of rigour and scepticism will be needed, but they may not be enough. The auditor's role is to express an opinion on the fairness of the financial statements, usually tested by reference to accounting standards and materiality. There are circumstances, however, where materiality considerations should not cloud financial reporting integrity and ethics. For example, under some circumstances an immaterial adjustment could make the difference between a company recording a profit or a loss.

The audit committee should not acquiesce to deliberate errors or allow incorrect or inappropriate financial reporting interpretations.

### Keeping up to date with corporate reporting developments

The audit committee should consider the impact on the organisation's corporate reports of any changes to accounting standards, generally accepted accounting practices and other corporate reporting developments. Audit committees should satisfy themselves that:

- management has sufficient resources devoting appropriate attention to understanding recent developments in corporate reporting (including financial reporting); and
- the application of new requirements is appropriate in light of the company's operations and significant transactions.



To keep their knowledge up to date, audit committees should consider asking management and/or the external auditor to describe and explain recent developments in financial reporting. What is required is more than a general update. Audit committee members must clearly understand if and how the developments or changes will affect the organisation. Ideally, the audit committee should be briefed before any changes come into effect.

Audit committee members must also stay abreast of changes in such areas as securities and regulatory matters, corporate law, risk management and business trends. These development needs can be met by attending external courses and conferences, roundtables or discussion forums; through self-study and reading; or by web-based learning. It is the role of the chair of the board/audit committee to ensure that all directors, including the audit committee members, receive appropriate training and development.

## Evaluating the finance function and CFO

On a regular basis the audit committee should consider and satisfy itself of the appropriateness of the expertise and adequacy of resources of the finance function and experience of the senior members of management responsible for the financial function. This would include evaluating the suitability of the expertise and experience of the CFO.

### Evaluating the finance function

When evaluating the appropriateness of the expertise and adequacy of resources of the finance function, the audit committee might consider:

- Getting exposure to key finance people beyond the CFO. This might include:
  - requesting formal attendance at audit committee meetings to present, and answer questions, on relevant topics; and/or
  - visiting different parts of the finance function to better understand the challenges faced, the quality of the people and the information they produce. Site visits are also a good mechanism to meet the key finance people at different business units and/geographies.
- Requesting a report from the CFO (verbal or written) on the quality of the finance function and the challenges it faces. This might include an analysis of the people, their backgrounds, strengths and weakness, and how the CFO is responding to them.
- Discussing the effectiveness of the finance function with those individuals who come into regular contact with it. This might include the CFO, treasurer, the head of internal audit and the external auditor.
- Attending the finance functions annual meeting.

## Evaluating the CFO

Assessing the CFO's performance is an evolving area – not least because (anglo-american) corporate governance best practice suggests audit committees to evaluate the suitability of the expertise and experience of the CFO and/or finance director on regular basis.

The CEO has the prime role to play in evaluating the performance of the CFO, but the board, audit committee, and remuneration committee should all input into the process. Indeed, from a broader governance perspective, it is important that the CEO isn't given sole responsibility for evaluating the CFO.

When evaluating the suitability of the expertise and experience of the CFO, the audit committee might consider whether the CFO:

- oversees the creation of good financial reporting and internal control processes
- is an independent thinker who speaks up and challenges the CEO
- has integrity
- has a cooperative attitude towards the audit committee and shows a willingness to help the audit committee understand complex issues
- has a commitment to transparency in corporate reporting and other matters
- has a good track record in recruiting, managing and retaining good staff

“Assessments of CFO performance and interactions with the audit committee are generally viewed as effective; yet more than 40 percent of audit committee members say the committee is “not effective” in CFO succession planning. Many audit committees would like to hear about various aspects of the finance organization's work – financial risk management, capital allocation, tax, debt – in greater depth.”

ACI's Global Audit Committee Survey 2015

### Short-term results and long-term value

Companies and boards are sharpening their focus on the company's drivers of long-term value creation. And while financial health is vital – cash flow, growth in revenues and profits, are key – these short-term measurements may provide little, if any, insight about the company's likelihood of achieving long term growth and returns. As a result, more companies and directors are putting greater emphasis on key measures relevant to the long-term health and performance of their organizations.

Every company needs to translate the drivers of long-term value – whether it is innovation, operational efficiency, or talent management – into more tangible or specific drivers of value based on its particular strategy and risk profile, strengths and weaknesses, and a broad range of external factors shaping the business and risk environment. Such external factors can include emerging technologies and social media, globalisation, sustainability of natural resources, disruptive business models and the interests of key stakeholders – all of which may have a direct impact on the company's long-term value.

A number of questions and considerations can help audit committees and boards sharpen the company's focus on its key long-term metrics, including:

- Do we understand the key drivers of long-term value for the enterprise?
- What are the measures that will best help us track progress against long-term goals? Customer satisfaction? Investment in R&D? Early adoption of new technology?
- Are we focused on enhancing alignment between short-term measures and long-term goals?
- How do performance management and incentive compensation balance the short term and the long term? How do we communicate the alignment of long-term and short-term metrics to investors?

In short, a key role for the audit committee and board is to help align short- and long-term considerations – by setting the right tone, focusing on the right metrics, and ensuring that the company is communicating its long-term focus to investors.



## Chapter 5

# Risk management and internal control systems

**Boards are responsible for both determining the nature and extent of the significant risks an organisation is willing to take in achieving its strategic objectives and for ensuring that the significant risks faced by an organisation are properly identified, evaluated and managed in the manner which it has approved.**

The management of risk requires the establishment and maintenance of effective systems of internal control. Internal control comprises all the policies, processes, tasks, behaviours and other aspects of an organisation that, taken together ensure, as far as practicable, the orderly and efficient conduct of business. This includes adherence to management policies, compliance with applicable laws and regulations, the safeguarding of assets, the detection of fraud and error, the accuracy and completeness of accounting records and the timely preparation of internal and external reports.

Risks manifest themselves in a range of ways and the effect of risks crystallising may have a positive as well as a negative outcome for the organisation. It is vital that those responsible for the stewardship and management of an organisation be aware of the best methods for identifying and subsequently managing such risks.

Internal controls are one of the principal means by which risk is managed. Other devices used to manage risk include the transfer of risk to third parties, sharing risks, contingency planning and the withdrawal from unacceptable risky activities. Organisations can accept risk, but need to do so objectively and transparently and within the governing body's policy regarding risk appetite.

**“Some level of risk is inherent, and attempts to have it completely eliminated are not only futile but also wrong from a business point of view.”**

Polish Audit Committee Chair

The risks facing organisations are continually changing and the system of internal control should be responsive to such changes. Effective risk management and internal control are therefore reliant on a regular evaluation of the nature and extent of the risks facing the organisation.

Successful risk management is the process that achieves the most efficient combination of controls necessary to provide reasonable assurance that the organisation's objectives can be achieved reliably.

“The number one priority is making sure the committee really understands all the different risk areas ... and that it has enough time, resources and expertise to do the job.”

Danish Audit Committee Chair

## Responsibilities

Boards are ultimately responsible for maintaining sound risk management and internal control systems, however the task of establishing, operating and monitoring such systems are generally delegated to management.

The audit committee is generally responsible for reviewing the effectiveness of the company’s internal control and risk management systems, with a view to ensuring that the main risks (including those relating to fraud and compliance with existing legislation and regulations) are properly identified, managed and disclosed according to the framework approved by the board.

The board should ensure, based on the reviews by the audit committee, that management sets appropriate policies for risk management and internal control, and regularly assure itself that appropriate processes are functioning effectively to monitor the risks the organisation is exposed to, and that the internal control system is effective in reducing those risks to an acceptable level. It is essential that the right tone is set at the top of the organisation – the board should send out a clear message that risk and control responsibilities must be taken seriously.

In determining its policies with regard to risk management and internal control, and thereby assessing what constitutes a sound system, the board should consider the:

- nature and extent of the risks facing the organisation;
- extent and categories of risk it regards as acceptable for the organisation to bear;
- likelihood of risks materialising;
- organisation’s ability to reduce the incidence and impact of materialised risk; and
- cost of control relative to the benefit obtained in managing the related risks.

While ultimate responsibility for the risk management and internal control system rests with the board, all employees have some accountability

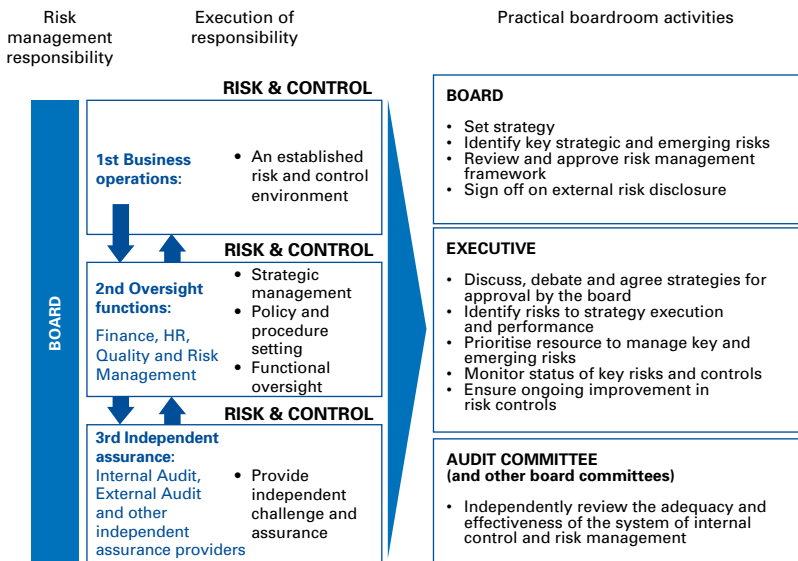
towards implementing the board’s policies on risk and control. Management is responsible for implementing the policies adopted by the board. In fulfilling these responsibilities, management should identify and evaluate the risks faced by the organisation, and design, operate and monitor an appropriate system of internal control.

### Oversight

Reviewing the effectiveness of internal control and risk management systems is an essential part of the board’s responsibility but the review work is delegated to the audit committee.

Traditionally, audit committees have been concerned with the oversight of internal financial controls. However, in most jurisdictions today, the remit of audit committees includes responsibility for monitoring the effectiveness of internal control and risk management systems company-wide. This goes beyond the financial reporting process and encompasses the system of risk and control associated with other areas such as operational matters and compliance with laws and regulation.

The precise role of the audit committee in the review process should be for the board to decide and will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company’s operations; and the nature of the significant risks that the company faces.



What risk oversight responsibilities are appropriate for the audit committee? The answer to this question varies from company to company, based on the unique needs of the business and industry. In general, in addition to financial statement and disclosure risks, the audit committee may focus on one or more of the following risks:

- *Cybersecurity, data privacy, and other IT-related risks.* Most boards are enhancing oversight of the range of IT-related risks – including cybersecurity and data privacy. Boards that are in the forefront oversee these issues as part of overall risk oversight rather than as a narrow question of technology. Has management assessed the highest risks to the company? Have employees been properly trained, and are there plans in place to handle problems if they occur? The ‘home’ for these discussions – full board, audit committee, another committee, or multiple committees – varies by company. However the board allocates these oversight responsibilities, it’s clear that the pace of technology change – and the escalating and persistent threat of cyberattacks – have pushed IT risk steadily higher on board agendas, and audit committees may play a pivotal role in helping to ensure robust discussions around IT risk generally, and cybersecurity in particular.
- *Legal/regulatory compliance risk.* In most jurisdictions, the audit committee assists the board in oversight of the company’s compliance with legal and regulatory requirements, and many audit committees monitor compliance with the company’s code of ethics. As companies move quickly to capitalize on opportunities in new global markets, leveraging new technologies and data, and engaging with more vendors and third parties across longer and more complex supply chains, a key role for the audit committee is to monitor whether the company’s ethics and compliance programmes are keeping pace with the new vulnerabilities to fraud and misconduct.
- *Tax risk.* An important role for the audit committee is to understand the company’s domestic and international tax positions and risks – both tax compliance risks and related financial reporting risks. Of particular concern for audit committees of international companies is the Organisation for Economic Co-operation and Development (OECD) and several governmental efforts globally to address perceived transfer pricing abuses (e.g., the OECD’s Action Plan on Base Erosion and Profit Shifting, which includes an agreement on automatic sharing of tax information). In general, the audit committee should understand how the company’s tax director and executives deal with significant tax risks



and how they coordinate their activities with risk management generally. What are the processes management uses to identify, measure, and manage the company's significant tax risks – such as uncertain tax positions; significant judgments and estimates; internal controls; global enforcement activities; taxation of major transactions, etc.? Do the company's tax decisions take into account reputational risks and not simply whether the company has technically complied with tax laws? In short, tax is no longer simply an expense to be managed; it now involves fundamental changes in attitudes as the global “tax transparency and morality” debate is increasingly driven by notions of “fairness” and “morality.”

- *Finance, liquidity, and capital structure risks.* If the board does not have a finance committee, the audit committee often assumes many of the responsibilities of a finance committee. It is critical here that the board clarify the role of the board versus the audit committee in this area.

In practice, some boards create separate risk committees to look at aspects of risk management. In such circumstances, it is usual for the risk committee to (on behalf of the board) concern itself with issues associated with risk strategy and risk appetite; and, at the same time, to continue to provide oversight over the processes and procedures designed to providing assurance over the systems of risk management and internal control. Whatever the precise arrangements are, it is important that the audit and risk committee liaises with the board as to the scope of the audit committee's involvement in risk oversight. The potential for fragmented oversight – with critical risks falling through the cracks – continues to pose challenges, particularly given the scope and complexity of risks facing companies today. Among the approaches that boards are using to better coordinate their risk oversight activities include mapping the committees' oversight responsibilities, regular communication among standing committee chairs, and overlapping committee memberships or informal cross-attendance (e.g. the audit committee's deep dive with management on cyber security issues being attended by other board members on a voluntary basis).

Risk committees continue to be part of the discussion on improving board oversight of risk; yet, outside of financial services (where a risk committee may be required in certain cases), directors caution that use of a risk committee may create a false sense of confidence – that the risk committee has everything covered – and should be weighed carefully.

## Audit (and risk) committee oversight

Some organisations, particularly those in the financial sector, allocate risk oversight responsibilities to a separate risk committee to provide focused support and advice on risk governance. Those responsibilities typically include:

- providing advice to the board on risk strategy, including the oversight of current risk exposures, with particular, but not exclusive, emphasis on prudential risks;
- developing proposals for consideration by the board in respect of overall risk appetite and tolerance, as well as the metrics to be used to monitor the organisation's risk management performance;
- oversight and challenge of the design and execution of stress and scenario testing;
- oversight and challenge of management's day-to-day risk management and oversight arrangements;
- oversight and challenge of due diligence on risk issues relating to material transactions and strategic proposals that are subject to approval by the board;
- providing advice to the organisation's remuneration committee on risk weightings to be applied to performance objectives incorporated in the incentive structure for the executive; and
- providing advice, oversight and challenge necessary to embed and maintain a supportive risk culture throughout the organisation.

The audit committee's role is not an executive function that properly belongs to management; rather the committee is aiming to satisfy itself that management has properly fulfilled its responsibilities. As such, the audit committee needs to establish:

- the degree to which management has assumed ownership for risk and control;
- how key business risks are identified, evaluated and managed;
- whether the controls are fit for purpose and working as intended; and
- the rigour and comprehensiveness of the review process.

By asking probing questions about risk management, the audit committee can help bring clarity to the process used to manage risk and the assignment of accountabilities to monitor and react to changes in the organisation's risk profile.

“In the last few years, the audit committee has become much more risk-conscious and risk-driven. But that means you must take some time to reflect on the question whether those risks are really the risks that count. Are we not overlooking things? Sometimes you have to take some time to sit back and think out of the box.”

Belgian Audit Committee Chair

## The system of risk management and internal control

An effective risk management and internal control system provides reasonable assurance that policies, processes, tasks, behaviours and other aspects of an organisation, taken together, facilitate its effective and efficient operation, help to ensure the quality of internal and external reporting, and help to ensure compliance with applicable laws and regulations. An organisation’s system of internal control commonly comprises the following elements:

- *Control environment.* The control environment provides discipline and structure by means of standards, processes and structures. Factors include the integrity and ethical values of the organisation, the parameters enabling the board to carry out its governance oversight responsibilities, the organisational structure and assignment of authority and responsibility, the process for attracting, developing, and retaining competent individuals and the rigour of performance measures, incentives, and rewards to drive accountability for performance.
- *Identification and evaluation of risks and related controls.* Risk assessment is concerned with identifying and evaluating those risks that threaten the achievement of the organisation’s objectives.
- *Control activities.* Control activities are the policies and procedures which help to ensure that necessary actions are taken to address those risks that threaten the achievement of the organisation’s objectives.
- *Information and communication processes.* Relevant and qualitative information must be identified, captured and communicated in a timely manner as a continual iterative process and in a form that supports the functioning of other components of internal control.

- *Processes for monitoring the effectiveness of the internal control system.* The performance of the system of internal control should be assessed through ongoing monitoring activities, separate evaluations such as internal audit, or a combination of the two.

These elements of internal control are based on those set out in *Internal Control – Integrated Framework 2013*, published by the *Committee of Sponsoring Organisations of the Treadway Commission (COSO)*.

“The challenge for an audit committee and its chair is to step back and try to figure out what’s most material to the fortunes of the company, and make sure that between the audit committee, the financial management team, and the external auditor, everyone’s focusing their efforts on those things.”

US Audit Committee Chair

## Reviewing the effectiveness of risk management and internal control

An organisation’s system of risk management and internal control has as its principal aim the management of risks that threaten the achievement of the organisation’s objectives. Therefore, in order to have effective risk management and control processes, an organisation needs to:

- identify its objectives;
- identify and assess the risks that threaten the achievement of those objectives;
- design internal controls and strategies to manage/mitigate those risks;
- operate the internal controls and strategies in accordance with their design specification; and
- monitor the controls and strategies to ensure that they are operating correctly.

### Risk identification and assessment

The board should have clarity over the strategic business objectives that are crucial to the organisation’s success. By making these explicit, the likelihood of overlooking significant risks which threaten the survival of the organisation or could lead to a significant impact on its performance or reputation will be reduced.

“If you’re not constantly assessing strategy and risk, and adjusting as you go, there’s no way you’re keeping pace as a business or a board.”

US Board Chair

Linking the identification of key business risks to the organisations strategic objectives may already be part of the normal calendar of work supporting the strategic planning and budgeting process. However, it is important to ensure that the risk identification process:

- *has a sufficiently broad perspective* – external risks such as macro-economic and systemic risks as well as internal risks such as weak controls and compliance related matters;
- *is dynamic* – the unpredictability of the financial crisis has shown the speed to which ‘new’ risks can materialise and therefore the importance of giving due consideration to both those risks ‘flying under the radar’ and early warning indicators; and
- *extends sufficiently far into the future* – while there is often a temptation to focus on immediate operating and reporting issues, boards should also look forward to understand what the organisation and its markets will look like in (say) 10 years time.

The audit committee should review the process by which the organisation’s significant risks are identified and ensure that the board is fully apprised of the significant risks facing the business.

When assessing risk, the audit committee should ensure that management has given proper consideration to the underlying gross risks, which are the risks faced by the organisation before any form of control or mitigation, not merely the net risk to which the organisation is exposed after controls have been exercised. This enables evaluation of potentially critical controls and any significant under or over control.

It is particularly important to consider the reputational impact as well as the direct financial or operational impact, since the consequence of a risk crystallising may go beyond the initial financial/operational impact. The effect on an organisation’s reputation may over the medium term have a far greater cost than the perceived initial impact.

Management's process for assessing risks should:

- be clear and transparent;
- assess both the probability of the risk occurring and its likely impact;
- apply causation analysis to identify the root cause of risk; and
- acknowledge that risks can have single or multiple causes and single or multiple impacts. These interdependencies can be critical in identifying the real impact of risks, and hence the cost-benefit analysis applied to their mitigation.

Being responsible for both determining the nature and extent of the significant risks an organisation is willing to take in achieving its strategic objectives - the organisation's risk appetite – the board must decide whether to accept each significant risk or mitigate it through control procedures. For those risks that cannot be controlled, the board must decide whether to accept them or whether to withdraw from or reduce the level of activity concerned.

### The audit committee may want to ask:

- Does the organisation have clear objectives and have they been communicated so as to provide effective direction to employees on risk assessment and control issues? For example, do objectives and related plans include measurable performance targets and indicators?
- Do management and others within the organisation have a clear understanding of what risks are or are not acceptable to the board?
- Can management articulate a clear understanding of (say) the 10 major risks within the organisation?
- Is there clarity over the role of the audit committee? Do the committee's terms of reference explicitly set out the remit of the audit committee vis-à-vis other committees?
- Does management have a clear and structured process for the identification, assessment and reporting of risk? Does this process provide a complete picture of the organisation's risk profile?
- Does the organisation have the right risk professionals and are they sufficiently integrated with both operations and assurance functions?
- How often are the major risks reviewed? Is the process sufficiently dynamic? Can the organisation adapt to new risks?
- Does the risk horizon extend sufficiently far into the future? What time-frames are management considering?
- Does management take a sufficiently broad perspective to risk identification? Are significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis?
- What risks have recently been added or removed from the organisation's risk profile and why? What risks are flying just under the radar?
- Could other sources of information e.g. external data be used to identify emerging risks?

**Appendix 8** provides a number of high level questions on identifying and assessing risk that the board or audit committee may wish to

consider when framing their discussions with management. The list is not exhaustive and will require tailoring based on the particular circumstances of the organisation as well as the terms of reference of the committee.

“The right culture has an openness and transparency in terms of how the leadership works with each other and the wider organisation – where employees are comfortable providing feedback in an open and honest discussion, where there are checks and balances and different views are heard.”

US Board Chair

### Identification of appropriate controls

Internal controls should be used to maintain the risks facing the organisation within the defined risk tolerance levels set by the board, bearing cost-benefit considerations in mind.

The audit committee should be satisfied that proper control policies, procedures and activities have been established and are operating as intended. Controls may be both preventative and detective.

### The audit committee may want to ask:

- Does management have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks? Has the board been consulted?
- Does the organisation’s culture, code of conduct, human resource policies and performance reward systems support its objectives and the risk management and internal control system?
- Does senior management demonstrate, through their actions as well as their policies, the necessary commitment to competence, integrity and fostering a climate of trust within the organisation?
- Is authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the organisation appropriately co-ordinated?
- Does the organisation communicate to its employees what is expected of them and the scope of their freedom to act? This may apply to areas such as health, safety and environmental protection; security of tangible and intangible assets; expenditure; accounting; and financial and other reporting.
- Do employees have the knowledge, skills and tools to effectively manage risk?
- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

## Monitoring of controls

Procedures for monitoring the appropriateness and effectiveness of the identified controls should be embedded within the normal operations of the organisation. Although monitoring procedures are part of the overall system of control, such procedures are largely independent of the elements they are checking.

Examples of monitoring procedures include:

- *Management self-assessment reviewed and tested by internal audit.* Such self-assessment needs to be carefully managed. Management already has an implicit responsibility for the design and operation of the system of internal controls, and self-certification is a means of formalising this responsibility.  
Self-certification may not be sufficient on its own, as the right amount of independent challenge may not be built into the process. The results should be independently reviewed (for example, by internal audit) on behalf of the board or audit committee. This independent review should challenge the:
  - completeness of the organisational objectives covered;
  - process for identifying and assessing the associated risks;
  - design and operation of the key mitigating controls;
  - process for reporting any excess of residual risk beyond defined risk tolerance levels; and
  - process for reporting any significant over or under control.
- *Internal audit visits on a cyclical basis.* Although internal audit should maintain independence from management, it can perform more than just a monitoring role. In many organisations internal auditors also act as facilitators and internal advisers to management on effective means of controlling operational risk. Internal audit arrangements naturally vary, but have the potential to play a central role within the monitoring process.
- *Special reviews by external auditors or specialists on a cyclical basis.* Responsibility for reviewing and concluding on the effectiveness of internal control rests with the board. However, the external auditors are likely to have useful knowledge and access to specialist consultants with expertise in specific aspects of risk management and control evaluation. Such procedures are outside the scope of the statutory audit, but could be provided as part of a separate engagement. Before any such review takes place, care must be taken to ensure that there are no circumstances which could potentially impair the independence and objectivity of the external audit.



While effective monitoring throughout the organisation is an essential component of a sound system of internal control, the board cannot rely solely on embedded monitoring processes to discharge its responsibilities. The board, with the assistance of the audit committee, should regularly receive and review reports on internal control and be informed about how the reviews giving rise to the reports have been undertaken.

The audit committee should define the process to be adopted for its (annual) review of the effectiveness of internal control and risk management systems. It should also ensure that it is provided with appropriately documented support for its review. Much of this support will come from management, the work of the internal auditor, other assurance providers and, to a lesser extent, the external auditors. (Note: external auditors are not part of an organisation's internal control framework and carry out control work with the aim of forming an opinion on the true and fair view of the financial statements.)

#### The audit committee may want to ask:

- Do management and the board receive timely, relevant, reliable reports on progress against the company's objectives and the related risks that provide them with the information needed for decision-making and review purposes?
- Are information needs and related information systems reassessed as objectives and related risks change, or deficiencies are identified?
- Are periodic reporting procedures effective in communicating a balanced, understandable account of the organisation's position and prospects?
- Are there areas of the organisation's operations that are not fully understood by internal audit or other assurance providers?
- Are there established channels of communication (e.g. whistle-blowing) for individuals to report suspected breaches of laws or regulations or other improprieties?

As part of its assessment, the audit committee should obtain from management an overview of the risks facing the organisation together with the policies, procedures and controls in place to mitigate such risks. The committee should request, however, that the information it receives is manageable; it should not be so voluminous as to deter a proper understanding of the key risks. It is more important that the audit committee gains meaningful insight into the key sources of risk and how such risks are managed, rather than being presented with a long list of every imaginable risk facing the business.

“One role for the audit committee is to review the wider risk map and ensure all important components are under the purview of the board and/or a board committee.”

UK Board Chair

An example risk summary and register focused on a small number of key risks is included as **Appendix 9**. Such a summary is designed to give audit committee members a quick insight into the key risks and the effectiveness of the controls in place.

Indications that the system of internal control isn't working as intended	
Symptom	Warning signs
Executive and business teams are not engaged in the risk and control processes	<ul style="list-style-type: none"> <li>— Formal risk and control discussions are regularly postponed</li> <li>— Risk and control processes are disconnected from 'business as usual'</li> </ul>
Development of the system of internal control is seen as the ultimate goal	<ul style="list-style-type: none"> <li>— The process seems overly complex and business teams are slow to adopt, or develop their own models</li> <li>— Little enhanced debate or further quantification</li> </ul>
Oversight and challenge is not robust	<ul style="list-style-type: none"> <li>— Reporting focuses on risk coverage, rather than action</li> <li>— Risk and control assessments, reports/processes rarely change</li> <li>— Business owners are not challenged, and receive little feedback</li> </ul>
The role of the risk function is confused, at best misunderstood – at worst ignored	<ul style="list-style-type: none"> <li>— Little remit to challenge strategy and key investments</li> <li>— Seen as consolidators of information</li> </ul>

Unclear accountability for risk and control	<ul style="list-style-type: none"> <li>— Risks are not addressed in a timely manner, and struggle to find a home</li> <li>— Internal audit facilitates the process</li> </ul>
Assurance is patchy – strong for traditional risks; confused for emerging risks	<ul style="list-style-type: none"> <li>— No clear assurance map</li> <li>— Internal audit plans rotate around the same topics</li> <li>— Executive teams rely heavily on management self-assurance</li> </ul>

### The ongoing review process

The reports from management and/or others qualified to prepare them in accordance with agreed procedures should provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in the areas covered. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact they have had, could have had, or may have on the organisation and the actions being taken to rectify them.

It is essential to have a frank, open dialogue between management and the audit committee on matters of risk and control. When reviewing reports during the year, the audit committee should consider:

- What the significant risks are and assess how they have been identified, evaluated and managed. The significant risks threatening the achievement of business objectives should have been identified, assessed and controlled within the board's defined risk tolerances.
- The effectiveness of the related system of internal control in managing the significant risks, having regard in particular to any significant failings or weaknesses that have been reported.
- Whether appropriate action is being taken on a timely basis to remedy any significant failings or weaknesses. It is not sufficient for the audit committee to satisfy itself that weaknesses are being identified; it must also consider the remedial actions taken and whether such steps are appropriate.
- Whether the findings indicate a need for more extensive monitoring of the internal control system. Where a weakness identified in one area of the organisation may be duplicated in other areas, it may be appropriate for the audit committee to seek a more comprehensive review.

## Indications that risk information is weak and therefore the system of internal control is compromised

Symptom	Warning signs
Risk information is produced, but not used	— Strategies, plans, budgets and processes do not change as new risks emerge
Inconsistent risk data is delivered from a number of competing risk functions	— There is no single, accepted risk process and management cannot give a united, single view of risk
The risks on the register do not reflect business reality	— Risk assessments rarely change
Risk information is not escalated to the right person at the right time	— Lack of strategic or emerging risks — Risks are materialising, but were not on the risk register
Quantity has the upper hand over quality	— Risk reports run to many pages, and are in fact risk registers — There is little analysis of key themes or interactions between risks

“In discussions with the CRO, I do not want to have too much formalism – quantification is important but my experience is that understanding the qualitative aspects is even more fundamental.”

Swiss Audit Committee Chair

### The annual review exercise

The annual review exercise should consider the issues dealt with in the reports reviewed during the year, together with additional information necessary to ensure that the board has taken account of all significant aspects of internal control period concerned.

The annual assessment should consider:

- Changes since the last review in the nature and extent of the significant risks and the organisation’s ability to respond effectively to changes in its operations and external environment. The audit committee should

review the organisations activities and operational structure to identify changes that might alter the risk profile. The ability to respond effectively to changed circumstances is vital.

- The scope and quality of management’s ongoing monitoring of risks, the system of internal control and, where applicable, the work of the internal audit function and other assurance providers. The audit committee should consider whether management’s approach to ongoing monitoring of the internal control system covers the key risks to the organisation in what it believes to be an appropriate cycle and with a level of diligence it deems satisfactory. The internal audit function may provide significant additional comfort, as long as it has sufficient resources and authority to be effective.
- The extent and frequency of communications with the audit committee, enabling it to build up a cumulative assessment of the state of control in the organisation and the effectiveness with which risk is identified and managed. The audit committee should consider whether it receives the output from the monitoring process regularly enough to be able to form a timely opinion of the ongoing effectiveness of the process. Strategic decision-making may be impaired if the results of monitoring activities are not received, reviewed and acted upon on a timely basis.
- The incidence of significant control failings or weaknesses identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have a material impact on the organisation’s performance or reputation. The audit committee will want to reflect on the incidence of control weaknesses occurring during the period and the effect those weaknesses have had, could have or still may have on the organisation operations and results.
- The effectiveness of the reporting process. The efficiency of the year-end reporting process from all areas of the organisation will provide an indication of the level of management control throughout the organisation.

Should the audit committee become aware at any time of a significant failing or weakness in internal control, it should determine how this failing or weakness arose and reassess the effectiveness of management’s ongoing processes for designing, operating and monitoring the system of internal control.

## Audit committee questions

- Are there ongoing processes embedded within the organisation's operations, and addressed by senior management, that monitor the effective application of the policies, processes and activities related to internal control and risk management? (Such processes may include control self-assessment, confirmation by personnel of compliance with policies and codes of conduct, internal audit reviews or other management reviews.)
- Do these processes monitor the organisation's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, business and external environment?
- Are there effective follow-up procedures to ensure that appropriate modification or action occurs in response to changes in risk and control assessments?
- Is there appropriate communication to the board (and committees) on the effectiveness of the ongoing monitoring processes for risk and control matters? This should include reporting any significant failings or weaknesses on a timely basis.
- Are there specific arrangements for management to monitor and report to the board on risk and control matters of particular importance? These could include, actual or suspected fraud and other illegal or irregular acts, or matters that could adversely affect the organisation's reputation or financial position.

### Reporting

The results of the audit committee's monitoring of the effectiveness of the company's internal control and risk management systems on behalf of the board and the related deliberations should be reported to, and considered by, the board. The board will need to form its own view on effectiveness based on the information and assurances provided to it by the audit committee, exercising the standard of care generally applicable to directors in the exercise of their duties.

### External reporting

The audit committee needs to review any external reporting relating to risk and internal control – whether that is private reports to regulators or disclosure in the annual report. The audit committee should ensure that it is provided with appropriately documented support for any risk and/or internal control statements/reports it is required to review.

Specific requirements will depend on jurisdiction and on the nature and circumstances of the organisation, but organisations generally have to disclose the following within their annual report:

- a description of the main characteristics of the risk management and internal control systems. **Appendix 10** contains a practice aid for reviewing the description of internal control and risk management systems over financial reporting;
- a description of the principal risks and uncertainties facing the organisation;
- that the board is responsible for maintaining the organisation's risk management and internal control systems and for reviewing their effectiveness;
- that risk management and internal control systems are designed to manage rather than eliminate the risk of failure and can only provide reasonable assurance against material misstatement or loss; and
- that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified during the board's review.

### Monitoring special circumstances

A company's risk profile can also change as a result of its stage in the growth cycle. To illustrate, we highlight two very common examples – a fast-growing, entrepreneurial company and a company expanding globally through mergers, acquisitions and reorganisations.

#### *Emerging companies*

Fast-growing entrepreneurial companies often lack a formalised management structure and may not have well-established corporate governance programmes. Policies, procedures, and processes may be evolving haphazardly to meet demands. In addition the dominant role of an individual executive may overshadow the need to foster a strong control environment and can potentially affect the financial reporting and audit processes.

As companies grow, a more standardised corporate governance process becomes a necessity, regardless of the entity's public aspirations. For companies considering an initial public offering, the need for a formalised structure becomes obvious. While the risks described in this publication represent important issues in today's marketplace for public companies, they also apply to entrepreneurial and other companies that remain private. Responding to these risks is equally important to companies that wish to deter fraud and improve the quality of their corporate reporting.

Dominant or autocratic management can also be a cause for concern in an established company. Such leadership can put a strain on the enterprise's controls and corporate governance processes and set the wrong tone from the top. Ensuring that management fosters an atmosphere that supports a strong control environment is a core audit committee responsibility.

### *Complex corporate structures*

Mergers, acquisitions and reorganisations often involve melding organisations not only with distinct corporate cultures but also from different industries and different areas of the world. In today's business environment, companies frequently cross borders for every aspect of their business. This environment presents management and the audit committee with unique oversight challenges. While governance practices in such environments are evolving, the influence of different cultures needs careful consideration.

For the audit committee, many questions will need answers.

- How are management's reporting, control, and compliance responsibilities integrated?
- Is there effective oversight of local boards?
- How does the committee evaluate domestic and international audit results, both internal and external?
- How does management determine the company's compliance with various countries' rules and regulations?



Reorganisation often means downsizing and outsourcing. The process of downsizing often means that companies remove or weaken controls. As companies focus on core competencies, they often outsource to third party providers non-core activities and specialised skills. Has the organisation carefully evaluated the ongoing internal control impact of such decisions?

Audit committee's responsibilities do not stop at national or organisational boundaries – they extend to the organisation as a whole. Audit committees of parent companies and subsidiaries should coordinate and communicate with one another. They should have a common appreciation of the control frameworks and cultures of the entities, and undertake substantial sharing of information.



Chapter 6

# Fraud and misconduct

**Audit committees play an important role in defining guidelines and clear expectations relating to the systems in place to mitigate the risk of fraud and misconduct. These systems should be fit for purpose and working as intended.**

While ultimate responsibility rests with the board as a whole, audit committees are typically tasked with the principal oversight of the way the risk of fraud and misconduct is managed within the organisation; including *inter alia*:

- ensuring that any issues raised during the organisation’s assessment of the risk of fraud and misconduct are properly reviewed and discussed;
- discussing with the internal and external auditors any findings on the quality of the organisation’s anti-fraud systems and controls;
- ensuring that proper arrangements are in place allowing employees (and others) to raise concerns about possible fraud and misconduct issues in confidence; and
- ensuring that arrangements are in place for the receipt and proportionate investigation of questions or concerns regarding possible issues of fraud and misconduct and for appropriate follow-up action.

### **Responsibilities**

Direct responsibility for anti-fraud efforts generally reside with a member of the senior management team, such as the CFO or another officer with specific compliance duties. This person is responsible for coordinating the organisation’s approach to the prevention, detection and response relating to fraud and misconduct. When potential fraud and irregularity issues arise, this individual can bring together the right resources to deal with it and react appropriately taking any legal restrictions into account.

This member of the senior management team may also co-ordinate the organisation’s risk assessment efforts in this area by:

- establishing policies and standards allowing the organisation to manage the risk of fraud and misconduct;
- overseeing the design and implementation of anti-fraud programmes and controls; and
- reporting to the board and/or audit committee on the results of the organisation’s fraud risk management activities.

The internal audit function as third line of defense, supports management's anti-fraud activities to prevent, detect and respond to fraud and misconduct. Typically, internal audit is tasked with:

- planning and conducting evaluations of the design and operating effectiveness of the anti-fraud controls implemented;
- reviewing the organisation's fraud risk assessment and the mitigation strategies suggested; and
- reporting findings to the audit committee.

It should be noted that external auditors have a duty to report to those charged with governance (usually the audit committee) any serious weakness in the system of internal control that can potentially give rise to, fraud, irregularities or accounting breakdowns.

### **The role of the audit committee**

How can the audit committee ensure that appropriate procedures are in place to minimise the risk arising from fraud and misconduct? Although discussing potential fraud and fraud risks can be a challenge, the audit committee has to address these risks head-on. Identification of the potential fraud risks within the organisation, is an important step. Once the potential fraud risks have been identified, assessing the impact and the likelihood of these risks is the next step. The audit committee should challenge management making sure the most significant potential fraud risks are being addressed. This should include a rigorous assessment of any relevant internal controls and their ability to address the potential fraud risks identified.

The audit committee should determine whether a consistent approach is taken across the organisation, whether the risks assessed as high are dealt with appropriately, and whether management is engaged in the process.

It is important that staff at all levels receive training relevant to their role: this might include fraud awareness training, training on conflict of interest, anti-bribery and corruption training.

A common theme arising from fraud investigations is that several people in the affected organisation knew or suspected that fraud or misconduct was occurring, but were not given the opportunity to communicate their concerns. The audit committee should enquire as to whether the organisation has an effective awareness programme informing employees on how they can react if they suspect fraud or misconduct.

The audit committee is not involved in day-to-day management, and therefore not closely involved with the detail of matters related to fraud and misconduct. However, it can usefully focus attention on the need for proper policies and procedures to help in preventing fraud.

The audit committee should make sure appropriate policies and procedures have been implemented, whether they are understood within the organisation and management demonstrates the desired 'tone-at-the-top' making fraud risk management part of the agenda. Policies which may be considered include, amongst others a code of conduct, an anti-fraud policy, an anti-bribery and corruption policy, a whistle-blowing policy (see below) and a response plan. The committee should consider not just whether these policies are appropriate, but whether they are effective and the way management was able to confirm this.

The committee should ensure that management is providing clear direction to the employees on fraud and misconduct. The committee should also request all relevant information on suspected issue of fraud or misconduct.

The following are, among other factors, sometimes seen as red flags for potential fraud or misconduct:

*Employee behaviour:*

- autocratic management style / domineering decision making;
- obsessive secrecy;
- senior management overrides;
- close relationship with supplier or customer dealt with exclusively by one employee and guarded jealously;

- certain suppliers or customers dealt with outside of the appropriate department;
- certain mundane tasks are retained when they could be delegated;
- evasive or excessively complicated answers to routine queries.

*Cultural indicators:*

- overriding management attitude of results at all costs;
- low morale, high staff turnover;
- minor but regular failures to follow company procedure or policies and disrespect for systems;
- passive and unquestioning staff who may be turning a blind eye to irregularities;
- use of a favoured few suppliers / agents;
- habit of protracted discussions with regulators;
- culture of favouritism and nepotism.

*Structural indicators:*

- discovery of undisclosed private companies controlled by employees or directors;
- private companies related to the organisation are part of an unnecessarily complex or confusing structure perhaps involving off-shore entities;
- lack of separation between private and public company affairs remote locations which are evasive or provide minimal or inadequate information;
- transactions or structures created with no clear purpose;
- different auditors and different year ends for different parts of the organisation;
- frequent change of auditors;
- unnecessarily large numbers of adjusting journals.

*Business indicators:*

- results always at or just above budget;
- results exceed market trend;
- aggressive accounting policies;
- aggressive forecasts;
- increasing number of complaints for products / services;
- reward schemes linked to results;
- unnecessarily confusing or complex transactions entered into.

**Measures to guard against fraud and misconduct include:**

- Boards taking responsibility for the fight against fraud and misconduct
- Appointing a senior officer accountable for oversight
- A clear statement of an anti-fraud and anti-corruption culture
- Documented policies and a code of ethics, applicable regardless of local laws or culture, which must also apply to business partners
- Consistent disciplinary processes providing for individual accountability
- Assessing risks specific to the organisation
- Financial controls and record-keeping to minimise the risk of fraud, bribery and corruption
- Policies and procedures on gifts, hospitality, and facilitation payments
- A policy and procedure on the use of outside advisers/third parties including vetting, due diligence and appropriate risk assessments
- A policy covering political contributions and lobbying activities
- Training to ensure dissemination of the anti-fraud and anti-corruption culture to all staff
- Establishing whistle-blowing procedures e.g. a helpline
- Regular and risk-based checks and auditing
- Wherever possible, implementation of procurement and contract management procedures to minimise the opportunity for corruption by sub-contractors and suppliers

### Reporting procedures and whistle-blowing hotlines

Reporting procedures and whistle-blowing hotlines are important aspects allowing the detection of potential fraud and misconduct within an organisation. The audit committees have a role in ensuring such procedures exist and are effectively implemented and supported by senior management.

Barriers to an effective whistle-blowing procedure include:

- *Operational* – is the reporting and whistle blowing process fully embedded within the organisation? Do all staff members know what to do, what to look for? Do the hotlines and reporting lines actually work?
- *Emotional and cultural* – Whistle-blowers are commonly viewed as snitches, sneaks, grasses, super grasses and gossips. This perception can make it difficult to blow the whistle even though individuals recognise that it is good for the company, employees, shareholders and other stakeholders.
- *Fear* – Potential whistle blowers often fear reporting incidents to management. Areas such as legal protection, fear of trouble and potential dismissal all play a part when an individual is considering whistle blowing.

When reviewing whistle-blowing procedures, the audit committee should consider the following:

- Are reporting and whistle-blowing procedures documented and communicated throughout the organisation?
- Does the policy make clear that it is both safe and acceptable for employees to raise concerns about wrongdoing?
- Were the reporting and whistle-blowing procedures arrived through a consultative process? Do management and employees 'buy into' the process?
- Are concerns raised by employees (and others) responded to with a reasonable time frame?



- Are procedures in place to ensure that all reasonable steps are taken to prevent the victimisation of whistle-blowers?
- Are there procedures to ensure that all reasonable steps are taken to keep the identity of whistle-blowers confidential?
- Has a senior person been identified to whom confidential concerns can be disclosed? Does this person have the authority and determination to act if concerns are not raised with, or properly dealt with, by line management and other responsible individuals?
- Does management understand how to act if a concern is raised? Do they understand that employees (and others) have the right to blow the whistle?
- Has consideration been given to the use of an independent advice centre as part of the whistle-blowing procedure?

An example of a whistle-blowing policy is set out at Appendix 11.

### Audit committee questions

Audit committees can add value by asking how much detected fraud is captured by the whistle-blowing system. If it's less than (say) 50%, they might want to consider whether:

- there are areas of the business (either geographical or functional) where there are few, if any, whistle-blowing reports – suggesting effectiveness is patchy;
- management are motivated to follow up whistle-blowing activity; and
- a significant number of detected frauds were not detected by the whistle-blowing process – suggesting procedures are less than effective.

## Chapter 7

# Internal Audit

**The audit committee is responsible to the board for the oversight on internal control and risk management systems. The mission of internal audit is to enhance and protect organizational value by providing risk-based and objective, assurance, advice and insight.**

**The internal audit function plays a significant role in the evaluation of risk management and internal control. They can support the audit committee by providing their independent view and advice on the adequacy of the control environment of the organization. Part of the audit committee's role is to annually review the need for an internal audit function and, where such a function exists, its effectiveness.**



The need for an internal audit function will vary depending on organisation specific factors including the scale, diversity and complexity of the organisation's activities and the number of employees, as well as cost/benefit considerations. When undertaking its assessment of the need for an internal audit function, the audit committee should also consider whether there are any trends or current factors relevant to the organisation's activities, markets or other aspects of its external environment which have increased, or are expected to increase, the risks faced by the organisation. Such an increase in risk may also arise from internal factors such as organisational restructuring or from changes in reporting processes or underlying information systems. Other matters to be taken into account may include adverse trends evident from the monitoring of internal control systems or an increased incidence of unexpected occurrences.

In the absence of an internal audit function, management needs to organise other monitoring processes in order to assure itself, the audit committee and the board that the system of internal control is functioning as intended. In these circumstances, the audit committee will need to assess whether such processes provide sufficient and objective assurance.

### Establishing and maintaining an effective internal audit function

Internal audit can be sourced either through an in-house function or an external service provider. The decision as to which is appropriate will usually be driven by the availability of appropriate skills and the breadth and depth of experience to cover the organisation's operations adequately. The cost implications of each approach may differ significantly.

Outsourcing continues to be a common option, not least because it arguably enhances the internal audit function's independence from operational management and provides access to a wider range of skills and experience than can typically be maintained by a small in-house team.

The relative strengths and weaknesses of different internal audit sourcing options are discussed in more detail in **Appendix 12**.

Where an internal audit function exists, the audit committee should participate in the appointment, promotion or dismissal of the head of internal audit, and help determine the required qualifications, reporting obligations and compensation. The audit committee should also help to ensure internal audit has access to all appropriate persons both at board level and within the company.

The audit committee should be involved in developing and approving internal audit's remit, goals and mission, to be certain of its proper role in the oversight function. Collaboration with both management and internal audit in developing internal audit's remit should help ensure a proper balance between the assessment of internal control and any responsibilities for operational efficiency, risk management and other special projects.

Establishing the 'right' role for the internal audit function is not a 'one size fits all' exercise, and the focus areas and strategic ambitions of any internal audit function rarely stay the same from one financial year to the next. Indeed, if there are signs that an internal audit plan simply rolls-over, this in itself offers a warning sign that there could be an absence of the kind of robust challenge that is needed; an organisation's key risks are rarely static – especially in the current economic environment.

Audit committees looking to optimise internal audit's resources and activities need to ensure that the function's audit plans are clearly defined in the context of the organisation's overall assurance landscape. A clearly defined and communicated remit helps to remove unnecessary duplication of effort and ensure the audit teams and expertise are focused and the investment in the internal audit function is maximised.

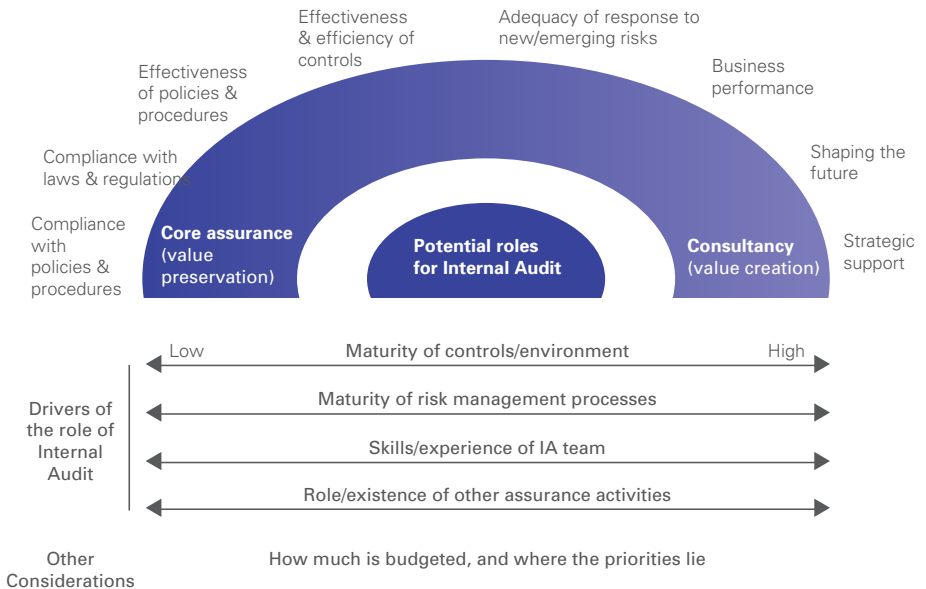
### **Getting the right balance between core assurance and value creation audit**

In a business that has an unstable control environment, or is experiencing significant change or growth, value is often demonstrated by giving high quality assurance over the effectiveness of core controls. This helps to mitigate the risk of control failures and associated financial surprises. Newly established internal audit functions are also often more likely to assess the effectiveness of the 'basic' processes and controls.

Where there is a strong and stable control environment and where the risk management processes are mature and have an experienced team in place, internal audit can focus more on risk-based auditing and consultancy and advice. Particularly where there are other sources of assurance over core controls, such as self-assessment.

Adjusting the balance can see internal audit working alongside management in a business partnering role. The richness of assurance and opinion can help to support major change programmes or challenge controls design as processes are streamlined. This is at the high end of value creation and is an achievable ambition provided that a number of factors are in place (see diagram). This type of role requires careful management to ensure the responsibilities of the business and the independence of internal audit do not become blurred.

### An overview of the potential roles and range of input internal audit can provide



### Ensuring adequate resources for the internal audit function and access to information

The audit committee should also ensure that the internal audit function has adequate resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors. The audit committee should pay particular attention to the experience and resources within the internal audit function in times of crisis and ensure the internal audit budget and activities are not inappropriately curtailed as a result of cost cutting exercises.

When considering the skills and experience of the internal audit function, the audit committee should not overlook the personal attributes of those within the internal audit function and the need to balance quality internal audit/ operational management relationships with the need to remain impartial and maintain professional scepticism. The audit committee will require internal audit to be objective and 'to the point' – and this may involve implicit or explicit criticism of management. Consequently, internal audit will need the right mix of internal audit skills, technical skills, industry/business knowledge and 'soft skills' if they are to be fully effective.

#### Audit committee questions

- Does the organization need an internal audit function ?
- Does internal audit has appropriate authority and standing within the organisation to carry out its duties effectively?
- Does internal audit has clearly defined terms of reference that articulate the scope of its work? Is the charter regularly reviewed to ensure it remains appropriate?
- Are internal audit's reporting lines unambiguous and is it clear that internal audit has direct access to the audit committee?
- Do internal audit's terms of reference provide for regular meetings between the head of internal audit and the audit committee – including in camera meetings without management being present?
- Is an appropriate relationship maintained between the internal audit function and the external auditors (and other assurance providers)?
- Does the internal audit function has the adequate skills and resources to execute its role ?
- Does the internal audit function have access to personnel, information, records, properties ?

### Assessing the annual internal audit work plan

The internal auditor should prepare an audit plan based on the organisation's assurance needs. This plan should address how the organisation's key systems and processes will be audited during the audit cycle, together with the resources to be applied – normally expressed in 'man days'. Areas of greater risk might be addressed at the beginning of the audit cycle and then revisited later in the cycle.

“Recent events have highlighted the need for audit committees to focus on the controls judged by management to bring the most significant risks facing the organisation before mitigation down to acceptable risks after mitigation. The audit plan should be designed primarily to provide the board with the assurance that these controls are truly effective.”

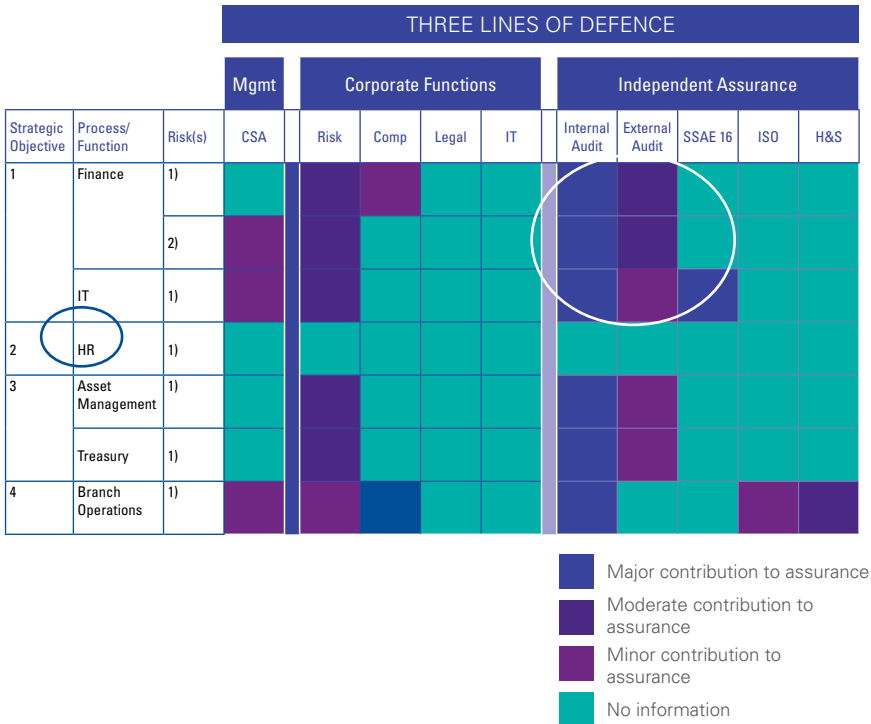
UK Chair of Audit & Risk Committee

As an audit plan is unlikely to cover all areas of risk within a single year, the plan for any given year should place its work in the context of work done in the preceding year and projected for the succeeding year. The audit committee and management may take a different view of timing and priorities, which should be resolved through discussion.

A specimen internal audit plan is included at **Appendix 13** and the key steps in a typical internal audit annual cycle are discussed at **Appendix 14**.

### Assurance mapping

The audit committee should review the risk map and audit plan to satisfy itself that appropriate audit coverage will be devoted to all the organisation’s assurance needs. If internal audit is not covering a particular risk area – or not covering it in sufficient depth – then other means of assurance should be in place, whether that be assurance from the business operations, head office functions or other independent assurance providers.





When the audit committee is satisfied with the audit plan, it should recommend the plan to the board for approval, if its terms of reference so require. Once the plan has been approved, the audit committee should monitor the auditor's progress against it during the year.

Internal auditors may carry out additional work at the request of management (including investigations), provided such work does not compromise the independence of the audit service or achievement of the audit plan. The audit committee should satisfy itself that the independence of internal audit has not been affected by the extent and nature of other work carried out.

### **Internal audit reports and monitoring management's response**

While internal audit reports to management (preferably the CEO) on a day-to-day basis, audit committees have a responsibility for oversight and therefore need to determine appropriate communication channels and reporting arrangements with internal audit. Some audit committees want to see every audit report, some a summary of every report, and others a periodic summary. Progress reports, comparing audit activity against the audit plan, are also useful.

An illustrative internal audit report is set out at **Appendix 15**.

It is important that the audit committee considers significant individual audit findings or recommendations, though it need not be concerned with more detailed findings unless the committee considers it valuable to do so. It is good practice for internal auditors to prioritise their findings against agreed standards. This indicates the importance of each audit recommendation and the urgency of any required action.

The audit committee should concentrate on gaining assurance that the organisation's risk management, control and governance arrangements are adequate and effective. For this purpose, the committee should ensure that there is an adequate system to monitor the implementation of agreed audit recommendations. An implementation plan detailing the recommendation, the required action, priority, person responsible and timescale is a good method of fulfilling this objective.

Internal audit should have a systematic process of follow-up to obtain appropriate assurance that management has taken timely and effective action. It should promptly advise the audit committee of its findings and further action required.

The board, advised by the audit committee, should ultimately be responsible for either ensuring that management takes prompt and effective action on those audit reports which call for it; or recognising and accepting the risks of management not taking action.

### What is internal audit telling the audit committee?

An audit committee might reasonably question what assurance it is receiving when confronted with audit reports drafted along the following lines:

**‘Significant improvements have been made in this area in the last 12 months. However, the management agenda reflects a number of issues whose resolution would enable further’**

This is ‘compromise wording’. Such reports are not uncommon. However, if an audit committee ever receives a summary like this, it may legitimately ask itself what on earth it means. For example: having done extensive testing and comparison to best practice, the internal auditor wants to say, ‘the management of controls in this area is poor’. However, management believe (say) that the area in question was poorly managed some time ago, but a lot of work has been done during the year and therefore there is no value in internal audit raising issues that they are already both aware of, and dealing with (albeit slowly). They will express incredulity that internal audit should want to make a fuss about a well-known issue. Hence the compromise wording: carefully crafted to maintain pride on both sides.

The audit committee might reasonably conclude that the head of internal audit is too weak, or too junior, or too bullied and does not feel able to say what he or she really thinks.

**‘Whilst a number of improvements have been made in this area, further change is required if its management is to become world-class.’**

This is ‘told you so’ wording. It means that if controls fail, some financial catastrophe looms and the audit committee turns to the head of internal audit and asks, ‘Why wasn’t I warned?’ she or he can reply, ‘I told you so. We reported it to you. Wasn’t it clear? You could have asked for more details if you had any questions or even requested the full report.’

The underlying cause of such wording might be that people are afraid of bringing bad news either to the audit committee or, more likely, they’re afraid of trying to get it past the executive team.

**‘Wider variations in base rate and potential dynamic margin shifts to reflect market positioning would mean that the business would be more exposed to rate increases than decreases.’**

This is ‘preventative’ wording. Many audit committee members might legitimately have a problem understanding what this means; yet all it is saying is that the business in question is vulnerable to a rise in interest rates. Preventative wording is designed to prevent the reader understanding the issue. Can it really have any other purpose?

Internal audit does not want the audit committee to understand because they might ask difficult, inconvenient questions that will be embarrassing or maybe just tedious to answer. Or maybe, no one can do anything about the issue anyway so why make trouble? Whatever the motivation, whether it is conscious or sub-conscious, internal audit are reporting to the audit committee in a way designed to elicit a reduced reaction. Preventative wording is extremely dangerous and audit committees should be alert to it.

**‘In the last six months, we have issued 74 reports of which 27 were rated as significant. These are split by division in the table below. A further chart showing traffic light ratings etc.’**

This is ‘death by statistics’. An audit committee can look at all of this information yet be unable to draw a single, meaningful insight from any of it. Of course, this form of reporting can be valuable where internal audit is doing standard processes at multiple locations, such as retail store audits. But, where one piece of work is not directly comparable with another, it is just filler. The underlying cause is that the internal audit function wants to demonstrate progress but has no idea how to demonstrate value.

### In camera meetings with the head of internal audit

Many audit committees want to meet the head of internal audit in a private session where management is not present. This approach allows the audit committee to ask questions on matters that might not have been specifically addressed by the internal audit function’s formal work programme – nevertheless, the head of internal audit might, as a result of his work, have valuable views and opinions. A private session allows the head of internal audit to provide candid, often confidential, comments to the audit committee on such matters.

Typically there should be few items to discuss. Ideally all key matters relating to internal audit should have been addressed in a candid and robust manner by management, the audit committee and the head of internal audit during the formal audit committee meeting. The audit committee can use the private session as a follow-up if members were

not satisfied with the answers given at the audit committee meeting or if they thought discussions had been too guarded or uneasy. However, such matters should have been fully aired at the audit committee meeting and generally should not need to be readdressed in the private session.

The private session should focus on areas where the head of internal audit can provide additional, candid, and often confidential, comments to the audit committee on other matters. The private session gives the audit committee an opportunity to explore such matters in a frank and open forum. In addition, the audit committee may have more knowledge than the head of internal audit on other matters, and this session allows the audit committee an opportunity to air such issues.

Overall, private sessions can play an important role in the development of a trusting and respectful relationship between the audit committee and the head of internal audit.

#### The audit committee may want to ask questions around relationships, attitudes and resources, such as:

- How strong is the relationship between the internal audit function and management/operations?
- Does internal audit receive appropriate cooperation from operational and head office management?
- Have any requests for information been denied or otherwise obstructed?
- Is the internal audit function subject to undue pressure from any source?
- How constructive is the relationship between the internal audit function and external audit?
- What is management's attitude towards risk management and internal controls?
- Are adequate people and other resources devoted to key areas of the business and control functions?

#### Assessing the internal audit function's performance

The internal audit profession is governed by a Definition of Internal Auditing, a Code of Ethics and standards. The professional organization for internal auditors – the IIA (Institute of Internal Auditors) – requires the internal audit function to have an external assessment conducted in order to assess compliance with the IIA Standards.

Corporate governance best practice generally requires audit committees to monitor the performance and effectiveness of internal audit. This should include any matters affecting the audit function's independence and objectivity.

Self-assessment by the head of internal audit is a useful assessment tool, but it should not be the sole means of assessing the effectiveness of internal audit. The audit committee should draw its own conclusions based on its experience and contact with internal audit as well as the views of others such as the CFO, divisional heads and external audit. In evaluating the work of internal audit, the audit committee should review the annual internal audit work plan, receive periodic reports on the results of the internal auditor’s work and monitor management’s responsiveness to the internal auditor’s findings and recommendations.

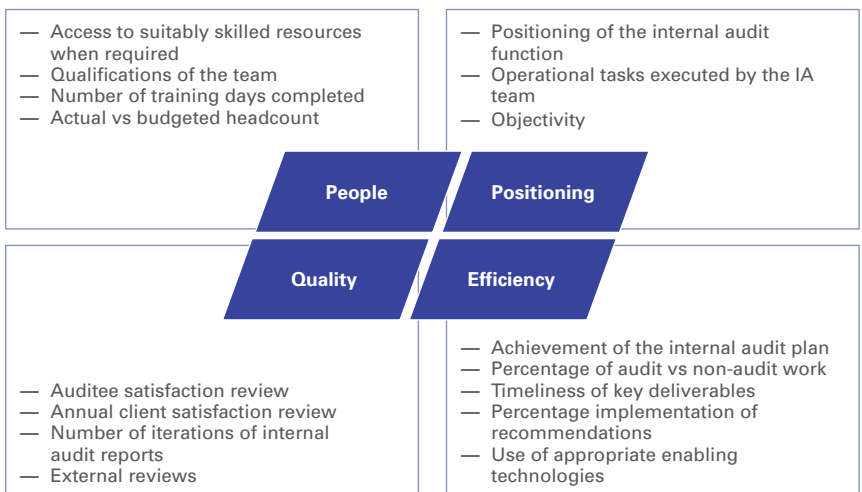
When agreeing appropriate performance measures for internal audit, the audit committee should recognise that such measures need to be adapted to each organisation’s circumstances. The following diagram illustrates some of the more common measures used to monitor the performance of internal audit.

**Appendix 16** provides a framework to assist audit committees when reviewing the effectiveness of the internal audit function.

**Relationship with the external auditor**

The audit committee should ensure that there is a constructive relationship between the internal audit function and external audit. While each audit function provides independent assurance, the audit committee should, where appropriate, seek to ensure that the internal audit function and external auditor coordinate their audit effort and avoid duplication.

**Three lines of defence**



Chapter 8

# External Audit

**Audit committees have an important role in helping boards discharge their duties by providing independent oversight over external audit.**



Audit committees are usually tasked with:

- assessing and monitoring the external auditor’s independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements;
- making recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor; and
- developing and implementing a policy on the engagement of the external auditor to supply non-audit services, taking into account any relevant ethical guidance regarding the provision of non-audit services by external auditors.

### Maintaining an effective relationship

The external auditor and audit committee should have a strong and candid relationship – anything less may limit the committee’s effectiveness in achieving its oversight responsibilities. The audit committee should establish that the auditor is directly accountable to the committee and, through it, to the board and ultimately the company’s shareholders.

The audit committee should make sure its actions and communications with the auditor are consistent with this accountability. The audit committee should also be sure to communicate its expectations to the auditor, and ensure that both parties understand and have agreed to those expectations.

It is good practice for audit committees to regularly meet the external auditor to discuss matters relating to its remit and any issues arising from the audit, either in camera or as part of the formal meetings. **Appendix 5** addresses these private meetings between the auditor and audit committee in more detail

A good working relationship between the audit committee chair and the lead audit engagement partner is essential – both to the audit committee’s effectiveness and to the effectiveness of the engagement team. From preparing committee agendas and walking through the pre-meeting materials together, to discussing important developments on a real-time basis, informal conversations between the audit committee chair and the lead audit engagement partner are critical to the effectiveness of the audit committee. This step allows the chair and the audit partner to review agenda items and should reduce any surprises arising at the audit committee meeting. If particularly controversial or difficult items are identified, the chair should also discuss those issues with management and consider the need to give advance warning to the other members of the audit committee.

Make sure to know the firm’s engagement partners as well as its national office partners who may be involved in the engagement: Given the complexity of accounting and auditing standards today, external auditors are consulting their national offices more frequently on technical accounting and other matters. To gain a better understanding of the consultation process, consider having a national office partner of the firm meet with the audit committee to discuss current issues and developments, as well as the role of the national office. Get to know their technical accounting experts, industry leaders, and thought leaders. Also develop relationships with other partners involved in the engagement – the engagement quality review partner, the relationship partner, as well as other partners on the engagement team (such as the tax partner, IT partner, and partners in foreign countries, if the company has international operations). Audit committees should know the partners they are dealing with and relying on.

### Auditor selection

Making recommendations to the board on the appointment, reappointment and removal of the auditor is an important audit committee responsibility. The audit committee’s recommendation to the board should be based on its assessment of the qualifications, expertise and resources, and independence of the auditor and the effectiveness of the audit process. As described later in this chapter, the assessment should cover all aspects of the audit service provided by the audit firm and include obtaining a report on the audit firm’s own internal quality control procedures and, when relevant, consideration of the audit firm’s annual transparency report.

### Top three criteria for auditor selection<sup>3</sup>



<sup>3</sup> The Audit Committee Oversight Process of the External Audit: Auditor Selection and Monitoring, Maastricht University (June 2012).



Making the recommendation to the board on the appointment of the external auditor has in many countries around the world for many years been a fundamental audit committee responsibility and many countries recently even introduced legally binding requirements in relation to audit tendering and rotation. In any case, the audit committee should evaluate the external auditor on a periodic basis. If the evaluation of the performance of the external auditor is generally positive and no mandatory rotation requirements are to be met, the audit committee can suggest to the board to propose the reappointment of the external auditor, without a formal audit tender being needed.

If the audit committee considers a formal audit tender is appropriate or if one is legally required, it should oversee the selection process and in doing so ensure the process is conducted in a fair and unbiased manner.

The audit committee is responsible for initiating and supervising the audit tender process and for recommending the best auditor to suit the needs of the company. The audit committee has to make sure to have the tender process approached in a way that makes it a really worthwhile exercise – one that delivers lasting benefits for your organisation. Getting the balance right in the audit tendering process is really important – it will help to become more efficient and it can also help you keep down the time and cost of the process itself.

Parties involved have to think about what they want to achieve before starting the process. Stakeholders may have different objectives so it is important to align each stakeholder well in advance to avoid later disruption to the process or decision making. It is often beneficial to hold a stakeholder workshop to identify and collate the objectives of the collective group. One may want to involve the existing auditor in this discussion where appropriate, to ensure to cover all considerations.

Further guidance on how to conduct an audit tender is set out in **Appendix 17**.

The audit committee should approve the terms of engagement and recommend the compensation to be paid to the auditor in respect of audit services provided. In doing so, it should satisfy itself that the level of fees in respect of the audit is appropriate, and that an effective audit can be conducted for such a fee.

When considering the appointment (or reappointment) of the external auditor, consideration is normally given to a range of factors including:

- understanding of the company's risks and needs (including strategic management issues);
- geographical coverage;
- perceived value added;
- experience of sector and existing client list;
- staff experience and number of planned partner/senior staff hours; and
- proposed fee and value for money considerations.

It is important that in making its recommendation the audit committee also has regard to the effectiveness of the audit process (see below).

In the unlikely event that the board does not accept the audit committee's recommendation regarding the appointment/reappointment of the auditor, it is good practice to include in the annual report, and in any papers recommending the appointment or reappointment of the auditor, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different position.

If the auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

### Audit team rotation

The audit committee should insist on a clear plan for audit partner rotations, as well as rotations for key members of the engagement team. In most jurisdictions, lead audit engagement and engagement quality review partners must be rotated periodically. In order to provide continuity and avoid disruptions, audit committees should ensure that the audit firm has developed a clear schedule and time line for partner rotations – in effect, a succession plan – as well as a process to identify new partners to assume these positions.

Making sure the right people are working on the audit requires advance planning, particularly in connection with the rotation of the lead audit engagement partner. For example, many audit committees develop the qualities and characteristics the committee seeks in the next engagement partner. The audit firm then proposes a candidate – or perhaps several candidates, depending on the size and nature of the

engagement. This can be a significant challenge, particularly for a company in a specialised industry such as banking or energy.

“Audit quality is rooted in the quality of the engagement team – the quality of the lead engagement partner, the sufficiency of the firm’s resources, how auditors are trained, their level of expertise, their ability to be sceptical and objective and to push back on management when needed.”

US Audit Committee Chair

### Audit quality initiatives

In recent years, investors, regulators, and other stakeholders across the globe – noting stronger communications and deeper engagement between audit committees and auditors – generally have expressed confidence in the quality of financial statement audits. That said, they also continue to engage in various projects to enhance audit quality and auditor independence, objectivity, and professional scepticism, including changes to the auditor’s reporting model, enhanced transparency, audit quality indicators, and others.

Audit committees should stay apprised of these initiatives (and consider sharing their views with regulators, as appropriate), and understand the implications for the company’s audit (including multinational audit activities) and the audit committee’s oversight role and interaction with auditors. The audit committee should always take the lead role in helping to ensure audit quality.

### Assessment of audit effectiveness

In the current environment, many audit committees are considering how they should discharge their responsibilities in relation to the effectiveness and efficiency of the external audit arrangements. Tendering is by no means the only available option under this responsibility – audit committees are capable of evaluating the performance of their external auditors and holding them accountable for the performance of their professional duties.

In this respect, it is important to give the external auditor clear performance objectives and evaluate the auditor against those objectives. Audit committees should work with the external auditor to develop clear performance objectives against which the committee will evaluate the auditor's performance in the coming year, and then evaluate the auditor accordingly.

A review of the audit process, the effectiveness and performance of the audit team, and the output, quality and cost effectiveness of the audit is considered corporate governance good practice since many years already. Not only does such a review help optimise the performance of auditors; it also encourages good communication between the auditor and the audit committee.

Such a review should evaluate the relationship between the auditor and executive management and ensure that an appropriate balance exists. The relationship should not be so close as to put at risk the auditor's independence and objectivity yet, at the same time, should be such that management and auditors can work together in an environment of constructive challenge.

**“A good auditor is constructive, but critical. Reasoned, but concise explanation of judgements adds real value.”**

UK Audit Committee Chair

In determining the effectiveness of the external auditor, the audit committee should have full regard to the auditor's competence, the quality and efficiency of the audit, and whether the audit fee is appropriate in relation to size, complexity, and risk and control profile of the company. The committee might consider:

- ensuring the external auditor has met the agreed audit plan. Understanding the reasons for any changes, including changes in perceived audit risks and the work undertaken by the auditor to address those risks;

- the robustness and perceptiveness of the auditor in handling the key accounting and audit judgements identified, responding to questions from the audit committee, and commenting where appropriate on the systems of internal control;
- obtaining feedback about the conduct of the audit from key stakeholders such as the CFO and chief internal auditor;
- the views of shareholders;
- the timeliness and quality of communication between the external auditor and the audit committee – including, where appropriate, audit highlights memoranda, reports on control weaknesses, conduct during audit committee meetings and ad hoc communications between meetings.

### Drivers of audit quality – *ACI Global Boardroom Insights 5 – The Future of Audit – 2015*

*Professional skepticism and training* – Put forward as the pinnacle drivers of audit quality: audit teams and partners bringing the skills, independent discussion and challenge to the company.

*Robust focus on critical areas of risk* – Risk-oriented audit plans and approaches that are articulated and addressed rigorously.

*Open and transparent communication with the audit committee* – Auditors and audit committees communicating through open and frank dialogue where sensitive or difficult matters can be aired, and where expectations can be established and reinforced.

*Linkage between internal and external audit* – Fundamental for the audit committee in seeking to ensure that key areas of risk – financial or otherwise – are subject to some assurance.

*Value beyond the statutory audit scope* – Bringing wider perspectives to the table: benchmarking industry and other relevant information, leveraging audit work to help companies understand the strategic risks they face and offering perspectives on financial information outside the statutory annual report.

*Innovation* – The use of big data and analytics – allowing testing of larger populations versus small samples, supporting better identification of high risk audit areas, and bringing value to companies through the benchmarking opportunities it offers. Auditors, however, should not compromise on genuine understanding of the business and the financials when computers are doing a progressively larger part of the work.

## Audit Quality Framework

The framework depicted below provides an overview of the key drivers of audit quality and is a useful tool in assisting audit committees in both evaluating audit proposals and undertaking annual assessments of the effectiveness of external audits.

Driver	Indicator
<p><b>The culture within an audit firm</b></p>	<p>The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm:</p> <ul style="list-style-type: none"> <li>— Creates an environment where achieving high quality is valued, invested in and rewarded.</li> <li>— Emphasises the importance of ‘doing the right thing’ in the public interest and the effect of doing so on the reputation of both the firm and individual auditors.</li> <li>— Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise.</li> <li>— Ensures financial considerations do not drive actions and decisions having a negative effect on audit quality.</li> <li>— Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgement.</li> <li>— Ensures robust systems for client acceptance and continuation.</li> <li>— Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing.</li> <li>— Ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.</li> </ul>
<p><b>The skills and personal qualities of audit partners and staff</b></p>	<p>The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> <li>— Partners and staff understand their clients’ business and adhere to the principles underlying auditing and ethical standards.</li> <li>— Partners and staff exhibit professional scepticism in their work and are robust in dealing with issues identified during the audit.</li> <li>— Staff members performing detailed ‘on-site’ audit work have sufficient experience and are appropriately supervised by partners and managers.</li> <li>— Partners and managers provide junior staff with appropriate ‘mentoring’ and ‘on the job’ training.</li> <li>— Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.</li> </ul>

### The effectiveness of the audit process

An audit process is likely to provide a positive contribution to audit quality where:

- The audit methodology and tools applied to the audit are well structured and:
  - Encourage partners and managers to be actively involved in audit planning.
  - Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently.
  - Require appropriate audit documentation.
  - Provide for compliance with auditing standards without inhibiting the exercise of judgement.
  - Ensure there is effective review of audit work.
  - Audit quality control procedures are effective, understood and applied.
- High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with.
- The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor.
- The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.

### The reliability and usefulness of audit reporting

Audit reporting is likely to provide a positive contribution to audit quality where:

- Audit reports are written in a manner that conveys clearly and unambiguously the auditor's opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations.
- Auditors properly conclude as to the truth and fairness of the financial statements.
- Communications with the audit committee include discussions about:
  - The scope of the audit.
  - The threats to auditor objectivity.
  - The key risks identified and judgements made in reaching the audit opinion.
- The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting.

<p><b>Factors outside the control of auditors</b></p>	<p>Factors outside the control of auditors which are likely to make a positive contribution to audit quality include:</p> <ul style="list-style-type: none"> <li>— An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process.</li> <li>— Audit committees that are active, professional and robust in dealing with issues identified during the audit.</li> <li>— Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period.</li> <li>— Appropriate agreed arrangements for any limitation of liability.</li> <li>— An audit regulatory environment that focuses on the drivers of audit quality.</li> </ul>
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**Appendix 18**, Evaluation of the external auditor, provides a framework for an audit committee to carry out a formal review of the effectiveness and efficiency of the external auditor. Such a review provides the audit committee with a disciplined approach to monitoring the auditor’s performance.

**“high level of reliability, based on performance against clearly-defined expectations, meaningful and close communication, as well as delivering high level of audit quality is essential in the external auditor’s role in supporting the audit committee.”**

UK Audit Committee Chair

### **Safeguarding auditor independence**

The external auditor should remain independent and objective at all times. The audit committee should, at least annually, consider the external auditor’s independence and carry out procedures to help ensure the auditor’s independence and objectivity, taking into consideration relevant professional and regulatory requirements. For its part, the audit firm should have internal policies and procedures in place, which are properly monitored, to establish that the audit firm and its individual members are independent from the organisation.



In considering matters that may bear on the auditor's independence, both the auditor and the audit committee should consider whether conflicts exist, such as:

- the auditor holding a financial interest, either directly or indirectly, in the organisation;
- personal and business relationships of the auditor's immediate family, close relatives and partners with the organisation;
- the nature of the relationship between the audit partner and the CEO and/or the CFO;
- economic dependence by the auditor through its relationship with the organisation; and
- the nature and extent of services provided by the auditor in addition to the audit engagement.

Each year, the audit committee should obtain from the audit firm information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners. The audit committee should understand the audit firm's plans for audit partner rotation on its engagement and engage in discussions relating to succession.

#### *Employment of former employees of the external auditor*

The audit committee should agree on a policy for the employment of former employees of the external auditor, taking into account the relevant ethical guidelines governing the regulations profession and any local regulation or recommendations.

The audit committee should monitor application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the organisation, and consider whether, in the light of their employment, there has been any impairment, or appearance of impairment, of the auditor's judgement or independence.

Particular attention should be given to members of the audit team moving directly to the organisation and former employees moving into financial oversight positions within the organisation. In both cases, the audit committee should consider 'cooling off' periods are necessary or legally required.

An example policy on employing former employees of the external auditor can be found at **Appendix 19**.

### *Pre-approving non-audit services*

To help ensure that non-audit services provided by the auditor do not impair, or appear to impair, the auditor's independence or objectivity, the audit committee should develop a policy on the provision and pre-approval of all non-audit services, taking into account any national regulations that restrict non-audit services provided by the external auditor. In determining the policy, the audit committee should consider the skills and experience of the audit firm, the potential threats to the auditor's independence and objectivity, local regulations and recommendations, and any controls put in place by the company and the auditor to mitigate such threats. The policy should indicate the prohibited services, the services that are permissible after evaluation and approval of the audit committee and the services for which no evaluation and approval by the audit committee is required.

In principle, the audit committee should not agree to the auditor providing a service if:

- The audit firm or a member of the audit firm has a financial or other interest that might cause him or her to be reluctant to take action that would be adverse to the interests of the audit firm or a member of the engagement team (*self-interest threat*);
- The results of the non-audit service performed by the audit firm may be included in the company's accounts, and thus no proper audit review can be performed (*self-review threat*);
- The auditor undertakes work that involves making judgements and taking decisions that are the responsibility of management (*management threat*);
- The audit firm undertakes work that involves acting as advocate for the company and supporting a position taken by management in an adversarial context (*advocacy threat*);
- The auditor is predisposed, for example because of a close personal or family relationship, to accept or not sufficiently question the company's point of view (*familiarity threat*);
- The auditor's conduct may be influenced by fear or threats (*intimidation threat*).

The pre-approved policy devised by the audit committee should formally specify the types of non-audit work from which the external auditor should be excluded and the types of work for which the external auditor can be engaged. Regarding the pre-approval of certain types of work, it may be appropriate for the policy to allow pre-approval for certain types of work, detailed as to the particular service, perhaps subject to a fee determined by the audit committee. The pre-approval policy may

also require that some or all non-audit services be approved by the audit committee, or by one or more members of it, on a case by case basis. The subsequent provision of any service by the auditor should be presented for review at the next meeting of the audit committee. The company's non-audit services policy should be disclosed in the corporate governance section of its annual report.

An example policy on the provision of non-audit services by the external auditors can be found at **Appendix 20**.

### **Understanding the audit cycle**

Once the external auditor has been appointed, the audit committee should review and agree to the audit engagement letter, ensuring that it reflects the organisation's current circumstances.

#### *Timing considerations*

Sufficient time should be allowed to enable the audit committee to complete its review and engage in an appropriate dialogue with the auditor. An appropriate timetable should therefore be agreed upon up-front by the board, management and the auditor.

One would expect the relationship with the auditor to be such that, if there are serious concerns, the auditor will bring them to the audit committee's attention promptly.

#### *Reviewing the audit plan*

The audit committee needs to understand the scope of the audit and how it is to be approached. An effective way to achieve this is to hold a meeting with the auditor prior to the auditor finalising the audit plan. The discussions may uncover areas where the committee assumes that work is done but is not, and other areas where audit effort is directed but of which the committee may be unaware. Discussion should also focus on what the auditor considers to be the significant balances and the transactions posing the most risk.

The audit committee should determine that an appropriate audit plan is in place. It should carefully consider the appropriateness of the business risks identified by the external auditor and whether, because of the audit committee's own knowledge of the organisation's risk environment, other risks should also be taken into account.

This focus applies both at a strategic level – those risks that are fundamental to the achievement of the entity's strategy – and at the more detailed operational level: those risks that affect day-to-day operations, the recognition of revenue and costs, the custody and value of assets, and the completeness of recognition of liabilities.

In general terms, the audit committee should understand:

- the areas where the external auditor intends to perform detailed substantive testing and those areas where the auditor intends to rely on internal controls and perform less substantive testing;
- whether divisions or subsidiaries receive adequate coverage, particularly those that are remote either geographically or culturally; and
- whether other audit firms are involved in auditing specific geographic locations or group entities that might impact on the organisations overall risk profile.

The audit committee should also seek to understand whether, and to what extent, the external auditor is content to rely on the work of the internal auditors in support of their audit work, and should at least be reviewing the work of the internal auditor.

At the pre-audit planning meeting, the audit committee may determine that the external auditor should perform additional work to satisfy the needs of the organisation, such as increased internal control testing or aspects of the internal audit work. In such circumstances, the audit committee should consider the effect this may have on the effectiveness of the company's overall arrangements for internal control.

#### *Reviewing representations by management or the board*

The audit committee should review any written representations by management or the board.

Representation letters must cover matters such as:

- confirmation that all accounting records have been made available, all transactions properly recorded in the accounting records, and all other records and related information made available;
- management's plans or intentions that may affect the carrying value of assets and liabilities;
- knowledge of events occurring subsequent to the balance sheet date that would require adjustment to the financial statements;
- presentation and disclosure of the fair value measurement of material assets, liabilities and components of equity;
- knowledge of fraud, or suspected fraud, affecting the organisation;
- confirmation that the effects of uncorrected financial statement misstatements are immaterial; and
- confirmation that the information provided regarding related parties is complete.

The audit committee should give particular consideration to matters relating to non-routine or unusual issues. It should consider whether the information provided is complete and appropriate based on its own knowledge.

### *Reviewing audit findings*

The audit committee should review the external auditor's findings, including any changes in audit approach or any modification to the statutory audit report. In particular, the audit committee should review key accounting and audit judgements and discuss with the external auditor both major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved – obtaining explanations about why certain errors might remain uncorrected. Consideration of those issues that have subsequently been resolved and uncorrected misstatements that are not material in the context of the financial statements, can provide insight into the appropriateness of the system of internal control, or be indicative of management's approach to the preparation and presentation of financial information.

The audit committee should also have a frank and open dialogue around the quality and acceptability of corporate reporting, including, for example:

- the appropriateness of the accounting policies to the particular circumstances of the company;
- the timing of transactions and the period in which they are recorded;
- the appropriateness of accounting estimates and judgements;
- the potential impact of any uncertainties, including significant risks and exposures, such as pending litigation;
- material uncertainties that may cast doubt on the company's ability to continue as a going concern;
- the extent to which the financial statements are affected by unusual transactions;
- inconsistencies between the financial statements and any other information in the document containing the financial statements for example, narrative reporting;
- the overall balance and clarity of the financial statements; and
- the design and operation of the company's internal control and risk management systems (see below).

## Communication

The external auditor and audit committee should have a strong, candid relationship – anything less may limit the committee’s effectiveness in achieving its oversight responsibilities. The committee should establish that the auditor is directly accountable to the audit committee and, through it, to the governing body. The committee should make sure that its actions and communications with the auditor are consistent with this accountability. The audit committee should also be sure to communicate its expectations to the auditor, and that both parties understand and agree to those expectations.

It is good practice for the external auditor to attend all audit committee meetings at which the audited financial statements are discussed, and to attend governing body and other meetings when appropriate.

The chair of the audit committee should communicate with the audit partner prior to each audit committee meeting. This allows the chair and the audit partner to review agenda items, and should reduce any surprises arising at the committee meeting. Of course, if particularly controversial or difficult items are identified, the chair should also discuss these with management and consider the need to give advance warning to the other members of the audit committee.

Sufficient time should be allowed to enable the audit committee to complete its review and engage in an appropriate dialogue with the external auditor, including one or more discussions in camera. The governing body, management and the auditor should agree on an appropriate timetable.

Major issues should not be raised for the first time at the meeting at which the audit committee intends to recommend approval of the financial statements. While this notion may appear common sense, it is not always followed in practice and can create significant pressure on the committee. If the final audit committee meeting is to be conducted effectively, audit findings should be reviewed on an ongoing and timely basis, for example after any interim audit work. Issues can then be identified at an early stage and surprises reduced. The audit committee chair should talk with the external auditor in advance of each meeting so that the chair can direct the attention of the committee members to matters of substance on the agenda. The relationship with the external auditor should be such that if there are serious concerns the auditor will bring them to the audit committee’s attention promptly.

The external auditor is required to bring to the attention of those charged with governance – usually the audit committee – any unadjusted misstatements in the financial statements, other than those that are ‘clearly trifling’.

## Communications from external auditors

Revised International Statement on Auditing 260 *Communication with those charged with governance* (Revised ISA 260) formalises auditors' communications with those charged with governance in respect of the financial reporting process - for listed companies, this will usually be the audit committee. Matters to communicate include *inter alia*:

**The Auditor's Responsibilities in Relation to the Financial Statement Audit** – The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance;
- (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities; and
- (c) The planned scope and timing of the audit.

**Significant Findings from the Audit** – The auditor shall communicate with those charged with governance:

- (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, which is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
- (b) Significant difficulties, if any, encountered during the audit;
- (c) Unless all of those charged with governance are involved in managing the entity:
  - (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and
  - (ii) Written representations the auditor is requesting; and
- (d) Other matters, if any, arising from the audit that, in the auditor's professional judgement, are significant to the oversight of the financial reporting process.

**Auditor Independence** – In the case of listed entities, the auditor shall communicate with those charged with governance:

- (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and
- (b)
  - (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgement, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and
  - (ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

## Management letter

International Standards on Auditing require auditors to communicate appropriately to those charged with governance (the audit committee) and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgement, are of sufficient importance to merit their respective attention.

International Standards on Auditing acknowledge that external auditors only consider internal control and risk management systems to the extent necessary for them to form their opinion of the financial statements. However, where the auditor identifies deficiencies in internal control during their audit and judge such deficiencies to be significant, International Standards on Auditing require the auditor to report their findings in writing to the audit committee on a timely basis.

In this context, a significant deficiency in internal control is a deficiency or combination of deficiencies in internal control that, in the auditor's judgement, is of sufficient importance to merit the attention of the audit committee. A deficiency in internal control exists when:

- A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Where significant deficiencies in internal control are identified by the external auditor, the audit committee should expect to receive a description of the deficiencies and an explanation of their potential impact – including sufficient information to enable the audit committee (and management) to understand the context of the report, such as:

- The purpose of the audit was for the external auditor to express an opinion on the financial statements;
- The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and



- The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to the audit committee.

The audit committee should also expect the external auditor to report the following to management at an appropriate level of responsibility on a timely basis:

- significant deficiencies in internal control that the auditor has reported (or intends to report) to the audit committee (unless it would be inappropriate to communicate directly to management in the circumstances); and
- any other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgement, are of sufficient importance to merit management's attention.

Management should provide written responses to any recommendations made or issues raised by the external auditor and, as part of the ongoing monitoring process, the audit committee should review and monitor management's response to the auditors' findings and recommendations, to ensure that appropriate action is taken in a timely manner.

The management letter should also indicate:

- whether the external auditor has reviewed the work of the internal auditors; and
- whether, or to what extent, the external auditor is content to rely on the work of the internal auditors in support of external audit work.

The letter, with management responses, should be made available to the audit committee (in draft if necessary) in time before the annual report issuance date. If submitted in draft, a final version should be submitted to the audit committee as soon as possible thereafter, and preferably not later than two months after issuing an opinion on the financial statements.

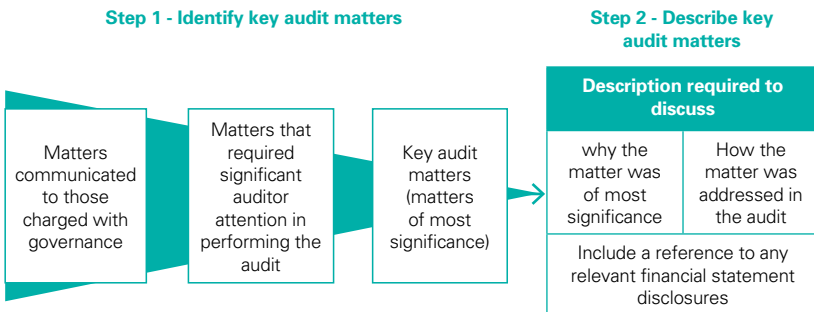
A specimen management letter is included in **Appendix 21**.

### Enhanced reports

Under International Standards on Auditing auditors are required to describe in the audit reports of listed entities the key areas they focused on in the audit and what audit work they performed in those areas (effective for annual periods ending on or after 15 December 2016) . They also have to provide transparency regarding the auditor’s and management’s responsibilities with respect to the audited financial statements.

Without changing the scope of an independent audit, the requirements force auditor to give users more insight into the audit and improve transparency. The most significant requirement is the requirement for the auditor to include descriptions of key audit matters in the audit report.

This requirement is designed to give the auditor the platform to highlight the matters they worried about most and focused on during the audit, and how they addressed these matters.



Key audit matter descriptions are written by the auditor based on their judgement, so the way in which similar key audit matters are described may vary from auditor to auditor. A key audit matter description would generally meet the objectives of the requirements if it includes the following features.

- Fact based
- Tailored to the company
- Concise and free from technical jargon
- Sufficient detail to understand how the matter was addressed.

Boilerplate text would obviously not meet the requirements.

Auditors may have the primary responsibility for implementing the requirements, but they are relevant to and affect other stakeholders as well, in particular audit committee members. As audit committee members, you should to interact in-depth with the auditor, in particular in discussing the expanded auditor's report prior to release. This is in fact an opportunity to consider whether disclosures in the financial statements or elsewhere in the annual report and/or in other investor communications need refreshing, otherwise the auditor might be disclosing more information about an item than the company. Engaging in early and open communication with the auditor is crucial in this regard.

#### Relationship with the internal auditor

The audit committee should ensure that internal and external audit complement one another and that, where appropriate, they co-ordinate their audit effort and avoid duplication.

External auditors should be given access to the internal audit service's working papers and plans so that their work programmes can be adjusted accordingly and the extent of their reliance on the work of the internal audit service determined.

Copies of the internal audit service's reports should be available to the external auditors. The internal audit service should also receive copies of the external auditor's plans and management letters, and any other relevant reports.



## Chapter 9

# Communication with shareholders

**There are two main channels of communication between the audit committee and shareholders: the written report which forms part of the published financial statements, and the annual general meeting, at which the audit committee chair is generally available to answer questions.**

### Annual general meeting

It is becoming more and more usual, for the audit committee chair to have face-to-face contact with investors. However, any dialogue should generally be limited to questions about governance and the manner in which the financial statements are put together, rather than commercial questions which are better left to the executive directors.

### Annual reports

Most governance codes and regulations have for some time contained disclosure recommendations/requirements relating to how an audit committee discharges its duty. However, since the financial crisis there has been considerable international debate around the need for greater transparency about the auditor/audit committee relationship and in particular about the judgements made in the course of preparing and auditing financial statements.

In this context, where the board (or audit committee) reports on how the audit committee has discharged its duties, consideration could also be given to disclosure of *inter alia*:

- the names and qualifications audit committee members (ie, why these individuals are the right people for the audit committee);
- the number of audit committee meetings;
- a summary of the audit committee's remit and how it addresses that remit during the year;
- the reasons for the absence of an internal audit function if no such function exists;
- the significant issues the audit committee considered in relation to the financial statements and how these issues were addressed, having regard to matters communicated to it by both management and the auditors;
- confirmation that a robust going concern risk assessment has been made together with information on the material risks to going concern which have been considered by the board/audit committee and, where applicable, how they have been addressed;
- the approach taken to the appointment or reappointment of the external auditor, including:
  - an assessment of the effectiveness of the external audit process (and internal audit process where relevant);
  - the steps taken in deciding whether or not to recommend that the audit be put out to tender, when a tender was last carried out and the tenure of the current audit firm;

- whether and when the organisation intends to put the audit out to tender in the foreseeable future;
- where the board does not accept the audit committee's recommendation on the appointment or reappointment of the auditor, an explanation of the committee's recommendation and the reasons why the board has taken a different position; and
- if the external auditor provides non-audit services, how auditor objectivity and independence is safeguarded.

Example disclosures are shown in **Appendix 22**.

The Enhanced Disclosure Working Group of the Global Auditor Investor Dialogue published comprehensive guidelines to both assist boards and audit committees when preparing their reports; and also help investors and shareholders who are being increasingly challenged to engage on audit and corporate reporting issues. The *'Audit Committee Reports: Global Disclosure Guidelines'* are reproduced below. The Audit Committee Report Disclosure Checklist appended to the guidelines is reproduced in **Appendix 23**.

## Global guidelines for enhanced disclosure

### **Guideline 1 – Substance not form**

The audit committee should provide a non-boilerplate report that provides a useful and engaging account of its activities, giving informative emphasis to key audit issues and how they are managed. For example providing specific information about:

- key areas of judgements and estimates used for the preparation of the financial statements;
- the use of experts to cover specific issues;
- any incidents of disagreements with management and/or the auditors; and
- any fraud that was brought to the committee's attention will help to achieve this.

All members of the committee, and particularly the chair, are encouraged to take an active role in writing the audit committee report.

### **Guideline 2 – Audit committee charter**

The board and audit committee should undertake annually a considered and in depth review of the audit committee charter, which should be disclosed on the company's website and, where appropriate, be included in the proxy statement, and satisfy themselves that it provides the terms of reference to enable the audit committee to fulfil its responsibilities.

<sup>3</sup> The Global Auditor Investor Dialogue is an informal forum whose members comprise the major global auditing networks and leading global investors and share owners. The Global Disclosure Guidelines (October 2011) may or may not represent the views of the individual Dialogue members.

The board and the audit committee should disclose that the charter has been reviewed and summarise any changes that have been made to enable the audit committee to fulfil its responsibilities. The audit committee should confirm that it has fulfilled its responsibilities under its charter.

The audit committee should confirm that its charter permits it to obtain independent external advice at the company's expense. It should disclose whether or not it has obtained such advice.

### **Guideline 3 – Audit committee membership**

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

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

### **Guideline 4 – Information flows to the audit committee**

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

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

### **Guideline 5 – Risk and internal controls**

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

### **Guideline 6 – Valuation of assets and liabilities**

The audit committee should confirm that the significant assumptions used for determining fair values have been disclosed, scrutinised and, where appropriate, challenged by the audit committee, and that they have satisfied themselves that the auditors have brought to bear an appropriate degree of professional scepticism in fulfilling their responsibilities. In addition, the audit committee should confirm that they have satisfied themselves that the markets and/or models to which the valuations are marked have liquidity and transaction profiles that are adequate and sufficiently robust for enabling reliable and relevant valuations to be determined. Also, that they are satisfied that there is meaningful disclosure of critical judgements and key estimates.

**Guideline 7 – Write-downs and impairment provisions**

The audit committee should provide a brief, informative discussion of the factors which they have taken into account and the considerations they have made when fulfilling their responsibilities in respect of endorsing material write-downs and impairment provisions. Also, the audit committee should confirm that they have satisfied themselves that the auditors have fulfilled their verification responsibilities with diligence and professional scepticism.

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

**Guideline 8 – Securitisation, off-balance sheet and contingent liabilities**

The audit committee should satisfy itself that all material securitisation arrangements, off-balance sheet liabilities and contingent liabilities have been identified for financial reporting purposes and that they are disclosed in sufficient detail in the financial statements.

The audit committee should critically assess and, when appropriate, challenge the valuations ascribed to these liabilities, and the methodologies used to determine them, to satisfy itself that the valuations used are fair and reasonable. The audit committee report should contain a meaningful description of the work it has undertaken in this regard.

**Guideline 9 – Internal and external auditors**

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

In addition, the audit committee should provide an informative account regarding the controls over non-audit services and a commentary on the level and nature of non-audit services provided.

The audit committee should state how long the audit firm has been retained as auditor to the company, and it should set out its policy in respect of putting the audit out to tender, confirming that it has complied or otherwise with that policy.

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

**Guideline 10 – Audit planning and main audit issues**

The audit committee should provide an engaging and informative account of how it has fulfilled its responsibilities in respect of audit planning by both the internal and external auditors. The audit committee should disclose whether or not it has met with the auditors of the key subsidiaries and/or joint ventures.



The audit committee should report, subject to issues of commercial confidentiality, on the nature of the main audit issues arising and how they have been resolved.

The audit committee should confirm that it has considered internal control and risk issues that have been brought to its attention by the internal and external auditors. It would be helpful to shareowners and investors to have some indication as to the nature of the issues arising. The audit committee should state that it is satisfied that management has addressed the issues or has plans to do so.

**Guideline 11 – Executive compensation and risk**

When addressing the financial crisis, many regulators, commentators and others have called into question executive compensation policies and practices which may incentivise executive behaviour that has been counter-productive to maintaining a well controlled, sustainable enterprise. Determining compensation and remuneration policies and practices is the responsibility of compensation and remuneration committees, and the audit committee should assist these committees in ensuring that compensation policies and practices are consistent with an effective control environment. In particular, the board and/or the audit committee should satisfy itself that key finance, control and risk management personnel have appropriate performance incentives. In fulfilling this responsibility, regard should be had to KPIs, as referred to in Guideline 5 (Risk and internal controls).

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

If this disclosure is provided by the compensation or remuneration committee, this should be referred to in the audit committee report.

## Appendix 1

# The global regulatory landscape

Matrix of regulatory framework and key features of audit committees

Area	Basis	Regulatory framework	Oversight responsibilities
<b>European Union</b>	2014 EU Directive and Regulation <sup>4</sup>	<p>Provisions affecting audit committees are contained in both a 2014 Directive and Regulation.</p> <p>The Directive states that EU member states shall ensure that each public-interest entity (PIE) has an audit committee. The audit committee shall be either a standalone committee or a committee of the administrative body. However, the functions assigned to the audit committee may be performed by the administrative body as a whole and member states have certain options to decide that certain PIEs are not required to have an audit committee.</p> <p>The Regulation contains a number of monitoring, reporting and approval provisions requiring oversight by audit committees of PIEs specifically related to external audit oversight.</p>	<p>The EU Directive states that audit committees shall:</p> <ul style="list-style-type: none"> <li>— Inform the administrative body of the outcome of the statutory audit and explain the role of the audit committee in that process;</li> <li>— Monitor the financial reporting process and submit recommendations or proposals to ensure its integrity;</li> <li>— Monitor the effectiveness of the internal quality control, risk management systems and internal audit (where applicable), regarding the financial reporting of the audited entity, without breaching its independence;</li> <li>— Monitor the performance of audits – taking into account the findings and conclusions of the audit reviews carried out by the competent authorities;</li> <li>— Review and monitor the independence of the statutory auditors; and</li> <li>— Be responsible for the procedure for the selection of the statutory auditor.</li> </ul>

<sup>4</sup> [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0196.01.ENG&http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.158.01.0077.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG&http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0077.01.ENG).

Matrix of regulatory framework and key features of audit committees		
Area	Audit oversight and selection	Composition and expertise
<b>European Union</b>	<p>The Regulation sets out specific activities required of a PIE's audit committee relate to the external auditor. The audit committee shall:</p> <ul style="list-style-type: none"> <li>— Monitor the statutory audit fees– including the 70% fee cap for permitted non-audit services;</li> <li>— Oversee the process by which the statutory auditor assesses the provision of permitted services;</li> <li>— Assess the threats to independence and the safeguards that the statutory auditor will apply to mitigate these threats, before approving permitted services. All permitted services require approval from the audit committee following this assessment.</li> <li>— Issue guidelines and appropriate policy in relation to (potentially) permitted services – e.g., in relation to certain tax services and valuation services – provided that they are immaterial, comprehensively documented and independent.</li> <li>— Assess and recommend potential statutory auditors. The audit committee is responsible for the procedure and recommendation for the selection of the statutory auditors. The recommendation should consist of two choices for the audit engagement and the justified preference for one of them. Tender documents should contain transparent and non-discriminatory selection criteria to be used for the evaluation of proposals. The audited entity has to prepare a report on the conclusions of the selection procedure, which is validated by the audit committee.</li> <li>— Recommend extension of audit tenure only if appropriate. The maximum initial period (of up to 10 years) may be extended (for member states that opt to permit extension) only if the audit committee recommends at the general meeting of shareholders that the engagement be renewed, and the proposal is approved.</li> <li>— Monitor auditor independence. The statutory auditor should confirm its independence annually to the audit committee of the audited entity and discuss any threat to its independence as well as the safeguards applied to mitigate those threats.</li> </ul>	<p>Provisions covering the make-up of the audit committee in the Directive are as follows:</p> <ul style="list-style-type: none"> <li>— The audit committee should be composed of independent non-executive members of the administrative body.</li> <li>— A majority of the members of the audit committee have to be independent of the audited entity. Audit committee members can be directly appointed at the annual general meeting.</li> <li>— At least one member of the audit committee has to have competence in accounting and/or auditing.</li> <li>— The committee as a whole should have competence relevant to the sector in which the company has its business.</li> <li>— The chair of the audit committee is appointed by its members or by the administrative body. Member States can opt to require the Chairman be elected annually by the shareholders general meeting.</li> </ul>

Matrix of regulatory framework and key features of audit committees			
Area	Basis	Regulatory framework	Oversight responsibilities
<b>United States</b>	<p>Sarbanes Oxley Act &amp; Rules</p> <p>NYSE &amp; NASDAQ listing requirements</p>	<p>The Sarbanes Oxley Act (SOX) prescribes the regulatory requirements for audit committees as to creation, qualifications of members and oversight responsibilities, among others. The Act mandates national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements on audit committees.</p>	<p>Audit committees have the following oversight responsibilities:</p> <ul style="list-style-type: none"> <li>— Oversee the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer (SOX);</li> <li>— Establish procedures for the receipt, retention and treatment of complaints regarding accounting internal accounting controls or auditing matters for the confidential, anonymous submission by employees of concerns regarding accounting or auditing matters (SOX);</li> <li>— Oversee related party transactions and code of conduct compliance by senior management (NYSE &amp; NASDAQ);</li> <li>— Oversee internal audit function (NYSE).</li> </ul>

Matrix of regulatory framework and key features of audit committees		
Area	Audit oversight and selection	Composition and expertise
<b>United States</b>	<p>The SOX and its rules set out specific activities required of a listed company's audit committee relating to the external auditor. The audit committee shall be responsible for the following audit oversight activities:</p> <ul style="list-style-type: none"> <li>— Appointment, setting the compensation and retention of the external auditor;</li> <li>— Overseeing the work of the external auditor in preparing and issuing any audit report including resolving any disagreements between the management and the audit firm regarding financial reporting;</li> <li>— Approval of all audit services and non-audit services;</li> <li>— Evaluation of reports of external auditor on the following matters: (1) all critical accounting policies and practices to be used; (2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and (3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.</li> </ul>	<p>Each audit committee must be composed of at least three members.</p> <p>Each member of the audit committee shall be a member of the board of directors, and shall otherwise be independent. In order to be considered to be independent, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:</p> <ul style="list-style-type: none"> <li>(i) accept any consulting, advisory, or other compensatory fee from the issuer; or</li> <li>(ii) be an affiliated person of the issuer or any subsidiary thereof.</li> </ul> <p>Additional independence requirements under NASDAQ requirements – The member must not have participated in the preparation of the financial statements of the company or any current subsidiary at any time during the past three years.</p> <p>At least one member of the audit committee must be a financial expert or a person who has an understanding of financial statements and GAAP; experience in preparing, auditing, analyzing or evaluating financial statements of companies comparable to the company or experience in actively supervising one or more persons engaged in such activities; experience in applying GAAP to accounting for estimates, accruals and reserves; and an understanding of internal accounting controls, procedures for financial reporting and the functions of audit committees.</p>

Matrix of regulatory framework and key features of audit committees			
Area	Basis	Regulatory framework	Oversight responsibilities
<b>Asia Pacific</b>	Codes and Rules	<p>The implementation of corporate governance regulations in the Asia Pacific region operates generally on a 'comply or explain' approach.</p> <p>Covered companies are mandated to benchmark their governance practices against those set in the codes or rules and if they do not conform, they must disclose that fact and the reasons why.</p> <p>One of the core governance practices provided in the codes or rules in the region is the creation of an audit committee.</p>	<p>The commonly specified areas where oversight function is exercised by audit committees are financial reporting, external audit and internal controls. The oversight responsibility involves the review of the adequacy and appropriateness of the systems and processes in financial reporting and internal controls including the estimates and standards adopted by the management in the preparation of the financial statements. It likewise includes the responsibility to make recommendations on the appointment, re-appointment and removal or rotation of the external auditor.</p> <p>Less than majority in the Asia Pacific region adopted a detailed description of the oversight responsibilities of audit committees and included the review of risk policies and management as part thereof.</p> <p>A separate risk management committee is recommended for some type of entities such as financial institutions given the nature of their business.</p>

Matrix of regulatory framework and key features of audit committees		
Area	Audit oversight and selection	Composition and expertise
<b>Asia Pacific</b>	<p>The role of the audit committee is usually to review and make recommendations to the board in relation to:</p> <ul style="list-style-type: none"> <li>— the appointment or removal of the external auditor;</li> <li>— the rotation of the audit engagement partner;</li> <li>— the scope and adequacy of the external audit;</li> <li>— the independence and performance of the external auditor; and</li> <li>— any proposal for the external auditor to provide non-audit services and whether it might compromise the independence of the external auditor.</li> </ul>	<p>The required composition of the audit committee varies from one jurisdiction to another. Majority prescribes that all members must be non-executive directors (NEDs) with half of them independent directors (IDs). Some countries do not mandate NED members but require that majority of them be independent directors.</p> <p>Under OECD Principle VI, being used as a reference to the ASEAN Corporate Governance Scorecard, the Board should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest.</p> <p>Common to all jurisdictions in the region is the qualification of the Chair of the audit committee who must be an independent director. Likewise, most codes specify the need for at least one or more members with accounting or finance expertise or experience considering that the key responsibilities of the committee involve the exercise of such technical skills and knowledge.</p>

## Appendix 2

# Example audit committee terms of reference

### **A. Membership**

Members of the committee shall be appointed by the board, on the recommendation of the nomination committee in consultation with the chair of the audit committee.

The committee shall be made up of at least three members of the board of directors.

All members of the committee shall be non-executive directors, at least a majority of whom shall be independent and at least one of whom shall have relevant experience in finance, accounting and/or auditing. The chair of the board shall not be a member of the committee. The audit committee as a whole shall have sufficient relevant expertise, notably in accounting, auditing and finance and competence relevant to the sector in which the company operates.

Only members of the committee have the right to attend committee meetings. However, other individuals such as the chair of the board, chief executive, finance director, other directors, the heads of risk, compliance and internal audit and representatives from the finance function may be invited to attend all or part of any meeting as and when appropriate.

The external auditors will be invited to attend meetings of the committee on a regular basis.

Appointments to the committee shall be for a period of up to four years, which may be renewed, provided the director remains independent.

The board shall appoint the committee chair who shall be an independent non-executive director. In the absence of the committee chair and/or an appointed deputy, the remaining members present shall elect one of themselves to chair the meeting.

### **B. Secretary**

The company secretary or their nominee shall act as the secretary of the committee.

### **C. Quorum**

The quorum necessary for the transaction of business shall be 2 members. A duly convened meeting of the committee at which a quorum is present shall be competent to exercise all or any of the authorities, powers and discretions vested in or exercisable by the committee.



#### **D. Frequency of meetings**

The committee shall meet at least four times a year at appropriate times in the reporting and audit cycle and otherwise as required.

#### **E. Notice of meetings**

Meetings of the committee shall be called by the secretary of the committee at the request of any of its members or at the request of external or internal auditors if they consider it necessary.

Unless otherwise agreed, notice of each meeting confirming the venue, time and date together with an agenda of items to be discussed, shall be forwarded to each member of the committee, any other person required to attend and all other non-executive directors, no later than 5 working days before the date of the meeting. Supporting papers shall be sent to committee members and to other attendees as appropriate, at the same time.

#### **F. Minutes of meetings**

The secretary shall minute the proceedings and resolutions of all meetings of the committee, including recording the names of those present and in attendance.

The secretary shall ascertain, at the beginning of each meeting, the existence of any conflicts of interest and minute them accordingly.

Minutes of committee meetings shall be circulated promptly to all members of the committee and, once agreed, to all members of the board, unless a conflict of interest exists.

#### **G. Authority**

The committee is authorised:

- to seek any information it requires from any employee of the company in order to perform its duties;
- to obtain, at the company's expense, outside legal or other professional advice on any matter within its terms of reference;
- to call any employee to be questioned at a meeting of the committee as and when required;
- to appoint, compensate and oversee the work of any registered public accounting firm employed by the company;
- pre-approve all auditing and non-audit services;
- resolve any disagreements between management and the auditor(s) regarding financial reporting; and
- meet with company officers, external auditors, or outside counsel, as necessary.

#### **H. Duties**

The committee should carry out the duties below for the parent company, major subsidiary undertakings and the group as a whole, as appropriate.

##### *Corporate reporting*

The committee shall monitor the integrity of the financial statements of the company, including its annual and half-yearly reports, interim management statements, and any other formal announcement relating to its financial performance, reviewing significant financial reporting issues and any judgements which they contain. The committee shall also review summary financial statements, significant financial returns to regulators and any financial information contained in certain other documents, such as announcements of a price sensitive nature.

The committee shall review and challenge where necessary:

- the consistency of, and any changes to, accounting policies both on a year-on-year basis and across the company/group;
- the methods used to account for significant or unusual transactions where different approaches are possible;
- whether the company has followed appropriate accounting standards and made appropriate estimates and judgements, taking into account the views of the external auditor;
- the clarity of disclosure in the company's financial reports and the context in which statements are made; and
- all material information presented with the financial statements, such as the operating and financial review and the corporate governance statement (insofar as it relates to the audit, internal control and risk management);

#### *Internal controls and risk management systems*

The committee shall:

- at least once a year, monitor the effectiveness of the company's internal controls and risk management systems, with a view to ensuring that the main risks (including those relating to fraud and compliance with existing legislation and regulations) are properly identified, managed and disclosed;
- understand the scope of internal and external auditors' review of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management responses; and
- review the statements to be included in the annual report concerning internal controls and risk management systems.

#### *Whistle-blowing and fraud*

The committee shall:

- review the company's arrangements for its employees to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters. The committee shall ensure that these arrangements allow proportionate and independent investigation of such matters and appropriate follow up action whereby staff can inform the chair of the audit committee directly; and
- review the company's procedures for detecting fraud.

#### *Internal audit*

The committee shall:

- monitor and review the effectiveness of the company's internal audit function in the context of the company's overall risk management system;
- approve the appointment and removal of the head of the internal audit function;
- approve the internal audit charter;
- consider and approve the remit of the internal audit function and ensure it has adequate resources and appropriate access to information to enable it to perform its function effectively and in accordance with the relevant professional standards. The committee shall also ensure the function has adequate standing and is independent from management or other restrictions;
- review and assess the annual internal audit plan;
- review promptly all reports on the company from the internal auditors;

- review and monitor management’s responsiveness to the findings and recommendations of the internal auditor and all changes to the plan;
- review the effectiveness of the internal audit function; and
- meet the head of internal audit at least twice a year, without management being present, to discuss their remit and any issues arising from the internal audits carried out. In addition, the head of internal audit shall be given the right of direct access to the chair of the board and to the committee.

### *External audit*

The committee shall:

- consider and make recommendations to the board, to be put to shareholders for approval at the Annual General Meeting, in relation to the appointment, re-appointment or removal of the company’s external auditor. The committee shall oversee the selection process for new auditors and if an auditor resigns the committee shall investigate the issues leading to this and decide whether any action is required;
- oversee the relationship with the external auditor including (but not limited to):
  - approval of their remuneration, whether fees for audit or non-audit services and that the level of fees is appropriate to enable an adequate audit to be conducted;
  - approval of their terms of engagement, including any engagement letter issued at the start of each audit and the scope of the audit;
  - assessing annually their independence and objectivity taking into account relevant professional and regulatory requirements and the relationship with the auditor as a whole, including the provision of any non-audit services;
  - satisfying itself that there are no relationships (such as family, employment, investment, financial or business) between the auditor and the company (other than in the ordinary course of business);
  - agreeing with the board a policy on the employment of former employees of the company’s auditor, then monitoring the implementation of this policy;
  - monitoring the auditor’s compliance with relevant ethical and professional guidance on the rotation of audit partners, the level of fees paid by the company compared to the overall fee income of the firm, office and partner and other related requirements;
  - assessing their qualifications, expertise and resources and the effectiveness of the audit process which shall include a report from the external auditor on their own internal quality procedures; and
  - seeking to ensure co-ordination with the activities of the internal audit function;
- meet regularly with the external auditor, including once at the planning stage before the audit and once after the audit at the reporting stage. The committee shall meet the external auditor at least twice a year, without management being present, to discuss their remit and any issues arising from the audit;
- review and approve the annual audit plan and ensure that it is consistent with the scope of the audit engagement;
- review the findings of the audit with the external auditor. This shall include but not be limited to, the following:
  - a discussion of any major issues which arose during the audit;
  - any significant accounting and audit judgements; and
  - levels of errors identified during the audit;

- review any representation letter(s) requested by the external auditor before they are signed by management;
- review the management letter and management's response to the auditor's findings and recommendations;
- develop and implement a policy on the supply of non-audit services by the external auditor, taking into account any relevant ethical guidance on the matter.

### *Reporting responsibilities*

The committee chair shall report formally to the board on its proceedings after each meeting on all matters within its duties and responsibilities.

The committee shall provide an open avenue of communication between internal audit, the external auditors and the board of directors.

The committee shall make whatever recommendations to the board it deems appropriate on any area within its remit where action or improvement is needed.

The committee shall compile a report to shareholders on its activities to be included in the company's annual report.

### *Other matters*

The committee shall:

- have access to sufficient resources in order to carry out its duties, including access to the company secretariat for assistance as required;
- be provided with appropriate and timely training, both in the form of an induction programme for new members and on an ongoing basis for all members. The induction programme for new members should at least cover the audit committee's terms of reference and provide an overview of the company's internal control organisation and risk management systems. This induction should also include meeting the external auditor and the relevant company staff;
- be responsible for co-ordination of the internal and external auditors;
- oversee any investigation of activities which are within its terms of reference and act for internal purposes as a court of the last resort; and
- at least every two to three years, review its own performance, constitution and terms of reference to ensure it is operating at maximum effectiveness and recommend any changes it considers necessary to the board for approval.

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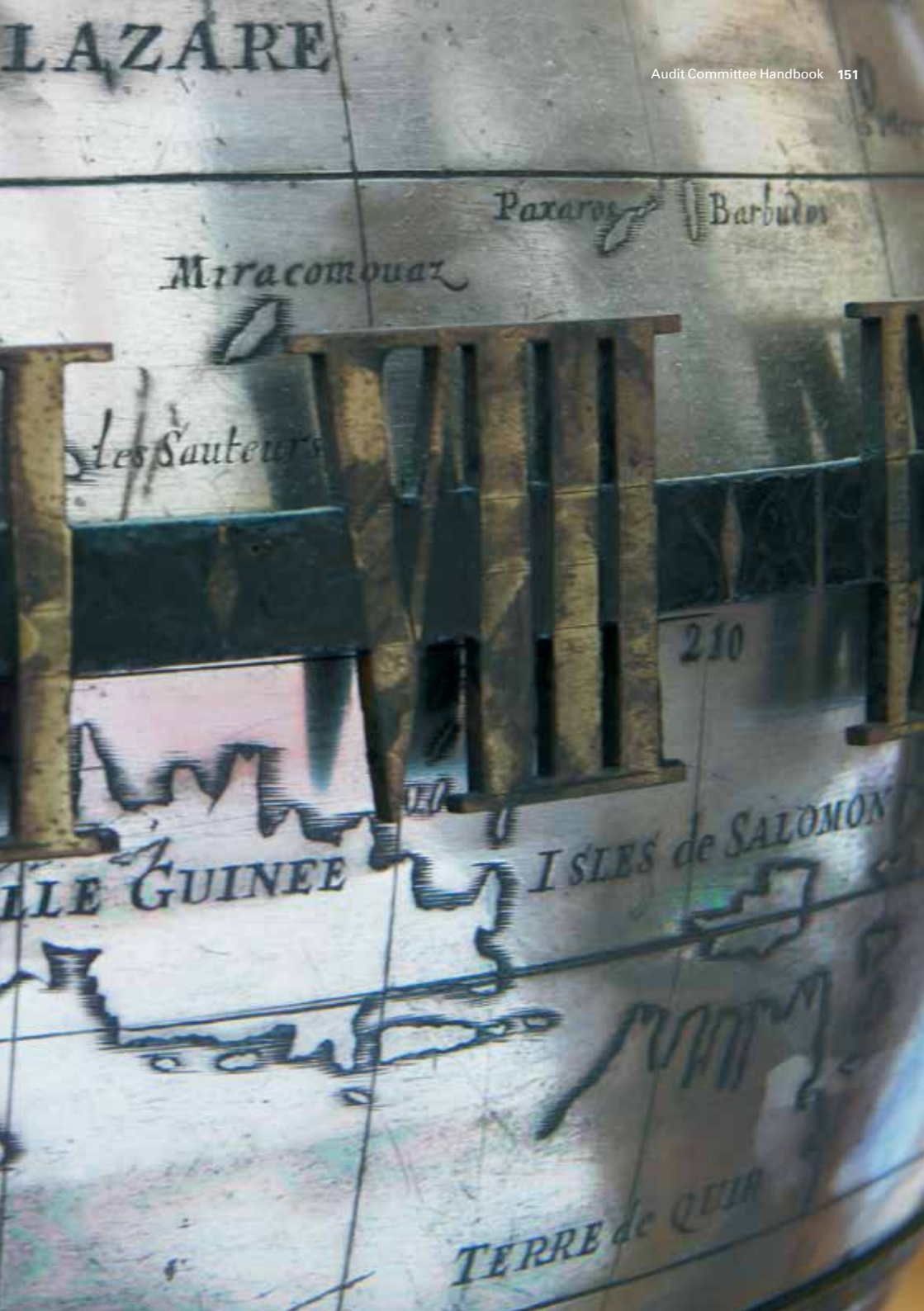
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## Appendix 3

# Potential audit committee topics

ACI's experience suggests that the following topics deserve consideration when establishing the detailed agendas for the audit committee meetings during the year.

### *Risk assessment*

- Risk management process and control (particularly financial reporting risks)
- Operating reviews
- Budget reviews
- Industry and market updates
- Review financial community expectations
- Information technology changes
- Legal briefings
- Understand senior management compensation programmes
- Executive sessions with appropriate senior management
- Current and emerging risk issues

### *Assess processes relating to the company's control environment*

- Compliance with code of ethical conduct
- Control policies and procedures (including earnings management, error and fraud)
- Management's assessment of key third-party providers
- Management's assessment of cyber security controls
- Internal and external auditor internal control observations and recommendations
- Compliance with specific industry regulations

### *Oversee financial reporting*

- Financial statements and earnings releases
- Recommend approval of financial statements to board of directors
- Periodic reports and filings
- Management overview of financial results for quarter/year
- Critical accounting policies
- Significant and unusual transactions and accounting estimates
- Current developments in auditing, accounting, reporting, and tax matters
- Executive session with senior management

### *Evaluate the internal and external audit processes*

- Coordination of the internal and external audit effort and definition of responsibilities
- External auditors
  - Engagement letter
  - Audit engagement team
  - Independence letter
  - Consider all significant non-audit services to be performed by the external auditor
  - Scope, procedures, and timing
  - Audit results
  - Audit reports
  - Quarterly review results
  - Meeting with external auditors
  - Management's responsiveness to audit results
  - Assess effectiveness
- Internal audit department
  - Assess need for internal auditing
  - Mandate and objectives
  - Appointment and compensation of chief auditor
  - Budget, staffing, and resources
  - Scope, procedures, and timing of the audits
  - Audit results
  - Audit reports
  - Meeting with internal auditors
  - Management's responsiveness to audit results
  - Assess effectiveness

### *Audit committee structure*

- Update mandate
- Assess audit committee performance

Appendix 4

# Audit committee meeting planner

This audit committee meeting planner pro-forma can be used to plan what gets addressed at each audit committee meeting. It should be tailored to suit the needs of each organisation.

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
<b>Constitution</b>							
Review audit committee's terms of reference	✓						
Review code of conduct	✓						
Assess independence, financial literacy skills and experience of members	✓						
Establish number of meetings for the forthcoming year	✓						
Audit committee chair to establish meeting agenda and attendees required			✓				
Enhance skills and experience – professional development			✓				



	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
<b>Corporate reporting</b>							
Hold in camera session with management		✓					
Review both corrected and uncorrected audit differences	✓						
Review new accounting and reporting developments			✓				
Review critical accounting policies and alternative accounting treatments	✓						
Review significant accounting judgements and estimates			✓				
Review large, unusual and complex transactions			✓				
Review and recommend approval of annual financial statements	✓						
Review the narrative sections of the annual report			✓				
Review and recommend approval of half year financial statements	✓						
Review and recommend approval of any earnings releases			✓				

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Review and recommend approval of any analyst briefings or investor presentations			✓				
<b>Risk management and controls</b>							
Evaluate the corporate culture and the 'tone from the top'			✓				
Review the process by which risk strategy and appetite are determined			✓				
Review and assess the risk management and internal control systems	✓						
Review weaknesses in internal control and management's remediation plan	✓						
Review anti-fraud and bribery programmes and the risk of management override			✓				
Review whistle-blowing arrangements			✓				
Assess crisis management and business continuity plans			✓				

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Understand management remuneration structures and the drivers of bias			✓				
Meet with the 'marzipan layer' (i.e. those below the executive tier)			✓				
Review reports from regulators and management's response			✓				
<b>External auditors</b>							
Recommend appointment and review performance			✓				
Approve audit fees and terms of engagement			✓				
Consider policy in relation to non-audit services			✓				
Consider hiring policy for former employees of the auditor			✓				
Consider objectivity/independence and obtain confirmation from auditor	✓						
Review audit plan and scope of audit work	✓						
Review external audit findings	✓						

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Discuss appropriateness of accounting policies, estimates and judgements			✓				
Discuss external auditors views on control environment	✓						
Discuss issues with auditor in absence of executives and management	✓						
Ongoing communication (written/oral) of external auditor with audit committee		✓					
<b>Internal auditors</b>							
Where no internal audit function, consider the need for an internal audit function	✓						
Recommend appointment and review performance	✓						
Review internal audit plan	✓						
Review significant internal audit reports and findings		✓					
Review progress on actions taken in response to the committee's representations		✓					

	Frequency			Scheduled meetings			
	At least annually	Quarterly	When necessary	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Discuss issues with auditor in absence of executives and management		✓					
<b>Other responsibilities</b>							
Review progress on actions taken in response to the representations of the auditors			✓				
Review legal and compliance developments			✓				
Review report to shareholders on role and responsibilities of the committee	✓						
Perform self assessment of audit committee performance			✓				
Assess the CFO and finance function			✓				
Review CFO and financial personnel succession planning			✓				
Work with the nomination committee to develop an audit committee succession plan			✓				
Conduct special investigations and perform other activities as appropriate			✓				
Provide appropriate induction for new members			✓				
Maintain minutes and report to board			✓				

## Appendix 5

# Private session with the auditor

**Most audit committees want to meet the external auditor in a private session where management is not present.**

Typically there should be few items to discuss. All key matters related to financial reporting should have been reviewed in a candid and robust manner with management, the audit committee and the auditor during the audit committee meeting. The audit committee can use the private session as a follow-up if members were not satisfied with the answers given at the audit committee meeting or if they thought discussions had been too guarded or uneasy. However, such matters should have been fully aired at the audit committee meeting and generally should not need to be readdressed in the private session.

Rather, the private session should focus on areas where the auditor can provide additional, candid, and often confidential, comments to the audit committee on other matters. The private session gives the audit committee an opportunity to explore such matters in a frank and open forum. In addition, the audit committee may have more knowledge than the auditor on other matters, and this session allows the audit committee an opportunity to talk to the auditor about them.

Overall, private sessions play an important role in the development of a trusting and respectful relationship between the audit committee and the auditor. Questions often focus on one or more of the following areas:

*Attitudes* – management’s attitude toward financial reporting, internal controls and the external auditor.

*Resources* – the adequacy of people and other resources in the financial management area and the internal audit function.

*Relationships* – the nature of the relationship between the auditor, management and the internal auditor.

*Other issues* – other issues of concern to the audit committee or the auditor.

The following is a list of illustrative questions. It is not an exhaustive list but is intended to stimulate thought as to the type of issues that could be raised with the auditor. Typically, each private session should address a few matters which may vary from meeting to meeting, in addition to any matters of current concern.

### *Attitudes*

- What is your assessment of the tone from the top?
- What is your assessment of the ethics, values and integrity of management?
- What do you believe are the reasons management did not adjust for the uncorrected audit differences?
- Does management have plans to correct these audit differences in the future?
- Was management fully supportive of the corrected audit differences?
- What is your assessment of the quality of the company's financial reporting, narrative reporting, and press releases?
- How does this company's attitude toward financial reporting compare to other companies?
- Is there excessive pressure on management or operating personnel to meet financial targets including sales or profitability incentive goals?
- Is there excessive pressure to meet unrealistic or aggressive profitability expectations by investment analysts or others?
- What is your assessment of management's attitude toward disclosure controls and internal control systems and procedures?

### *Resources*

- Do the finance and internal audit functions have the appropriate number of people?
- Do they have a sufficiently broad range of knowledge and experience to be able to deal with the types of transactions faced by the company?
- Are these people competent for their position? Do you have any concerns?
- Has management adequately responded to your management recommendations?
- Are there other areas where internal audit should focus its activities?
- If the company does not have an internal audit function, what is your assessment of the need to have one?

### *Relationships*

- Did you receive full cooperation during the audit and did you get full, honest answers to all questions that were asked?
- Was any information withheld from you?
- Was management forthcoming, open and candid in discussions with you?
- How are your relationships with financial management personnel? Internal audit? CEO? CFO?
- What was the nature of any consultations that were held with other accountants or auditors?

### *Other issues*

- Did you receive everything you requested on a timely basis?
- Did you have adequate time to carry out all your audit procedures?
- Is the audit fee at an appropriate level?
- On what issues was the most amount of audit time spent?
- What is the most complex issue that was encountered during the audit that has not been discussed at the audit committee meeting?
- What were the two or three issues that you spent the most amount of time discussing with management?

## Appendix 6

# Audit committee self assessment

This self assessment process focuses on your personal perception of the audit committee as a whole - it does not seek to evaluate individuals and their personalities.

The questionnaire takes about 30 minutes to complete and should be completed in the following manner:

- Using a scale of **1** (low) to **10** (high), complete each question by placing your score in the two boxes beside the question. **'Actual'** is your view of the current position of the audit committee on that issue. **'Ideal'** is the score that you would like to see. The difference will allow us to see the size of the issue and, therefore, its relative priority.  
You may wonder why we give you a choice of score on the **Ideal** position as you may think it should always be a ten. There are, however, occasions where, for example, you feel that the audit committee spends too much time and effort on an activity which should be done by someone else and in that case you would score the **Ideal** lower than ten. We would stress that the main reason for asking for the two scores is to see where the biggest gaps are between **Actual** and **Ideal** as this identifies where the committee's development priorities lie.
- There is a **Comments** space besides each question. This is for you to make any notes which you might wish to comment on during the later interview stage of the assessment exercise. You are, however, not obliged to make comments. We do appreciate that you may not always know the answer but the interview gives you an opportunity to seek clarification and to elaborate on the reasons for your scores.
- N/A can be used where you don't have a view on the matter in question, for example, an executive attending audit committee meetings will not necessarily have a view on all the questions e.g. the usefulness of private sessions with the auditors.
- All responses will be treated as anonymous.

Typical answers might look like this:

	Actual	Ideal	N/A	Comments
1. Audit committee members, both individually and collectively, understand what is expected of them and the committee?	8	10		<i>Several membership changes have altered the emphasis on what is important.</i>
2. Audit committee meetings allow sufficient time for the discussion of substantive matters?	7	10		<i>All agenda items are addressed but there is usually too little 'white space' to discuss last minute issues.</i>



**A. Creating an effective audit committee**

	Actual	Ideal	N/A	Comments
1. Appropriate steps have been taken by the audit committee / board to review / approve the committee’s terms of reference on a timely basis?				
2. Audit committee members, both individually and collectively, understand what is expected of them and the committee (e.g. how the committee supports the board in discharging its responsibilities with regard to financial reporting, risk management and control)?				
3. Audit committee members are independent of the organisation’s management and exercise their own judgement; voice their own opinions; and act freely from any conflicts of interest?				
4. The process by which audit committee members are appointed is appropriate?				
5. Appropriate succession planning is in place?				
6. Audit committee members, as a whole, have sufficient skills and experience notably in accounting, auditing and finance to undertake their duties?				
7. The audit committee includes at least one member with sufficient relevant accounting and auditing experience?				
8. The audit committee is not over reliant on any individual member (e.g. the committee member with recent and relevant financial experience)?				
9. Audit committee members have a sufficient understanding of the organisation and the sector in which it operates?				
10. Audit committee members demonstrate the highest level of integrity (including maintaining utmost confidentiality and identifying, disclosing and managing conflicts of interest)				
11. The level of ‘secretarial support’ placed at the audit committee’s disposal is appropriate?				
12. The process by which funds are made available to the audit committee to take independent legal, accounting or other advice (when it reasonably believes it necessary to do so) is appropriate?				

**B. Running an effective audit committee**

	Actual	Ideal	N/A	Comments
1. The audit committee chair’s leadership style attributes are appropriate (e.g. they are decisive, open minded and courteous; do they set a good example, allow members to contribute and hold members to high standards; do they relate well to other members/attendees, deal effectively with dissent and work constructively towards consensus)?				
2. The audit committee’s workload is dealt with effectively?				
3. Audit committee members work together constructively as a team?				
4. The audit committee maintains constructive working relationships with those individuals who attend audit committee meetings?				
5. The relationship between a) the audit committee and b) the CEO, CFO and members of the senior management team strikes the right balance between challenge and mutuality?				
6. The audit committee’s discussions enhance the quality of management’s decision making (e.g. the committee engages those reporting to the committee in dialogue that stimulates and enhances their thinking and performance)?				
7. The audit committee provides effective support to the board in fulfilling its responsibilities and adds value to the organisation?				
8. The audit committee’s work plan covers the committee’s main responsibilities and maps across to any regulatory requirements?				
9. The committee’s meeting arrangements (e.g. frequency, timing, duration, venue and format) enhance its effectiveness?				
10. Audit committee meetings allow sufficient time for the discussion of substantive matters?				
11. Audit committee meeting agendas and related background information are circulated in a timely manner to enable full and proper consideration to be given to the important issues?				

	Actual	Ideal	N/A	Comments
12. Audit committee papers are of an appropriate quality (e.g. not overly lengthy and clearly explain the key issues and priorities)				
13. Sufficient time is allowed between audit committee meetings and meetings of the full board to allow any work arising to be carried out and reported to the board as appropriate?				
14. Committee meetings are free from inappropriate management influence?				
15. All meeting attendees (e.g. audit committee members, executive directors, management and auditors) are appropriately involved in audit committee meetings?				
16. Appropriate arrangements are in place for the audit committee to meet with external / internal audit without management being present?				
17. Are private meetings with the internal and external auditors useful?				
18. The audit committee's meeting minutes are clear, accurate, consistent, complete and timely? They include key elements of debates and appropriate details of recommendations and any follow up action?				
20. Outstanding actions arising from audit committee meetings are properly followed up?				
21. The audit committee takes appropriate steps to ensure internal and external audit cooperate appropriately to ensure the completeness of assurance coverage?				
22. There is an appropriate dialogue between internal / external audit and management? Is 'bad news' communicated to the audit committee in a timely manner?				
23. Appropriate processes are in place for ensuring the audit committee is kept fully informed on all material matters between meetings (including appropriate external information e.g. on emerging risks and material regulatory changes)?				
23. The audit committee reports to the board on a timely and accurate basis and such communications are comprehensive, meaningful and focused?				

**C. Professional development**

	Actual	Ideal	N/A	Comments
1. New audit committee members are given an appropriate induction covering issues like: the role of the audit committee; its terms of reference; members' expected time commitment; an overview of the organisation; and the main operational and financial dynamics and risks?				
2. The ongoing professional development received by the audit committee (e.g. regulatory matters, accounting and financial reporting, audit and risk) is both appropriate and timely?				
3. Audit committee members are given appropriate opportunities to attend formal courses and conferences, internal talks and seminars, and briefings by external advisers such as the auditors and legal advisers?				
4. The induction and professional development programmes adequately equip audit committee members to understand the business environment in which organisation operates?				

**D. Overseeing financial reporting**

	Actual	Ideal	N/A	Comments
1. Appropriate processes and audit programmes are in place to enable members to understand: <ul style="list-style-type: none"> <li>• the appropriateness of the organisation's critical accounting policies, estimates and judgements?</li> </ul>				
<ul style="list-style-type: none"> <li>• the clarity and completeness of disclosures in the financial statements?</li> <li>• the impact on the financial statements of any developments in accounting standards or generally accepted accounting practice?</li> </ul>				
2. The audit committee robustly challenges the proposed financial reporting and seeks appropriate changes where necessary?				
3. The audit committee understands the risks of management bias inherent within the financial statements and other documents within its remit?				

**E. Overseeing risk management and internal control**

	Actual	Ideal	N/A	Comments
1. The audit committee fully understands its role in providing oversight over internal financial controls; the wider aspects of internal control; and risk management systems?				
2. Does the audit committee understand the organisation's risk appetite for each material category of risk falling within the committee's remit?				
3. Does the audit committee have an appropriate understanding of the processes in place to identify, evaluate and monitor the key risks facing the organisation?				
4. Appropriate processes are in place to enable the audit committee to understand how each material risk will impact the organisation's operations and financial condition?				
5. Appropriate processes are in place to monitor changes in the organisation's risk profile?				
6. Appropriate processes are in place to provide the audit committee with suitable reports on the effectiveness of risk management and internal control and to review the related disclosures included in the corporate governance statement in the annual report?				
	Actual	Ideal	N/A	Comments
7. Appropriate processes are in place to ensure the risk management and internal control systems are fit for purpose and working as intended?				
8. The reports presented to the audit committee are sufficient and timely? The focus on risk trends and management action is appropriate?				
9. The audit committee splits its time appropriately between focusing on risk identification and assessment, and time spent focused on the effectiveness of the risk management framework itself? (e.g. time spent on reports and risk content versus time spent on whether executives are taking the right approach.)				

## F. Overseeing external audit

	Actual	Ideal	N/A	Comments
1. The audit committee plays an appropriate role in recommending the appointment of the external auditor?				
2. External audit staff members are appropriately qualified and experienced (taking into account the skills and the breadth and depth of experience necessary to cover the organisation's operations)?				
3. The audit committee takes appropriate steps to ensure the external auditor has direct access to the audit committee and makes appropriate use of that access through informal as well as formal meetings?				
4. The audit committee has taken the appropriate steps to ensure the independence and objectivity of the external auditor is not compromised – including where the external audit provides non-audit services?				
5. The process by which the audit committee reviews and assesses the external audit work plan is appropriate?				
6. The external audit work plan focuses on the organisation's key audit risks?				
7. The quality of the external audit reports (and other documents) presented to the audit committee is appropriate?				
8. The audit committee has an appropriate dialogue with the external auditor regarding the major issues that arose during the course of the audit; the key accounting and audit judgements; and the levels of errors identified during the audit?				
9. The audit committee takes appropriate steps to ensure management responds to the external auditor's enquiries and recommendations in a timely and fitting manner?				
10. The process by which the audit committee reviews the effectiveness of the external audit is both timely and rigorous?				

G. Overseeing internal audit

	Actual	Ideal	N/A	Comments
1. The audit committee plays an appropriate role in approving the appointment of the internal audit provider?				
2. The internal audit function is appropriately resourced taking into account the skills and the breadth and depth of experience necessary to cover the organisation's operations?				
3. The audit committee takes appropriate steps to ensure the head of internal audit has direct access to the audit committee and makes appropriate use of that access through informal as well as formal meetings?				
4. The process by which the audit committee reviews and approves internal audit's remit is appropriate?				
5. The independence and objectivity of internal audit is not compromised in any way?				
6. The process by which the audit committee reviews and assesses the internal audit work plan is appropriate?				
7. The internal audit work plan focuses on the key risks and controls?				
8. The quality of internal audit reports (and other documents) presented to the audit committee is appropriate?				
9. The audit committee takes appropriate steps to ensure management respond to internal audit recommendations in a timely and fitting manner?				
10. The process by which the audit committee reviews the effectiveness of the internal audit is both timely and rigorous?				

H. Comparison of XYZ's audit committee with other audit committees you may have experience of

Issue	Comments



## Appendix 7

# Specimen year-end timetable

Year-end reporting timetables will vary for a variety of reasons. The timetable illustrated below is typical for a company with a December year-end.

Year-end	31 December
Management prepares draft financial statements	By mid January
Financial statements audited by external auditor (fieldwork)	Mid January to mid February
Meeting with CFO to discuss audit findings and draft audit committee memorandum	End of 2nd week in February
Audit committee papers circulated (including the draft financial statements and management and auditors comments thereon including any significant management letter points)	Beginning of 3rd week in February
Meeting between audit committee chairman and audit partner to discuss any contentious issues	End of 3rd week in February
Audit committee meeting to: <ul style="list-style-type: none"> <li>— Review and recommend approval of the annual report (including the financial statements) and preliminary announcement (and analyst presentation)</li> <li>— Review representation letters from CEO, CFO, etc.</li> </ul>	Beginning of 4th week in February
Board meeting to approve the annual report (including the financial statements), preliminary announcement and analyst presentation	Beginning of 4th week in February*
Preliminary results announcement to market and commence investor road shows	Middle of 4th week in February
External auditor prepares and issues the management letter	March
Management letter points considered by management	March
AGM papers to shareholders Publish annual report on internet and intranet	March
AGM	April

\* Ideally at least one day later than the audit committee meeting

## Appendix 8

# Example questions around identifying and assessing risk

In view of the different approaches boards may take in referring powers to the audit committee in respect of risk management and the control framework, it is vital that there is an unambiguous understanding of what the board of directors, other board committees and the audit committee are responsible for in this important area of corporate governance. The audit committee's responsibilities should be reflected in its terms of reference.

So as to meet its responsibilities under its terms of reference, the audit committee needs to assess whether it is getting appropriate risk management information regularly enough and in a format that meets the needs of members. It needs to evaluate at least annually the adequacy and timeliness of management reporting to the committee on financial, non-financial, current and emerging risk trends. The audit committee needs also to discuss risk management with senior executives, internal and external audit. The scope of those discussions should have reference to the audit committee terms of reference.

The following are high-level questions the audit committee may like to consider in framing discussions with management. The list is not exhaustive and will require tailoring based on the audit committee's terms of reference as well as the particular circumstances of the organisation.

Risk management framework	Evaluation of risk management framework
<p><b>Risk strategy: the approach for associating and managing risks based on the organisation's strategies and objectives.</b></p>	<ul style="list-style-type: none"> <li>— What are the risks inherent in our business strategies and objectives?</li> <li>— How is our risk strategy linked to our business strategy?</li> <li>— Is our risk management policy clearly articulated and communicated to the organisation? If not, why not? If yes, how has this been achieved?</li> <li>— Is our risk appetite (the amount of risk the organisation is willing to take) clear? How is it linked to our objectives?</li> <li>— How has the board's perspective on risk permeated the organisation and culture?</li> </ul>
<p><b>Risk structure: the approach for supporting and embedding the risk strategy and accountability.</b></p>	<ul style="list-style-type: none"> <li>— Is there a common risk management language / terminology across the organisation? If not, why not?</li> <li>— Is accountability for risk management transparent at the management level? If not, why not? If yes, describe how this has been achieved.</li> <li>— Are risk management activities / responsibilities included in job descriptions?</li> <li>— How do our performance management and incentive systems link to our risk management practices?</li> </ul>

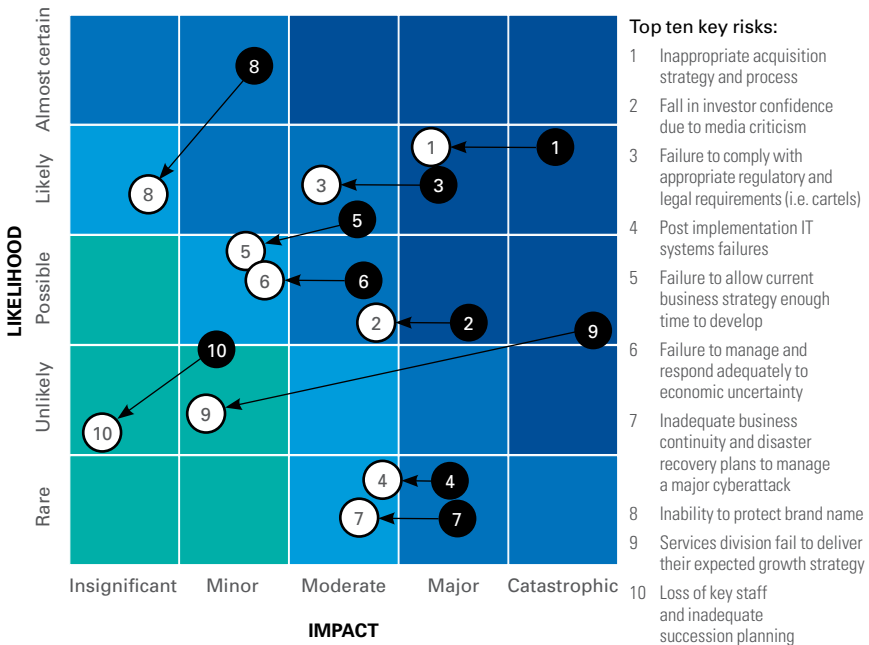
<p><b>Measuring and monitoring: the establishment of Key Performance Indicators (KPIs) and continuous measuring and improving of performance.</b></p>	<ul style="list-style-type: none"> <li>— Are risk owners clearly identified? If not, why not. If yes, How?</li> <li>— Are there systems in place for measuring and monitoring risk?</li> <li>— How are risks, including suspected improprieties, escalated to the appropriate levels within the organisation?</li> <li>— How is the risk management framework linked to the organisation's overall assurance framework?</li> </ul>
<p><b>Portfolio: the process for identifying, assessing and categorising risks across the organisation.</b></p>	<p><i>Risk Profile</i></p> <ul style="list-style-type: none"> <li>— Does a comprehensive risk profile exist for the organisation? If not, why not?</li> <li>— Does the risk profile evidence identification and evaluation of non-traditional risk exposures?</li> <li>— Are the interrelationships of risks clearly identified and understood?</li> </ul> <p><i>Operational Risk</i></p> <ul style="list-style-type: none"> <li>— What are the risks inherent in the processes chosen to implement the strategies?</li> <li>— How does the organisation identify, quantify and manage these risks given its appetite for risk?</li> <li>— How does the organisation adapt its activities as strategies and processes change?</li> </ul> <p><i>Reputation Risk</i></p> <ul style="list-style-type: none"> <li>— What are the risks to brand and reputation inherent in the way the organisation executes its strategies?</li> </ul> <p><i>Regulatory or Contractual Risk</i></p> <ul style="list-style-type: none"> <li>— Which financial and non financial risks are related to compliance with regulations or contractual arrangements?</li> </ul> <p><i>Financial Risk</i></p> <ul style="list-style-type: none"> <li>— Have operating processes put financial resources at undue risk?</li> <li>— Has the organisation incurred unreasonable liabilities to support operating processes?</li> <li>— Has the organisation succeeded in meeting measurable business objectives?</li> </ul> <p><i>Information Technology Risk</i></p> <ul style="list-style-type: none"> <li>— Is our data / information / knowledge reliable, relevant and timely?</li> <li>— Are our information systems reliable?</li> <li>— Do our security systems reflect our reliance on technology, including our e-business strategy?</li> </ul> <p><i>New Risks</i></p> <ul style="list-style-type: none"> <li>— In a business environment that is constantly changing, are there processes in place to identify emerging risks? If not, why not? If yes, describe.</li> <li>— What risks have yet to develop? These might include risks from new competitors or emerging business models, recession risks, relationship risks, outsourcing risks, political or criminal risks, financial risk disasters such as rogue traders, and other crisis and disaster risks.</li> </ul>
<p><b>Optimisation: balancing potential risks and opportunities based on the appetite to accept risk.</b></p>	<ul style="list-style-type: none"> <li>— Does the risk approach include a regular search for new markets, partnering opportunities and other risk optimisation strategies? If not, why not? If yes, how is this achieved?</li> <li>— Is risk a priority consideration whenever business processes are improved? If not, why not? If yes, describe how this is achieved.</li> </ul>

## Appendix 9

# Example risk summary and register

The following chart illustrates management’s view of the top 10 risks facing the business. Each of these risks has been assessed in terms of potential impact and likelihood of occurrence, using descriptive scales. The quantification criteria for likelihood and impact are set out below the risk summary.

The grid below has been used to provide a graphical illustration of the likelihood and impact for each of the group’s top ten risks, the arrows representing the influence existing internal controls are thought to have on that risk.



- Top ten key risks:**
- 1 Inappropriate acquisition strategy and process
  - 2 Fall in investor confidence due to media criticism
  - 3 Failure to comply with appropriate regulatory and legal requirements (i.e. cartels)
  - 4 Post implementation IT systems failures
  - 5 Failure to allow current business strategy enough time to develop
  - 6 Failure to manage and respond adequately to economic uncertainty
  - 7 Inadequate business continuity and disaster recovery plans to manage a major cyberattack
  - 8 Inability to protect brand name
  - 9 Services division fail to deliver their expected growth strategy
  - 10 Loss of key staff and inadequate succession planning

Minor Moderate High Critical Gross Risk Net Risk

Note: Arrows represent effectiveness of controls currently in place

Quantification criteria for likelihood and impact

LIKELIHOOD	Event is expected to occur in most circumstances	>90%	Almost certain	5					
	Event will probably occur in most circumstances	50 - 90%	Likely	4					
	Event should occur at some time	30 - 5%	Possible	3					
	Event could occur at some time	10 - 30%	Unlikely	2					
	Event may occur only in exceptional circumstances	<10%	Rare	1					

- Minor
- Moderate
- High
- Critical

		1	2	3	4	5
		Insignificant	Minor	Moderate	Major	Catastrophic
	Time	Resolution would be achieved during normal day to day activity	Resolution would require input from regional management team	Resolution would require input from executive team	Resolution would require the mobilisation of a dedicated project team	Resolution would require input from the board
	Profit	Less than 1% or no impact	1% to 3% impact	3% to 10% impact	10% to 25% impact	Greater than 25%
	Turnover	Little or no impact	1% to 3% impact	3% to 10% impact	10% to 25% impact	Greater than 25%
	Environment	On-site environmental exposure immediately contained	On-site environmental exposure contained after prolonged effort	On-site environmental exposure contained with outside assistance	On-site environmental exposure contained with outside assistance	Environmental exposure off-site with detrimental effects
	Reputation	Letters to local/ industry press	Series of articles in local/industry press	Extended negative local/ industry media coverage	Short term national negative media coverage	Extensive negative national media coverage
	Regulatory	Minor breaches by individual staff members	No fine - no disruption to scheduled services	Fine but no disruption to scheduled services	Fine and disruption to scheduled services	Significant disruption to scheduled services over an extended period of time
	Management effort	An event, the impact of which can be absorbed through normal activity	An event, the consequences of which can be absorbed but management effort is required to minimise the impact	A significant event which can be managed under normal circumstances	A critical event which with proper management can be endured	A disaster with potential to lead to collapse of the business

IMPACT

Summary risk register

Risk description		Inherent risk assessment					
Risk description	Cause(s)	Consequence(s)	Inherent Likelihood	Inherent Impact	Risk Score	Ownership	
What might occur?	What might cause the risk to occur?	What are the possible consequences if the risk occurs?	1= Rare 2=Unlikely 3=Possible 4=Likely 5=Almost certain	1=Insignificant 2=Minor 3=Moderate 4=Major 5=Catastrophe	Likelihood multiplied by impact	Who has overall accountability for this risk? (senior management level)?	
<b>WEAK</b>	Reputation	Bad publicity	Share price drop	5	5	25	All management
<b>STRONG</b>	Loss of a key customer impacting profit and growth objectives	1. Spread of customers not sufficient 2. Poor customer service e.g. deliveries	1. Customer represents 15% of revenue or profit 2. Impacts reputation for good service 3. Impacts ability to win new business	4	4	16	Commercial Director

- Risks linked to business objectives and their KPIs and/or categories of risk.
- Specific and concise, supported by key causes and consequences.

- Causes consider external and internal factors.
- Consequences directly linked to business objectives and their KPIs and consider direct and indirect impacts.

- Inherent and residual risk scores clearly explained.
- Likelihood linked to business planning cycle (e.g. 3-5 years).
- Impact includes both financial and non- financial impact and linked to financial performance targets.

Residual risk assessment					Improvement actions		
Existing Controls	Sources of assurance	Residual Likelihood	Residual Impact	Risk Score	Actions for further control	Action owner	Due date
What existing processes/ controls are in place to manage the risk?	What assurance do you get over these controls?	1=Rare 2=Unlikely 3=Possible 4=Likely 5=Almost certain	1=Insignificant 2=Minor 3=Moderate 4=Major 5=Catastrophe		What further action (if deemed necessary) is planned to treat the risk?	Who is responsible for developing the action plan (senior management level)?	When are the agreed actions to be delivered by?
All corporate policies and processes	Annual review of policies	5	5	25	None, ongoing	All management	Not applicable
1. Weekly verbal updates with key customer and account manager 2. Formal monthly reviews of performance with key customer and Commercial Director 3. Compulsory training for all customer facing staff	Internal Audit on complaints procedure tracking and marketing from annual independent client reviews	2	4	8	1. Align account team personal performance metrics with key customer satisfaction metrics 2. Informal account team customer feedback sessions on monthly basis per key customer update meetings 3. Improve IT data capture of informal complaints with weekly updates required from account teams	1. Account team manager 2. Commercial Director 3. IT Director with input from Commercial Director	1. Include in 1st Quarter goal setting 2. Immediate 3. By 1st Quarter 200X

- Controls are split between different types (formal/ informal).
- Controls include sources of assurance.
- Control owners are evident.

- Improvement actions are SMART, have clear owners, a due date and linked to formal management reporting.
- Action owners are accountable.

## Appendix 10

# Internal control and risk management disclosures

**Audit committees should critically review the design of the internal control and risk management systems related to financial reporting of the company at least annually, including the relevant documentation and disclosures. The checklist provided below aims to assist audit committees to fulfil this role.**

The information below is largely extracted from the *Internal Control - Integrated Framework 2013*, published by the *Committee of Sponsoring Organisations of the Treadway Commission (COSO)*. It includes the framework's principles for effective internal control and the information that is expected to be provided as part of the board of directors' description of internal control and risk management systems related to financial reporting to the extent that it is relevant to the entity. In all instances, the description provided should be adapted to the nature and complexity of the entity, its operations and its risk profile.

The COSO framework contains three categories of objectives:

1. Operations objectives – related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals and safeguarding assets against loss.
2. Reporting objectives – related to internal and external financial and non-financial reporting to stakeholders, which would encompass reliability, timeliness, transparency or other terms as established by regulators, standard setters or the entity's policies.
3. Compliance objectives – related to adhering to laws and regulations that the entity must follow.



## CONTROL ENVIRONMENT

### Principles

1. The organisation demonstrates a commitment to integrity and ethical values.
2. The board of directors and the audit committee demonstrate independence from management and exercise oversight of the development and performance of internal control.
3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
4. The organisation demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.
5. The organisation holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

### Integrity and Ethical Values

#### Background

Areas that relate directly to reliability of financial statement preparation include the following:

- Management's attitude toward bypassing established control procedures aimed principally at achieving financial reporting objectives.
- Management's interactions with internal and external auditors and outside counsel on financial reporting matters, such as the extent to which management provides full disclosure of information on matters that may have an adverse impact on the financial statements.
- Management's integrity in preparing financial statements (addressed further under 'Management's Philosophy and Operating Style').

#### Information expected

- Existence and implementation of codes of conduct and other policies regarding acceptable business practice, conflicts of interest, or expected standards of ethical and moral behaviour.
- Remedial action taken in response to departures from approved policies and procedures or violations of the code of conduct. Extent to which remedial action is communicated or otherwise becomes known throughout the entity.
- Management's attitude towards intervention or overriding established controls.
- Approach to balancing performance-based compensation and short-term vs. long-term performance targets and extent to which compensation is based on achieving short term results.

### Commitment to Competence

#### Background

Reliability of an enterprise's financial statements can be compromised if incompetent or unassertive people are involved in the financial reporting process. Directly affecting reliability of financial statements are the knowledge and skills of personnel involved in the preparation process relative to the nature and scope of operating and financial reporting issues, and whether such knowledge and skills are sufficient to properly account for any new activities, products and services, or existing ones in the face of downsizing.

#### Information expected

- Formal or informal job descriptions or other means of defining tasks that comprise particular jobs; announcements of job descriptions within the company.
- Process to analyze the knowledge and skills needed to perform jobs adequately.
- Hiring and performance evaluation policies and procedures.
- Process to determine segregation of responsibilities between the board and executive management.

## Management's Philosophy and Operating Style

### Background

The delegation of authority for financial reporting is important in achieving the entity's financial reporting objectives, in particular for making the accounting judgements and estimates that enter into financial reporting. Related issues include reasonableness of accounting policies and estimates in connection with preparation of financial statements, especially whether management's estimates and policies are conservative or aggressive (that is, on the boundary of 'reasonableness'). Management's attitude toward financial reporting also affects the entity's ability to achieve its financial reporting objectives.

### Information expected

- Nature of business risks accepted, e.g. whether management often enters into particularly high-risk ventures, or is extremely conservative in accepting risks.
- Process to establish values and strategy of the organisation.
- Frequency of interaction between senior management and operating management, including geographically remote locations.
- Roles and responsibilities in the selection of accounting principles including management attitude towards financial reporting e.g. selection of conservative versus liberal accounting policies.
- Establishment of a financial accounting principles and procedures manual (including e.g. time tables, execution and control of financial tasks).
- Adequate resources to implement the financial and accounting function(s) in view of adequate financial reporting process.

## Organisational Structure

### Background

Aspects of an entity's organisational structure that are specifically related to financial reporting objectives include factors related to accounting personnel, such as:

- Appropriateness of reporting lines;
- Adequacy of staffing and experience levels;
- Clarity of delegation of authority and duties;
- Extent to which the organisational structure allows accounting personnel to interact with other departments and activities in the organisation, to have access to key data and to properly account for resulting conclusions.

### Information expected

- Organisational structure, flows of information to manage activities.
- Reporting relationships.
- Process to define key managers' responsibilities, and their understanding of these responsibilities.
- Process to ensure adequacy of knowledge and experience of key managers in light of responsibilities.

## Assignment of Authority and Responsibility

### Background

Deficiencies in the way that authority and responsibility are assigned to employees in accounting, custodial and asset management functions may affect the entity's ability to achieve its financial reporting objectives. Matters to consider include the adequacy of the work force and whether employees are deployed to promote segregation of incompatible duties.

### Information expected

- Process to assign responsibility and delegate authority to deal with organisational goals and objectives, operating functions and regulatory requirements, including responsibility for information systems and authorizations for changes.
- Existence of control-related standards and procedures, including employee job descriptions.

## Human Resource Policies and Practices

### Background

An entity's ability to achieve its financial reporting objectives may reflect its recruiting, training, promotion, retention and compensation policies and procedures insofar as they affect performance of accounting personnel and employees outside of the accounting function who administer controls over financial reporting.

### Information expected

- Appropriate numbers of people, particularly with respect to data processing and accounting functions, with the requisite skill levels relative to the size of the entity and nature and complexity of activities and systems.
- Extent to which people are made aware of their responsibilities and expectations of them.
- Appropriateness of remedial action taken in response to departures from approved policies and procedures.
- Extent to which personnel policies address adherence to appropriate ethical and moral standards.
- Adequacy of employee retention and promotion criteria and information-gathering techniques (e.g. performance evaluations) and relation to the code of conduct or other behavioral guidelines

## Board of Directors and Audit Committee

### Background

Key aspects of the control environment are the composition and independence of the board and its audit committee and how its members fulfil responsibilities related to the financial reporting process. Of particular interest for controls over financial reporting is the involvement of the board or audit committee in overseeing the financial reporting process, including assessing the reasonableness of management's accounting judgements and estimates and reviewing key filings with regulatory agencies. Other committees of the board often are not a key part of controls over financial reporting

### Information expected

- Independence from management
- Knowledge and experience of directors
- Process to establish and publish the terms of reference of the Board and committees.
- Process to establish an audit committee and an internal function (or determine the need of).
- Frequency with which meetings are held with chief financial and/or accounting officers, internal auditors and external auditors
- Process for informing the board of significant issues timely
- Process to inform the board or audit committee of sensitive information, investigations and improper acts timely
- Oversight in determining the compensation of executive officers and head of internal audit, and the appointment and termination of those individuals.
- Role in establishing the appropriate 'tone at the top.'
- Actions the board or committee takes as a result of its findings, including special investigations as needed.

## Risk Assessment

### Principles

1. The organisation specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.
2. The organisation identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.
3. The organisation considers the potential for fraud in assessing risks to the achievement of objectives.
4. The organisation identifies and assesses changes that could significantly impact the system of internal control.

### Background

Are entity-wide objectives and supporting activity-level objectives established and linked? Are the internal and external risks that influence the success or failure of the achievement of the objectives identified and assessed? Are mechanisms in place to identify changes affecting the entity's ability to achieve its objectives? Are policies and procedures modified as needed?

### Information expected

- Process to develop entity-wide objectives, linked to the strategy as well as the financial reporting process, that provide sufficient guidance on what the entity desires to achieve including the identification of objectives that are important (critical success factors) to achievement of entity-wide objectives.
- Establishment of formal risk management procedures.
- Process to communicate the entity-wide objectives and risk policy to employees and board of directors.
- Process to identify and mobilise adequate resources relative to objectives and risk management.
- Mechanisms to identify risks (e.g. strategic, reputation, compliance, financial, IT and HR risks) arising from external and internal sources.
- Establishment of a risk map or chart for all external and internal risks.
- Risk analysis process, including estimating the significance of risks, assessing the likelihood of their occurring and determining needed actions.
- Mechanisms to anticipate, identify and react to routine events or activities that affect achievement of entity or activity-level objectives and related risks.
- Mechanisms to identify and react to changes that can have a more dramatic and pervasive effect on the entity, and may demand the attention of top management.
- Process to implement the same risk management language and culture through the company.
- Process to communicate risk analyses results amongst Board, audit committee and risk responsible and external parties (e.g. financial reporting compliance).
- Setting of acceptable risk appetite and tolerance level.
- Implementation of a crisis management plan.
- Process to ensure changes, if required, to the existing risk management procedures.
- Process to evaluate and continuously improve the risk management system.

## Control Activities

### Principles

1. The organisation selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
2. The organisation selects and develops general control activities over technology to support the achievement of objectives.
3. The organisation deploys control activities through policies that establish what is expected and procedures that put policies into action.

### Background

Are control activities in place to ensure adherence to established policy and the carrying out of actions to address the related risks? Are there appropriate control activities for each of the entity's activities?

### Information expected

- Existence of appropriate policies and procedures necessary with respect to each of the entity's activities.
- Process in place to ensure that identified control activities in place are being applied properly.
- Existence of appropriate policies and procedures necessary with respect to the implementation and follow up of the financial manual.
- Process in place to ensure that identified key control activities are in place related to the financial and accounting process (including consolidation topics).

## Information and Communication

### Principles

1. The organisation obtains or generates and uses relevant, quality information to support the functioning of internal control.
2. The organisation internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.
3. The organisation communicates with external parties regarding matters affecting the functioning of internal control.

### Background

Are information systems in place to identify and capture pertinent information—financial and nonfinancial, relating to external and internal events—and bring it to personnel in a form that enables them to carry out their responsibilities? Does communication of relevant information take place? Is it clear with respect to expectations and responsibilities of individuals and groups, and reporting of results? And does communication occur down, across and upward in the entity, as well as between the entity and other parties?

### Information expected

- Process to obtain external and internal information, and provide management with necessary reports on the entity's performance relative to established objectives.
- Process and allocation of responsibilities for the development of a strategic plan for information systems that is linked to the entity's overall strategy and responsive to achieving the entity-wide and activity-level objectives.
- Approach to ensuring completeness, sufficiency and timeliness of information to enable people to discharge their responsibilities effectively
- Process to communicate employees' duties and control responsibilities.
- Existence of channels of communication for people to report suspected improprieties.

	<ul style="list-style-type: none"> <li>— Process in place for a timely and appropriate follow-up by management resulting from communications received from customers, vendors, regulators or other external parties.</li> <li>— Existence of a whistle-blowing policy and procedure.</li> <li>— Existence of information systems and procedures in order to meet the criteria for relevant, timely and adequate financial information and reporting.</li> </ul>
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**MONITORING**

<b>Principles</b>	
<ol style="list-style-type: none"> <li>1. The organisation selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.</li> <li>2. The organisation evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.</li> </ol>	

<b>Background</b>	<b>Information expected</b>
<p>Are appropriate procedures in place to monitor on an ongoing basis, or to periodically evaluate the functioning of the other components of internal control? Are deficiencies reported to the right people? Are policies and procedures modified as needed?</p>	<ul style="list-style-type: none"> <li>— Existence of a mechanism by which communications from external parties is used to corroborate internally generated information, or indicate problems.</li> <li>— Existence of a process to compare amounts recorded by the accounting system with physical assets.</li> <li>— Scope and frequency of evaluation of the internal control system.</li> <li>— Process for capturing and reporting identified internal control deficiencies and ensuring appropriate follow-up actions.</li> <li>— Process for capturing and reporting identified significant financial deficiencies and ensuring appropriate validation by Board and audit committee.</li> <li>— Existence of procedures for periodic publication of financial information.</li> <li>— Approach to responding to internal and external auditor recommendations on means to strengthen internal controls.</li> <li>— Existence of a process for management and/or employees to confirm compliance with the entity's code of conduct regularly</li> <li>— Key characteristics of the internal audit department:                             <ul style="list-style-type: none"> <li>- Competence and experience;</li> <li>- Position within the organisation;</li> <li>- Access to the board of directors or audit committee;</li> <li>- Process to define scope, responsibilities and audit plans in function of the organisation's needs.</li> </ul> </li> </ul>



## Appendix 11

# Example whistle-blowing policy

All employees are encouraged to raise genuine concerns about possible improprieties in matters of financial reporting and other malpractices at the earliest opportunity, and in an appropriate way.

This policy is designed to:

- support our values;
- ensure employees can raise concerns without fear of suffering retribution; and
- provide a transparent and confidential process for dealing with concerns.

This policy not only covers possible improprieties in matters of financial reporting, but also:

- fraud;
- corruption, bribery or blackmail;
- criminal offences;
- failure to comply with a legal or regulatory obligation;
- miscarriage of justice;
- endangering the health and safety of an individual; and
- concealment of any of the above.

### *Principles*

- All concerns raised will be treated fairly and properly.
- We will not tolerate the harassment or victimisation of anyone raising a genuine concern.
- Any individual making a disclosure will retain their anonymity unless they agree otherwise.
- We will ensure that any individual raising a concern is aware of who is handling the matter.
- We will ensure no one will be at risk of suffering some form of retribution as a result of raising a concern even if they are mistaken. We do not however extend this assurance to someone who maliciously raises a matter they know to be untrue.



### *Grievance procedure*

If any employee believes reasonably and in good faith that malpractice exists in the work place, then he or she should report this immediately to their own line manager. However, if for any reason they are reluctant to do so, then they should report their concerns to either the:

- group company secretary; or
- director of human resources.

Employees concerned about speaking to another member of staff can speak, in confidence, to an independent third party by calling the **whistle-blowing hotline** on [ ]. This is provided through the independent party who provides the employee care counselling and legal advice service. Your concerns will be reported to the company without revealing your identity.

If these channels have been followed and employees still have concerns, or if employees feel the matter is so serious that it cannot be discussed with any of the above, they should contact the senior independent director on [ ].

Employees, who have raised concerns internally, will be informed of who is handling the matter, how they can make contact with them and if there is any further assistance required. We will give as much feedback as we can without any infringement on a duty of confidence owed by us to someone else.

Employees' identities will not be disclosed without prior consent. Where concerns are unable to be resolved without revealing the identity of the employee raising the concern, (e.g. if their evidence is required in court), we will enter in to a dialogue with the employee concerned as to whether and how we can proceed.

If you are unsure whether to use the procedure or you want independent advice at any stage, you may contact the independent charity [ ]. Their lawyers can give you free confidential advice at any stage about how to raise a concern about serious malpractice at work.

Appendix 12

# Internal audit sourcing options

The relative strengths and weaknesses of different sourcing models are captured below.

Sourcing model	Pros	Cons
<b>In-house function</b>	<ul style="list-style-type: none"> <li>✓ Continuity of staff</li> <li>✓ Certain and controllable cost</li> <li>✓ Full control of the function</li> <li>✓ A resource pool for the business</li> <li>✓ Training ground for employees</li> <li>✓ Greater cultural alignment</li> <li>✓ Insiders</li> </ul>	<ul style="list-style-type: none"> <li>✗ May not be fully employed effectively and efficiently</li> <li>✗ Difficult to acquire necessary / maintain all skills and experience to meet the risk profile of the business</li> <li>✗ Need to continually invest in training and development</li> <li>✗ Recruitment hassles</li> <li>✗ Ineffective / inefficient start up</li> <li>✗ Retention and development strategies required</li> <li>✗ Reduces opportunity to provide fresh perspective / risk of complacency or familiarity</li> </ul>
<b>Co-source</b>	<ul style="list-style-type: none"> <li>✓ Long term permanent onsite presence through HIA</li> <li>✓ Access to broad range of skills through the partner</li> <li>✓ Draw on specialist skills as and when, and only when, needed</li> <li>✓ Continuity through HIA</li> <li>✓ Pull in up to date skills and experience as needed</li> <li>✓ Quick to implement</li> <li>✓ Skills transfer to in house team</li> <li>✓ Flexible approach, clearly defined service level and KPI measures</li> <li>✓ Credibility to third parties</li> <li>✓ No or reduced training cost</li> </ul>	<ul style="list-style-type: none"> <li>✗ Time taken to recruit HIA</li> <li>✗ Possible cost impact</li> <li>✗ Management resource needed in recruitment and relationship development</li> <li>✗ Dependency on 3rd party</li> <li>✗ Possible lack of staff continuity</li> <li>✗ Other challenges for in house resource as above</li> </ul>

Sourcing model	Pros	Cons
<b>Full outsource</b>	<ul style="list-style-type: none"> <li>✓ Established methodologies &amp; benefit of refreshment based on experiences across different organisations</li> <li>✓ Up to date, skilled staff</li> <li>✓ Ability to draw on a wide range of skills as and when required</li> <li>✓ No time taken up by managing service and resources</li> <li>✓ Clearly defined service level and performance measures</li> <li>✓ Easily established and quickly effective</li> <li>✓ Credibility to third parties</li> <li>✓ Ability to manage costs by avoiding non-productive periods</li> </ul>	<ul style="list-style-type: none"> <li>✗ No permanent on-site resource to help other areas of the business</li> <li>✗ Potential cost impact</li> <li>✗ Possible lack of staff continuity</li> <li>✗ Remote from business developments, the culture and politics</li> <li>✗ Management time to establish and maintain relationships</li> </ul>

## Appendix 13

# Specimen internal audit plan

Internal audit provides independent, objective assurance over an organisation's risk management, internal control, governance and the processes in place for ensuring effectiveness, efficiency and economy.

Each audit plan will be different and tailored to the organisation's needs. However, there are common elements that the audit committee should expect to see when reviewing the audit plan, albeit in practice these elements might be presented in many different ways. These elements are discussed below.

### *Overview of the audit approach*

The audit committee should expect the audit planning document to set out that the audit plan has been developed by:

- taking account of the risks identified by the organisation in its risk register and other documents;
- using the internal auditor's experience of the organisation and the sector more generally to identify other areas of risk which may warrant attention; and
- discussing all identified risks and other relevant issues with the organisation's management to identify the potential scope of internal audit.

### *Risk-focused internal audit coverage*

Where the organisation's risk management policy allocates each risk a likelihood and impact rating between 'high' and 'low', the audit plan might for example focus on 'high' and 'medium' priority risks over (say) a three-year period. However the internal audit is focused, the audit committee should be fully informed of:

- which areas are being addressed;
- how many audit days have been allocated to each area;
- when the fieldwork is being undertaken; and
- when the internal auditors will report their findings.

Exhibit 1 (below) illustrates which risks identified by the organisation in the risk register are addressed by the internal audit plan. Exhibit 2 puts these risks in the context of a three-year audit plan. It is also useful to keep the audit committee apprised of the risks that are not addressed by the internal audit plan – see Exhibit 3.

### *Other reviews*

The internal audit strategy may address some *ad hoc* areas that do not feature as a high or medium risk. These are nevertheless areas where the organisation would benefit from an internal audit review, or they are being reviewed to provide assurance to the audit committee and external auditors regarding operation of the key financial and management information systems. The audit days, fieldwork and reporting expectations for these areas should also be identified in the audit plan.

### *Contingencies*

It is important to adopt a flexible approach in allocating internal audit resources, in order to accommodate any unforeseen audit needs. The audit plan should give an indication as to how many 'man days' have been allowed for contingencies.

### *Follow-up*

For internal audit to be as effective as possible, its recommendations need to be implemented. Specific resources should be included within the plan to provide assurance to the organisation and the audit committee that agreed audit recommendations have been actioned effectively and on a timely basis.

### *Planning, reporting and liaison*

The audit committee should expect the internal audit plan to identify a number of audit days relating to the following:

- quality control review by manager;
- production of reports, including the strategic plan and annual internal audit report;
- attendance at audit committee meetings;
- regular contact with the organisation's management;
- liaison with external audit; and
- internal quality assurance reviews.

### *The internal audit team*

Where the internal audit is outsourced, the audit committee (and management) should expect a brief introduction to the key individuals working on the audit. This might include partners, managers and any specialist advisers.

### *Timing*

The audit plan should set out the timing of the fieldwork and confirm the form and timeliness of reports to management and the audit committee. For example:

- a report for each area of work undertaken within X days of finishing the fieldwork;
- a progress report for each audit committee meeting; and
- an annual report on internal audit coverage to the audit committee (reporting to fit in with the committee meeting dates).

Exhibit 4 outlines how the timing might be presented for an internal audit carried out in three phases to coincide with the audit committee timetable.

### *Internal audit performance indicators*

The internal auditor might propose a series of performance indicators against which management and the audit committee can measure the function's performance. An example of proposed indicators is included as Exhibit 5.

*Exhibit 1: Internal audit plan – focus on the organisation's key risks*

<b>Risk identified in the risk register</b>	<b>Ranking</b>	<b>Internal audit reviews over a three-year period</b>
1. Failure of the new finance system	High	Finance system implementation
2. Reliance on small number of specialised staff	High	IT
3. Cyber security issues	High	IT
4. Ineffective project assessment procedures	Medium	Contract management
5. Non-performance of contracts	Medium	Contract management/departmental reviews
6. Poor procurement of projects	Medium	Estates
7. Failure to protect intellectual property	Medium	Intellectual property management
8. Statutory non-compliance (H&S)	Medium	Health and safety
9. Non-prevention of foreseeable accidents	Medium	Health and safety
10. Failure to adequately manage occupational stress	Medium	Human resources
11. Failure to attract and retain high-quality staff	Medium	Human resources
12. Non-financial control failure	Medium	Key financial systems/department reviews
13. Fraud, theft and misuse of assets	Medium	Key financial systems/department reviews
14. Breach of financial memorandum	Medium	Key financial systems – treasury management
15. Reputation unclear or fragmented	Medium	Strategic planning
16. Ineffective faculty business planning	Medium	Strategic planning/department reviews
17. Failure to consider future strategies	Medium	Strategic planning
18. Claw back of project funding	Low*	Contract management/departmental reviews
19. Unsatisfactory procurement procedures	Low*	Key financial systems – purchasing

\* Although categorised as a 'low' risk, this will be covered within a review of higher risks.

Exhibit 2: Three-year rolling plan

Internal audit reviews	Current year	Year 2	Year 3	Total days
<b>Risk based reviews</b>				
a. Contract management	-	-	15	15
b. Departmental reviews	-	25	20	45
c. Estates	-	-	15	15
d. Finance system implementation	50			50
e. Key financial systems	-	25	25	50
f. Health and safety	15	-	-	15
g. Human resources	15	-	-	15
h. Intellectual property management	15	-	-	15
i. IT systems	20	15	15	50
j. Strategic planning	20	-	-	20
<b>Total risk-based days</b>	<b>135</b>	<b>65</b>	<b>90</b>	<b>290</b>
<b>Other reviews</b>				
k. Risk management	10	8	8	26
l. Corporate governance	-	7	-	7
m. Corporate structures	-	-	22	22
n. Costing processes	-	15	-	15
o. Sickness management	-	15	-	15
<b>Total other review days</b>	<b>10</b>	<b>45</b>	<b>30</b>	<b>85</b>
<b>Other</b>				
p. Contingency	8	8	8	24
q. Follow-up	8	8	8	24
r. Planning, reporting and liaison	34	9	9	52
<b>Total other days</b>	<b>50</b>	<b>25</b>	<b>25</b>	<b>100</b>
<b>Total days</b>	<b>195</b>	<b>135</b>	<b>145</b>	<b>475</b>

*Exhibit 3: Risks not subject to internal audit review*

<b>Risk</b>	<b>Ranking</b>
18. Defamation/professional negligence	Medium
19. Necessity for redundancies	Medium
20. Fire/explosion	Medium
21. Influential connections lost	Medium
22. Failure to prevent a major incident	Medium
23. Failure to adopt equal pay provisions	Medium
24. Failure to prevent dismissals	Medium
25. Missed commercial opportunities	Low
26. Failure to adequately manage disability issue	Low
27. Failure to prevent major health incident	Low
30. Statutory non-compliance – services	Low
31. Failure to prevent outbreak of food poisoning	Low
32. Building collapse	Low
33. Exposure to higher interest rates	Low



Exhibit 4: Annual plan

Internal audit reviews	Current year	Phase	Fieldwork	Report to audit committee
<b>Risk-based reviews</b>				
d. Finance system implementation	50	All phases	All audit visits	Feb/May/Oct meeting
e. Health and safety	15	Phase 2	w/c 26.02.20xx	31.05.20xx
f. Human resources	15	Phase 1	w/c 20.11.20xx	08.02.20xx
g. Intellectual property management	15	Phase 2	w/c 26.02.20xx	31.05.20xx
h. IT systems	20	Phase 1	w/c 20.11.20xx	08.02.20xx
i. Strategic planning	20	Phase 1	w/c 20.11.20xx	08.02.20xx
<b>Total risk-based days</b>	<b>135</b>			
<b>Other reviews</b>				
j. Risk management	10	Phase 2	w/c 26.02.20xx	31.05.20xx
Total other review days	10			
<b>Other</b>				
q. Contingency	8			
r. Follow-up	8	Phase 3	w/c 14.05.20xx	09.10.20xx
s. Planning, reporting and liaison	34			
Total other days	50			
<b>Total days</b>	<b>195</b>			

Exhibit 5: Performance indicators

Performance indicator	Target
Percentage of audit work delivered by qualified staff	60%
Operational plan to be submitted by September each year	September of each year
Follow-ups to be performed within 1 year of the audit taking place	Within 1 year of assignments
Issue of draft reports within 30 days of work being completed	30 working days
Issue of final report within 10 working days of receipt of management responses	10 working days
Recommendations made compared with recommendations accepted	80%
Internal audit attendance at audit committee meetings	100%
Issue of internal audit annual report	September of each year

## Appendix 14

# Internal audit activities – key steps in the annual audit cycle

## The key steps in an annual cycle

<p><b>Produce the annual work programme</b></p>	<ul style="list-style-type: none"> <li>— Create an annual Internal Audit plan for approval by the audit committee, typically as part of an indicative 3 or 5 year plan linked to a wider risk/audit universe</li> <li>— Identify resource requirements, including relevant subject matter and industry experience to add value to the process, and associated budgets</li> <li>— Agree the timeline for performing individual assignments in the agreed plan</li> <li>— Additional reviews may be required: the approach needs to be nimble to respond to the needs of the audit committee and the executive team</li> <li>— Consideration should also be given at this stage to the interaction with risk management activities and the specific linkage of risk and assurance</li> </ul>
<p><b>Plan individual assignments</b></p>	<ul style="list-style-type: none"> <li>— For each allocated audit assignment, terms of reference should be agreed in advance</li> <li>— Staff requirements should be confirmed and communicated to the team reasonably far in advance of the work to help continuity</li> <li>— Planning meetings with the nominated business sponsor and business process owners, information gathering and briefing of team members prior to each assignment</li> </ul>
<p><b>Perform fieldwork</b></p>	<ul style="list-style-type: none"> <li>— Fieldwork should commence with an opening meeting involving all relevant team members so that:               <ul style="list-style-type: none"> <li>– expectations are understood; and</li> <li>– the objectives, scope, techniques and emphasis of the review are clear</li> </ul> </li> <li>— A ‘no surprises’ approach is fundamental. The nominated business sponsor should be informed of issues as they arise</li> </ul>

<b>The key steps in an annual cycle</b>	
	<ul style="list-style-type: none"> <li>— Ways of working should be defined and consistently applied and measured (including the business responsibilities)</li> <li>— Variations to timelines or budgets should be monitored and flagged as soon as they are identified to key sponsors</li> </ul>
<b>Exit meeting</b>	<ul style="list-style-type: none"> <li>— Prior to formal reporting, an exit meeting should be held with the relevant business sponsor and other employees as agreed</li> <li>— The purpose of the meeting is to:                             <ul style="list-style-type: none"> <li>– confirm that expectations have been met;</li> <li>– highlight and re-confirm the findings of the review;</li> <li>– validate the findings; and</li> <li>– where appropriate, obtain management’s acceptance and support for the recommendations made, including their commitment to actions with clear dates for implementation</li> </ul> </li> </ul>
<b>Reporting</b>	<ul style="list-style-type: none"> <li>— Prepare a draft report to be issued to management within an agreed number of working days of completion of each audit and finalise the report, again within an agreed timeframe of receipt of management responses</li> <li>— Report in accordance with standard template</li> <li>— Determine who should attend and present at stakeholder and Audit Committee meetings</li> </ul>
<b>Issue resolution tracking</b>	<ul style="list-style-type: none"> <li>— Following the issue of final reports, monitor agreed upon management action plans and subsequent reporting to senior management and the audit committee</li> <li>— Clear protocols for follow up work as and when needed</li> </ul>
<b>Overall considerations</b>	<ul style="list-style-type: none"> <li>— Defined audit charter</li> <li>— A defined strategy</li> <li>— An ongoing awareness of key business risks and how this drives audit</li> <li>— Clear role defined on related activities e.g. investigations / ad hoc assignments</li> <li>— Agreed communication protocols</li> <li>— Clear business case / cost analysis and monitoring</li> <li>— Ways of working protocols</li> <li>— KPI’s to track progress and delivery</li> <li>— Stakeholder satisfaction surveys</li> </ul>

Appendix 15

# Specimen internal audit report

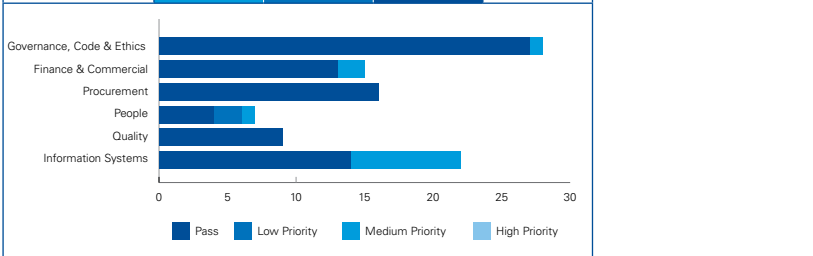
*Overall rating and summary of findings*

**Overview**

<b>Satisfactory</b> Represents an assessment of a control environment that is satisfactory and supports meeting management’s objectives.	<p>The vast majority of internal audits carried out during the period received a ‘pass’ grade and there were no ‘high priority’ observations. However, there were a small number of ‘medium priority’ and ‘low priority’ observations which are discussed in more detail below. Overall, the control environment is in good order and management are working to resolve the issues identified during the audits.</p>
<b>Adequate with opportunity for further development – Medium priority for management to address</b> Represents an assessment of an adequate control environment that broadly supports management’s objectives but has further opportunities for development.	
<b>Unsatisfactory – High priority for management to address</b> A high number of control deficiencies or business issues where the potential financial, operational or reputation risk exposure to XYZ is significant and management should address these issues immediately.	




<b>Performance improvement opportunities (‘PIOs’)</b>	<b>High Priority Observations</b>
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Status	High Priority	Medium Priority	Low Priority	Total	No high priority observations were noted.
<b>New PIOs</b>	0				
<b>Accepted PIOs</b>	0				



### Overview

A summary of the control environment and process improvement opportunities identified as part of this internal audit is provided below:

Area	Compliance/Good Practice	Process improvement/efficiency opportunity
 <p>Governance, Conduct and Ethics</p>		
 <p>Finance and Commercial</p>		
 <p>Etc.</p>		

### Detailed findings

This section summarises in the form of performance improvement observations (PIOs) the issues arising from this review that we believe require action. PIOs are rated using the scale in the legend below:

Priority rating for performance improvement observations raised		
<p><b>HIGH:</b> Issues referring to important matters that are fundamental to XYZ's system of internal control. We believe that the matters observed might cause a business objective not to be met or leave a risk unmitigated and need to be addressed as a matter of urgency.</p>	<p><b>MEDIUM:</b> Issues referring mainly to matters that have an important effect on XYZ's controls, but do not require immediate action. A business objective may still be met in full or in part or a risk adequately mitigated, but the weakness represents a significant deficiency in the system.</p>	<p><b>LOW:</b> Issues arising that would, if corrected, improve XYZ's internal control in general, but are not vital to the overall system of internal control.</p>

No	Priority	Issue	Risk	Performance Improvement Observation	Management Response	Responsibility/ Date
<b>Governance, Conduct and Ethics</b>						
1	<b>LOW</b>					
<b>Finance and Commercial</b>						
2	<b>HIGH</b>					
	<b>MEDIUM</b>					
<b>Etc.</b>						
3						

*Appendix: Scope of work and audit approach*

Objective	Issues/controls being reviewed	Internal audit approach

## Appendix 16

# Evaluation of the internal audit function

This assessment process focuses on your personal perception of the internal audit function as a whole – it does not seek to evaluate individuals and their personalities. The audit committee chair should determine who is asked to complete the questionnaire. It is not unusual for it to be completed by audit committee members, (prior to feedback from other areas of the organisation); the heads of major business units/subsidiaries and the CFO; and the head of the internal audit function (i.e. self assessment). The external auditor may also be asked to comment.

The questionnaire takes about 10 minutes to complete and should be completed in the following manner:

- Using a scale of **1** (low) to **10** (high), complete each question by placing your score in the two boxes beside the question. '**Actual**' is your view of the current position of the internal audit function on that issue. '**Ideal**' is the score that you would like to see. The difference can be used to determine the relative priority of each issue.

You may wonder why there is a choice of score on the **Ideal** position as you may think it should always be a ten (the maximum). This may often be the case; however, there may be occasions where you feel an area is of less importance and therefore may merit an **Ideal** score lower than ten. We would stress that the main reason for asking for the two scores is to see where the biggest gaps are between **Actual** and **Ideal** as this identifies where any development priorities lie.

- There is a space for comments beside each question. You are not obliged to make comments; however, comments do improve the quality of the review and therefore are to be encouraged.
- 'N/A' can be used where you don't have a view on the matter in question.
- All responses will be treated as anonymous unless the individual completing the questionnaire wishes otherwise.



Typical answers look like this:

	Actual	Ideal	N/A	Comments
1. Internal audit has a comprehensive strategic plan, developed in collaboration with the audit committee, executive management and principal stakeholders; and aligned to the organisation's own strategy and medium term risk profile?	6	10		<i>The audit committee has little input into the audit plan. It is received late in the day and is essentially a fait accompli.</i>
2. Internal audit harnesses technology throughout its audit and administrative processes to maximise efficiencies and improve audit effectiveness?	7	7		<i>The technology used is appropriate for a small organisation (and IA function), but it is recognised that more might be achieved if resources permitted.</i>

## A. Positioning

	Actual	Ideal	N/A	Comments
<b>Mandate and strategy</b>				
1. Internal audit has a comprehensive strategic plan, developed in collaboration with the audit committee, executive management and principal stakeholders; and aligned to the organisation's own strategy and medium term risk profile?				
2. Internal audit is recognised by business leaders as a function providing quality challenge (for example by telling them things they did not already know, identifying root causes of control breakdowns and opportunities for improving control design, and trends in risks and controls)?				

	Actual	Ideal	N/A	Comments
3. Internal audit has a sound understanding of business strategy and the associated risks, and be able and willing to challenge the control environment and infrastructure supporting the strategy and be able to read across from one part of the organisation to another?				
4. Internal audit has an integral role in the governance structure (as the 'third line of defence') which is clearly aligned with its stakeholders, clearly articulated in its mandate and widely understood throughout the organisation?				

#### Organisation and structure

5. Internal audit is independent from the business and has clear and unfettered reporting into the audit committee and direct access to the chairman of the board?				
6. Internal audit is structured so as to enable both the maintenance of independence and objectivity on the one hand, and proximity to the business (so as to establish and maintains relationships with and comprehensive understanding of the business) on the other?				
7. Internal audit consults and collaborates with risk control functions to ensure an appropriate allocation of responsibility within the organisation?				

	Actual	Ideal	N/A	Comments
8. Internal audit has a presence in major governance and control forums throughout the organisation, for example, any other committee?				

Stakeholders				
9. Internal audit is characterised by strong relationships at the highest levels (for example, does the head of internal audit and senior colleagues have direct and strong relationships with board members, business heads and senior management)?				
10. Internal audit regularly attends executive meetings to present audit findings, trends and current views (of the control environment)?				
11. Internal audit regularly attends audit committee meetings to present audit findings, trends and current views (of the control environment)?				
12. Through its activities, internal audit is able to articulate to senior management the risks of their actions in a structured and balanced manner, and provide credible recommendations to mitigate the risks?				
13. Internal audit has strong relationships with key external stakeholders (in particular, external auditors and any relevant regulators)?				
14. Internal audit proactively manages relationships with its key stakeholder population?				

	Actual	Ideal	N/A	Comments
<b>Funding</b>				
15. Internal audit has no unreasonable budgetary constraints which limit its ability to deliver on its mandate, given the risk appetite of the organisation?				
16. Internal audit manages its resources effectively to maximise the value of its service to the business?				

## B. People

	Actual	Ideal	N/A	Comments
<b>Leadership</b>				
1. Internal audit has the standing, credibility and impact to present its views in audit (and risk) committees, and influence the organisation?				
2. Internal audit includes sufficient individuals who are senior and experienced enough, with sufficient business understanding, to apply judgement and challenge the business on a broad array of topics?				

<b>Competencies</b>				
3. Internal audit comprises a diverse talent pool with a broad mix of skills and experience gained within internal audit and in business?				
4. Internal audit includes individuals recognised (by the business) as experts in governance, control and risk mitigation?				

	Actual	Ideal	N/A	Comments
5. There is an appropriate mechanism for identifying the skills and competencies required to deliver its annual plan, identifying and relieving gaps and being responsive to the changing risk profile of the organisation?				

#### Staffing strategy

6. Internal audit is forward thinking in its medium to longer term staffing strategy (for example, by taking into account growth areas in the business, new and emerging risk areas, and both internal and external factors affecting the function's ability to attract talent)?				
7. Internal audit is able to attract the 'right' people by providing a value adding career development opportunity to the organisation's top talent?				
8. Internal audit is able to develop its personnel through comprehensive training and development?				

#### Culture

9. Internal audit is characterised by a culture of challenge, probing, and continuous improvement?				
10. Internal audit is characterised by a culture of continuous improvement in the internal audit process?				
11. Internal audit acts as a role model and adheres to high ethical standards and values?				

	Actual	Ideal	N/A	Comments
<b>Reward and appraisal</b>				
12. Internal audit has competitive remuneration policies based on the achievement of defined performance metrics (for example, based on quality of work and impact upon the business, and not simply delivery against plan and business performance).				

## C. Processes

	Actual	Ideal	N/A	Comments
<b>Risk assessment and planning</b>				
1. Internal audit has a risk based audit plan based on a risk assessment accepted and approved by the board?				
2. Internal audit is forward looking when determining the audit plan and is nimble enough to adapt its planned activities, sometimes rapidly, in the case of new and emerging risks?				
3. Internal audit submits its plan to the audit committee for approval on a timely basis (at least annually) and as appropriate when updates are required?				

<b>Execution</b>				
4. Internal audit reflects on and adapts its methodology to ensure that it remains fresh and relevant, through integrated (not post hoc) quality assurance and learning programmes?				

	Actual	Ideal	N/A	Comments
5. Internal audit conducts end-to-end/corporate wide audit activities which enable it to obtain a holistic view (for example, within and across business units, functions, processes, and jurisdictions) as to whether the primary risks facing the organisation are appropriately mitigated?				
6. Internal audit harnesses technology throughout its audit and administrative processes to maximise efficiencies and improve audit effectiveness?				
7. Internal audit maintains and promotes comprehensive knowledge management systems, widely used by its staff?				

Reporting				
8. Internal audit produces reports for individual audits with a clear rating scale which identify both root causes and consequences of issues and which are delivered on a timely basis with clarity and impact, and include credible recommendations to management?				
9. Internal audit produce reports for the audit committee which present information in a clear, concise and impactful manner, including the identification of themes and trends, and their consequences for the organisation as a whole?				
10. Internal audit has rapid and effective mechanisms in place for the escalation of issues requiring senior management attention?				

	Actual	Ideal	N/A	Comments
<b>Overall</b>				
11. Internal audit has added value to the organisation? How?				

**D. Comparison of XYZ's internal audit function with other internal audit functions you may have experience of:**

Risk	Comments



## Appendix 17

# How to conduct an audit tender?

Choosing the right auditor for your organisation is essential – it will help to make sure to get the best out of the process and allow to reap the material benefits of an audit for your business.

### *What you need to do as an audit committee?*

Making the recommendation to the board on the appointment of the external auditor has in many countries around the world for many years been a fundamental audit committee responsibility and even many countries even recently introduced legally binding requirements in relation to audit tendering and rotation.

Audit committees are responsible for initiating and supervising the audit tender process and for recommending the best auditor to suit the needs of the company's business. This tool is aimed to help to approach the tender process in a way that makes it a really worthwhile exercise – one that delivers lasting benefits for the organisation.

## The approach

This is what a typical tender process looks like. Some key points around how to get the best from it.



### How many?

- Consider who to invite.
- Ensure firms are independent or able to obtain independence confirmation.
- Acknowledge the existing auditor, if it's useful, seek their collaboration and input.
- Consider how various firms in audit and non-audit roles may shuffle. What's likely to change? How do you benefit from any potential movements in both audit and non-audit service providers?

### Plan and confirm the process

### Invite a shortlist of firms

### Hold initial meetings/site visits



### Develop initial scorecard

- Workshop to align stakeholders – audit committee/board/executive management.
- Gain input from others and the existing auditor.
- Include tangible and intangible criteria.
- Prioritise and weight scorecard.
- Pre-tender evaluation.
- Keep scorecard flexible at feedback points.
- Share the scorecard with participants.
- Assign project management resource.



### Communication and data

- Be clear around what's involved in the project.
- Structured briefing to participants – 1 to many and 1 to 1.
- Workshops with tenderers.
- Involve executive management and AC.
- Create a data-room.
- Manage the relationship with the incumbent.
- Keep site visits well managed and efficient.
- Provide feedback.
- Update decision scorecard criteria.



## Document or not?

- Provide workable timings for tenders to give their best response.
- Think about how the formats they use to respond – traditional hard copy document response vs alternatives such as soft copies.
- Keep RFP and allowed response size guidance short.
- Link tender document questions to the scorecard.
- Provide feedback to tenderers.
- Update decision scorecard criteria.



## Manage any differing internal points of view

- Use scorecard as a guide.
- Give consideration to both tangible and intangible scoring.



## What is real?

- Consider alternatives to a formal presentation that will allow you to see what it's really like to work with prospective firms.
- Mark against decision scorecard criteria.
- What do the documents tell you?



## Now what

- Finalize any remaining commercial terms.
- Transition – allocate resources.
- Involve the incumbent.
- Consider any actions to be taken relating to changes to the services various firms will now provide (the service shuffle).
- When does independence start?
- Win/loss debriefs.

## Step 1 – Identify objectives

Think about what you want to achieve before starting the process. Stakeholders may have different objectives so it's important to align each stakeholder well in advance to avoid later disruption to the process or decision making. It's often beneficial to hold a stakeholder workshop to identify and collate the objectives of the collective group. You may want to involve the existing auditor in this discussion where appropriate, to ensure you're covering all considerations.

### *Give careful consideration to the services you need:*

- What's included in the tender? Should it include 'the fund' as well as the corporate audit?
- Which services should be tendered at the same time? Are there potential benefits from tendering internal audit and expat taxation or other services at the same time as the external audit? Tendering a number of services simultaneously will increase the effort involved, but this could be marginal compared with conducting separate tenders for separate services over a number of years.

### *Your objectives may include:*

- Improved audit quality and/or service.
- New ideas.
- New approach.
- Fee reduction.
- Testing the market.
- Rationalising the advisers in a group.
- Access to a wider range of experience.
- Better continuity.
- Responding to corporate governance best practice.

## Step 2 – Plan the process

Planning is important. Not only to help achieve a successful outcome – it also ensures the process is as efficient as possible. Careful planning can help you to control the amount of time devoted to the exercise, while allowing firms the access they need to develop an effective proposal.

A poorly managed tender can create additional work through, for example, participants needing to clarify matters or seek additional information, duplicated effort by internal personnel or an inefficient decision making process. There's also the potential for significant management time to be diverted from their "real" job – managing the business.

### *Appointing a project manager*

Appointing a project manager could allow you to focus your efforts on assessing the firms and reaching the right decision for you based on your evaluation criteria.

The role of the project manager is to manage the process and be the direct contact with the participants.

### *Setting the parameters*

The project manager will need direction, so ensure that the parameters of the process are clearly defined. The following activities could help smooth the process and increase efficiency:

- Document the objectives of the tender.
- Clearly define the scope of the work you're offering.
- Define the information to be made available to the participants and make it easily available to them.
- Establish a timetable for the process, which takes into account the commitments of both your senior executives and the financial management team.
- Consider access to the chair, chair of the audit committee and other non-executives and directors as appropriate.
- Agree the composition of the selection panel and the decision making process and criteria that you'll follow.
- Decide on the scope of the written proposals you require and the format of the oral presentations.

For the firms to be able to develop the right approach, they need a good understanding of your business, your needs and your key personnel. This means providing them with an appropriate level of information and access to management.

### *Designing the proposal process*

Professional services tenders traditionally follow a standard structure:

- Invitation to tender – the organisation writes to the firms asking if they're interested in pitching for the work and are capable of delivering to headline needs.
- Site visits – the firms meet with key personnel to understand the business and its needs.
- Document – firms submit a document setting out their proposal. The company reviews the documents and can then draw up a shortlist.
- Presentations – selected firms present to a panel and answer questions.
- Appointment – the decision makers agree which firm they want to appoint, notify the firm and complete negotiations and contractual aspects.

Discussion and negotiation may continue throughout the process.

Increasingly, organisations choose to design tender processes that don't strictly follow the approach set out above. For example, you may choose not to hold formal presentations and instead host deep Q&A sessions developed specifically for each individual firm. This can reduce time and cut straight to the areas where you need most clarity.

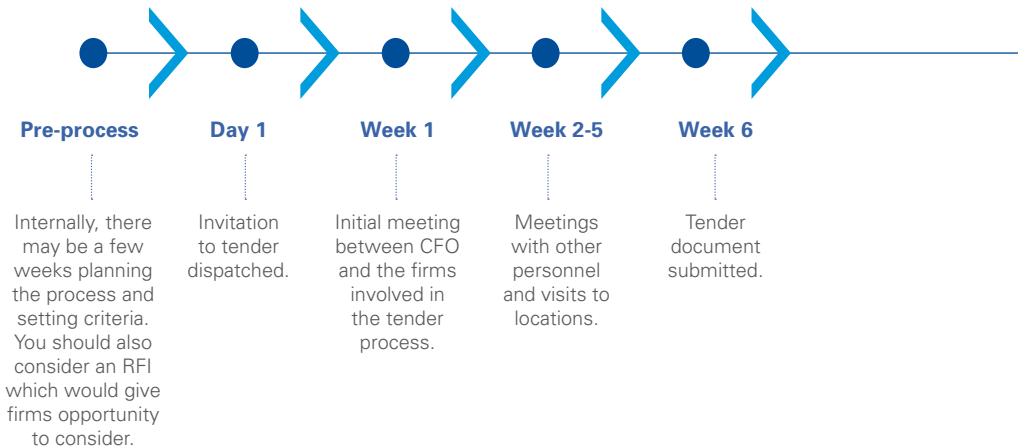
**Timetable**

The length of time you need for your tender will depend on a number of factors:

- The process you decide to follow.
- The number of firms you invite – the more you invite, the longer the process will take.
- Availability and other commitments of your personnel involved in the tender.
- Timing of existing board and audit committee meetings.

The timing of a tender can affect the ease of changing auditors and the efficiency of the process. Typically an audit tender process lasts between eight and twelve

**Example timeframe for a twelve-week external audit tender process**

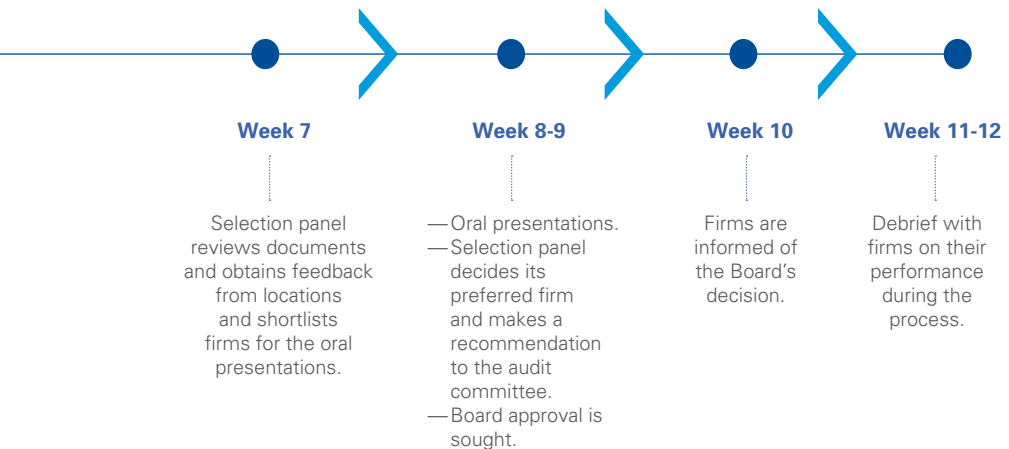


weeks from the time the invitation to tender letter is issued. However the timetable should be developed to accommodate the specific needs of your organisational requirements and objectives.

Remember that the ability of the firms to develop an offer tailored to your objectives and requirements depends on them being given reasonable access to management during the process. Balance this with the amount of time your organisation can commit.

Planning a tender process is very important and appointing a project manager is one way of improving the efficiency of the process.

As well as the timetable of your process it is also important to consider the timing of when you first connect with the market and subsequently run the process. This is particularly relevant for independence purposes as some firms might take longer than others to establish independence so it is important to factor in plenty of time for firms to work through what may be required to achieve independence. Of specific note, are the "cooling in" provisions, that prohibit certain design and implementation services in the year prior to the new auditor performing their first audit.



### *Selecting the invitee list*

It's a good idea to invite only those firms that you know have the resources, infrastructure and coverage to be able to do the job.

If you're not sure which firms to invite, think about those that you, or other people in your organisation, already have a relationship with. You could ask for recommendations from:

- *Other Board members.*
- *Current suppliers.*
- *Your own contacts.*
- *Other business networks.*
- *Other finance directors.*
- *Multipliers (bankers/lawyers).*

If you have a concern about a particular firm that could disqualify it from being appointed, for example over a conflict of interest, it's better to resolve the issue before the tender gets under way.

### *Shareholder consultation*

Whatever the timing you decide on, think about shareholder consultation and make sure they understand the context of any decision. Good practice is to disclose your intention to tender well in advance, for example, in your annual report up to 1-2 years before a tender. This would help you manage shareholder expectations and prevent any "spooks" in the market when you announce a tender.

## **Step 3 – Making the right decisions**

### *Factors to consider*

When planning the proposal process, you should agree:

- Who in the organisation should be involved in making the decision.
- How the decision will be reached.

Your decision is likely to be based on two elements:

- **Tangible** – a number of factual/tangible criteria for comparing the firms (the evaluation criteria).
- **Intangible** – how you feel about the firms, the teams they put forward and how well their cultures fit with your own organisation's style.

### *Decision makers and other inputs*

To find the best audit firm for your organisation, input should be sought from various perspectives from around the organisation and the process should include



representatives of all the parties who'll have a relationship with the auditor and impacted advisory services providers. This would typically be:

- Those who have responsibility for audit related matters – the audit committee, the finance director.
- Those who'll have a relationship with the advisers, head of internal audit, head of tax, general managers, members of the finance functions.

It's important to get the right balance between having enough input and involving too many people and wasting time. You can ask people for their views without them being involved in the whole decision making process, for example, general managers or subsidiary managers can feed back their views following the firm's site visits. Giving internal business units a voice in the development of the scorecard allows them to be heard and will reduce future internal noise around the decision.

It's essential to try to ensure that all the key people are available for significant meetings, for example, site visits and the firm's presentations. Also make sure they've been briefed on the proposal process and its objectives, and that the Audit Committee takes ownership of the evaluation criteria and decision making process.

### *Identifying the evaluation criteria*

It is good practice that tender documents contain transparent and non-discriminatory selection criteria that shall be used to evaluate the audit proposals.

Consider what you're looking for in your auditors and potentially other professional advisers. This will relate to your current needs and to the strategic plans for the future. The factors that are important to you should form the evaluation criteria that you apply.

They may include:

- *understanding your business* – how well do the prospective teams understand your business, the issues you face and the emerging industry trends?

The audit firms' experience in providing audit and other services to other companies in the same sector should be assessed. The perceived disadvantage of such sector experience may be that the audit firm provides services to direct competitors. Auditors are under a professional and legal obligation of client confidentiality and normally go to great lengths to construct 'Chinese walls' to prevent any abuse of an apparent conflict. This threat may be more perceived than real, but it could be a matter of genuine concern.

- *people* – are the team members authorities in their field? Do they have the experience that you're looking for? Do you trust them?

It's important that the audit team is able to address complex technical issues and that appropriate back-up resources are available if required.

- *relationship* – is there a personal fit with members of your team? Do the key partners and managers have the qualities to establish the type of relationship your executive management prefer?

One of the many important aspects of the auditors' position is the working relationship with the company's executive management. The finance director and the finance team must believe that they'll have a relationship with the new auditors that will work and can be based on trust and respect for each other. They need to be satisfied that the audit team will have the appropriate level of staff, with the necessary experience and knowledge and that the personal relationship at the key company/ audit contact points will be workable.

In particular, it's important that the audit partner has an appropriate working relationship with the finance director and the chair of the audit committee, and that the audit manager has an appropriate working relationship with the finance director and key finance staff.

- *proactivity, ideas and strategies* – to what extent have the teams demonstrated that they'll be proactive, bring new ideas and continually enhance their service to you?

Throughout the process, the level of ideas brought to you will provide you with an indication of the type of performance you can expect in your relationship with the firm. Ideas brought to you upfront in the process also allow you to assess the teams' commercial understanding of your business.

- *organisational fit* – does the firm have the coverage that you need? Do its culture and values fit well with your organisation?

The firm needs to be capable of serving the needs of the company. It also needs to really understand your priorities and values and ideally, display these characteristics itself.

- *commitment* – how committed is the firm to providing you with the service you want? How far are they prepared to go?

The level of input at partner level can be an indicator of the level of commitment that the firm has to developing a working relationship with your company.

- *approach* – how well does the proposed approach to the work address your needs and provide the added value that you're looking for?

- *independence* – can the firm achieve independence?

- *dedicated service professional input* – to what extent do the firms have the dedicated service professional experience that you'd like access to?

This can be a section required in the documentation by which you can assess approaches and use of industry authorities on the team.

- *fees* – will you get good value for money on an ongoing basis?

The executive management may be keen to demonstrate their tight control over the company's costs, through a reduction in the audit fee, but this may not necessarily be in the interests of the Board or the shareholders, or even of the

executive management themselves. A more appropriate measure may be value for money rather than absolute cost.

Where there's a downward pressure on the audit fee particularly, this poses a challenge to the audit process. The audit committee should be mindful of the appropriateness of the proposed audit fee, so as to strike a balance in which the fee is low enough to present a challenge to the audit process to improve the efficiency and effectiveness of the audit, but high enough to enable the auditors to undertake a thorough audit in accordance with auditing standards.

The audit committee must satisfy itself that the audit fee quoted is a realistic fee for undertaking a full and proper audit and that the auditors aren't relying on obtaining additional non-audit work to subsidise an unrealistically low audit fee.

To some extent, audit efficiency can be helped by the company providing the correct information in an appropriate format at the right time. In this way the company may have some influence over the overall audit cost. Such arrangements, and any other ways by which the company might be able to help the efficiency of the audit, should be discussed with the potential audit firms as part of the selection process.

### *Independence and objectivity*

You'll need to review your approach to awarding contracts for advisory and tax services, often referred to as "non-audit" services, in the case of certain services up to a year before the start of the audit period. The outcome of your tender process may affect other projects you have underway. Understanding how long it may take to resolve these issues and the impact on your business will prevent any last minute panics.

Also give consideration to the independence of your board and exec team. Could you be challenged on their independence? If so, you'll need to assess whether these are valid concerns and think about how you could mitigate or remove this. Because you need to be independent in decision making, you may even need to change your succession plans or committee chairpersonships. The earlier you can think about this, the better – consult your investors and have a proposed plan of action.

### *The decision making process*

Once you've identified the criteria that are important to your organisation, prioritise them according to importance and weight them with a number score. You might do this by asking all relevant internal parties to identify and weight the criteria that are important to them. Combining the responses should ascertain the overall weighting as fairly as possible.

Make sure that whatever process you devise takes into account both the tangible and the intangible. If you rely solely on the highest score for tangible elements, you may appoint a firm that's the best technically, but find that key people in your organisation don't want to work with them.

### *Rotation - consider the shuffle of services, role of the previous auditor and step change*

Discuss in advance with the previous auditor, the mutual benefit of change. What role would be most beneficial for them to play after they rotate? The rotating firm will also no doubt have insights into how the audit is most beneficially undertaken, what kind of approach, in their opinion, is best for your organisation and what kind of personalities will mesh best in your organisation. Involve them early in your identification of objectives and consider advice in other areas.

Maintaining an open dialogue with your incumbent will also allow you to consider what possible step change is desired or required. What would you like to improve upon? In what areas do you see most potential for gain?

## **Step 4 – Begin the audit tender**

### *Issuing the invitation to tender*

The first stage is to prepare and dispatch an information pack to the firms. The pack should include a formal invitation to tender and additional background information.

Your invitation to tender letter should clearly set out:

- The scope of the services being tendered.
- The period of the appointment.
- The process and timetable.
- The pre-determined non-discriminatory selection criteria.
- Areas to include in the proposal document.
- Document delivery information – number of copies required, format and delivery details.
- Likely format, content and timing for any presentation phase.
- Any ground rules for the proposal, for example, all communication must be copied to the project manager.
- Information regarding access to your personnel.
- Contact information for the key contact.

Provide as much relevant background information on the company as you can. Consider asking the firms to sign a confidentiality agreement before releasing documents that aren't in the public domain.

### *Site visits*

Get feedback from your staff on their impressions of the firms during their visits to your sites. To ensure some consistency in their feedback, you might find it helpful to provide a site visit scorecard for them to complete.

### *Managing site visits*

The firms' ability to develop propositions that are tailored to your objectives and requirements depends on them being given reasonable access to management during the process. If you want to reduce the amount of time this will absorb, you could:

- Cut down on the number of firms involved in the tender, rather than reduce the number of managers you allow them to see.
- Arrange a group briefing for all firms covering basic matters. Firms will still need individual time with management to discuss and refine their thoughts and ideas with you.

Arranging site visits can be time consuming. Either allow the firms to make their own arrangements, or let the project manager control this stage of the process. It may be easier for your staff to liaise with one internal project manager rather than representatives of a number of firms.

Ensure that the individuals are briefed thoroughly on the process, reasons for the tender and their role in the selection process.

You'll need a way for individuals to feed back their assessments of the tendering firms to the decision makers. This might be done informally, for example through a telephone call, or more formally through a scoring system linked to the evaluation criteria.

You may shortlist participants following assessment of the site visits and full written submissions. Shortlisting at this stage allows you to form a more informed view of what's on offer, without spending the time attending a large number of presentations.

It's important that you have time to build a rapport with the proposed teams to make a fair decision regarding the personal and cultural fit. If you already have strong relationships with the firms, this may be a good approach.

## Example invitation to tender letter

Dear [ ]

The Board of [ ] has decided to review its audit arrangements for the year ending [ 20xx]. The purpose of this letter is to invite your firm to propose, and to advise you of the process which the Board will adopt to select the firm to be recommended for the appointment and the proposed timetable. The selection process will be confined to [ ] and it is anticipated that each firm will bear the costs associated with the tender submission.

Each firm will be required to submit a written tender setting out your capabilities, the key elements of your service and team, as well as your proposed fee by [ ].

The tender should cover the following areas:

- Details of your firm
- Resourcing
- Approach
- Transition
- Quality assurance
- Independence and governance
- Fees
- Additional services.

Further detail that outlines the information to be included in tenderers' written submissions is set out in Appendix (E) to this letter.

From the tenders, we will identify a shortlist who will be asked to make a presentation to [selection panel] including a question and answer session. Appendix (B) details the key dates in the selection process.

Further information to be provided should you choose to tender is outlined in Appendix (D) to this letter.

Mr/Ms [ ] of our company will be responsible for coordinating the tender process and all questions and requests for further information should be coordinated through him/her. He/she can be contacted as follows [ ].

I should be grateful if you will confirm your willingness to participate in the selection process and your ability to comply with the indicated timetable by [ ].

Yours sincerely

## Example site visit scorecard

### *Firm: Completed by:*

Please answer the following questions by circling the relevant score based on your perception of the firm during the site visit.

1 = totally dissatisfied – do not believe they will deliver

4 = completely satisfied – wholeheartedly believe they will deliver the service discussed

### *Example site visit*

<b>1. Did the firm demonstrate clear understanding of:</b>				
- the business	1	2	3	4
- the industry	1	2	3	4
- the market place?	1	2	3	4
<b>2. Did the team clearly understand the business issues and take account of these in their approach to you and the work to be undertaken?</b>	1	2	3	4

### *People*

<b>1. Did the team have the requisite experience and availability?</b>	1	2	3	4
<b>2. Did the team have the necessary qualifications and expertise of your industry?</b>	1	2	3	4
<b>3. Did the team appear professional?</b>	1	2	3	4
<b>4. Was your importance as a client fully appreciated by the whole team?</b>	1	2	3	4
<b>5. Did the culture of the team fit with your site's culture?</b>	1	2	3	4
<b>6. Do you feel you could work well with the team?</b>	1	2	3	4
<b>7. Do you have any concerns about a member of the proposed team? If so who and what? Comments (please be succinct)</b>	1	2	3	4

*Approach – for audit tenders*

<b>1. Has the team explained and agreed the audit approach with you?</b>	1	2	3	4
<b>2. Will key audit areas and issues be discussed prior final audits?</b>	1	2	3	4
<b>3. Will issues be properly discussed and, where to Group Reporting?</b>	1	2	3	4
<b>4. Will audit evidence be cost-effectively obtained?</b>	1	2	3	4
<b>5. Does the proposed standard of reporting meet your expectations?</b>	1	2	3	4

*Previous experience of the firm*

<b>1. Has the team delivered on previous occasions?</b>				
<b>If yes</b>	1	2	3	4
<b>2. Has the team met expectations?</b>		Yes / No		
<b>If yes</b>	1	2	3	4
<b>3. Has the quality of reporting and feedback obtained from the team been consistently of a high quality?</b>		Yes / No		
<b>If yes</b>	1	2	3	4
<b>4. Have you found their approach to be robust in dealing with you and your team?</b>		Yes / No		
<b>If yes</b>	1	2	3	4
<b>5. Have the team been proactive and provided strategies to issues before they have become problems?</b>		Yes / No		
<b>If yes</b>	1	2	3	4
<b>6. Would you be happy to continue working with this team?</b>		Yes / No		
<b>If yes</b>				
Comments (please be succinct)	1	2	3	4



## Information to be supplied to participants in audit tenders

Information which firms find useful and you might consider providing is outlined below.

### *Selection criteria (required)*

- Transparent and non-discriminatory pre-determined selection criteria.

### *Organisational*

- Mission statement and corporate strategy.
- Organisation chart, showing the key individuals, responsibilities and reporting lines.
- Organisation structure, e.g. business processes, business units, functional, including key locations.
- List of subsidiaries and associates.
- Names of all Audit Committee members and senior management.
- Locations and operations, domestically and overseas.
- Cultural information.

### *Financial*

- Most recent financial statements for all key group companies (last two years).
- Group structure chart.
- Year-end / reporting / consolidation process and timetable.

### *Other (as appropriate)*

- Internal Audit scope and plan.
- Internal Audit department structure, responsibilities and reporting lines.
- IT systems in operation.
- Current tax arrangements / suppliers.
- Current tax status.

### **Example content for written audit submissions**

The tender document should include the following information.

#### *Details of your firm*

- A statement summarising the benefits to [client] of selecting your firm.
- The organisation and structure as it is relevant to this engagement.
- Industry experience and client base.

#### *Resourcing*

- Names of your core service team, location and relevant experience.
- Personal fit with the management team and culture.
- The time the key team members will commit to this appointment.
- Succession planning and steps to ensure staff continuity.

#### *Approach*

- Understanding of our broader business needs and risks.
- Processes for delivering audit services which are customised, responsive and aligned with [client's] specific needs.
- Processes that your firm will employ to address matters related to client satisfaction, performance measurement and continuous improvement.
- How you will liaise and work with our internal audit and/or tax department.
- How you will use technology to deliver your service.
- How you will report your audit findings to us.

#### *Transition (if appropriate)*

- Process for audit transition of [global] clients.
- Relevant previous experience with audit transitions of similar companies.
- Transition plan.

#### *Quality assurance*

- Describe the internal processes used for quality assurance.
- Describe your firm's approach to resolving accounting and financial reporting issues.

### *Independence and governance*

- Internal practices to ensure compliance with independence requirements and freedom from conflicts of interest.
- Summary of relationships that may reasonably be thought to bear on independence and the proposed plan to manage them (e.g. non-audit services).
- Confirmation by your firm that it will take all necessary steps to ensure its independence.

### *Fees*

- Competitive fee quote to complete the [global audit for 20XX].
- Separate estimates of your total audit fees for reporting on:
  - half year results
  - the final group accounts
  - the accounts of subsidiaries, required for statutory or other purposes.
- The basis on which fees will be determined in future years.
- General overview of the schedule and timing of billings.

## **Guidance for data rooms in audit tenders**

### *Why use a data room?*

Data rooms give you the chance to give tendering firms lots of information in one go, making the process much more efficient and saving you time and money.

### *Six things to think about when you're putting a data room together*

1. Make it virtual rather than an actual physical space. This way firms can have access to it as and when they need to. And you don't need to use valuable space in your office.
2. Make it easy for lots of people within each firm to get access to it by giving them just one ID and password. (Rather than an ID/password to each individual.)
3. Index and label the information clearly to make it easy to find. (This will also save you time if firms have questions about specific documents.)
4. Make sure documents can be downloaded. This will mean firms can have all the information at their fingertips and will scope and price the Audit appropriately.
5. Keep the questions that each firm asks confidential to protect each firm's competitive position.
6. Set up an automatic data alert, so firms know when you've added a new document.

### *What to include in a data room?*

Below you will find a list of all the information that's useful to include. We haven't included information that's publically available, e.g. Annual Report, Accounts and published strategy documents etc.

#### Group structure

- Organisation chart, showing key individuals, responsibilities and reporting lines including Finance, Compliance, Corporate Audit, Commercial organisation including clusters and categories, specialist areas (such as IT, Treasury, Tax, Enterprise support etc)
- Location of operations globally including addresses and number of personnel

#### Statutory accounts

Group structure chart and how it compares to the structure in the financial reporting system if different

- Detailed listing of audit requirements in each country including statutory audits within scope and any other requirements
- Latest statutory accounts of entities requiring an audit for last 2 years
- Prior year or indicative current year fees for subsidiary entities requiring an audit (indication whether statutory, regulatory and group reporting fees)
- Details of where local statutory accounts are prepared if it is other than the local country itself

#### Financial results for the last 2 years

- Breakdowns of revenue and operating profit (before and after tax) by company
- Balance sheet by company
- Tax workings
- Budget presentation
- Current bank model / cash flow forecast

#### Group reporting and consolidation

- Indicative reporting dates and detailed year end timetable
- Example reporting pack
- Full system databook or equivalent
- Description of the month end and year end consolidation process. Process notes to include how key transfer pricing works, how intercompany transactions and balances are processed, local sign offs and the top level journals process

### Standards and manuals

- Policy on Auditor Services
- Financial Planning and Budgeting Policy
- Financial Reporting and Control Policy
- Accounting Policy Manual

### Governance

- Risk register
- Description of the process for updating the risk register
- The process supporting:
  - Key Group risk policies
  - Credit risk policy
  - Insurance risk policy
  - Liquidity risk policy
  - Market commodity risk policy
  - Key audit risks

### Audit Committee/ Board papers

- Executive management and Audit Committee meeting dates
- Audit Committee Agendas (and attendees) for last 2 years
- Audit Committee papers for the last 3 years including key judgements papers
- Board papers including strategy papers
- Board committee papers

### Group Audit & Assurance

- Charter
- Plan
- Summary of key findings for prior year and year to date
- Corporate audit reports for key group processes for last 3 years
- Group audit & assurance department structure, responsibilities and reporting lines

### Compliance and controls

- Detail of any significant deficiencies and material weaknesses for last 2 years
- Description of compliance review process including scoping
- Copies of any agreed CIA with the regulator
- Internal Anti Bribery and Corruption policies and procedures

### Internal controls and risk management

- Description of Internal Control Questionnaire process
- Summary of the results of the internal control evaluation process
- Full details of the financial controls framework with description of controls and key controls highlighted
- End-to-end financial controls process documentation (including automated controls and specifying location of control operation) for the following processes:
  - Revenue
  - Purchases
  - Exploration and evaluation costs
  - Deferred stripping
  - Close down, restoration and clean-up
  - Tax accounting
  - Cash management
  - Intercompany elimination & profit in stock management
  - Foreign exchange management
  - Payroll
  - Impairment
  - Pension obligation and charge
  - Month end consolidation
  - SAP Master Data amendments
  - Technical reporting process and reserves
  - Quarterly reporting process
  - Annual Report and Accounts
  - Schedule with vision for key high level review controls planned to implement
  - Description of SOx compliance review process for the last two years including scoping to see progression
  - Results of testing for SOx
  - Compliance team structure, responsibilities and reporting lines

### IT Systems

- Overview of IT environment
- Details of global applications (version, description of use)
- Details of IT infrastructure and supporting tools
- Overview of IT organisation
- IT organisation structure, roles and responsibilities and geography
- Extent of use of third parties, and details of the services they provide
- Current and future IT Projects
- Overview of the current portfolio of IT projects
- Overview of key IT projects recently completed, ongoing or future projects likely to impact on systems / processes and controls
- IT Risk, Security and Control Environment
- Overview of current / emerging IT risks
- Details of tools currently used to serve as continuous monitoring of IT controls e.g. SAP GRC, Data analytics engines
- Controls catalogue detailing General IT Controls (User access, change management, security, segregation of duties, programme development, computer operations, etc)
- Any third party assurance reports over IT services (e.g. ISAE3402)
- IT internal audit reports from the past 2 years

### Enterprise support

- Structure, responsibilities and reporting lines
- Key priorities, strategy papers and project plans
- Details (and examples) of financial analysis/reports produced for local countries

### Accounting papers

- Accounting papers for key accounting issues
- Detailed accounting policy notes
- Notes on critical accounting estimates and judgments (for those in the annual report)
- All correspondence with regulators in respect of queries for the last five years

### Specialist areas

- Detailed tax workings
- Tax status
- Current tax arrangements
- Correspondence with tax authorities and similar for key countries
- Process description for preparation of taxes paid report
- Treasury set up and process description
- Banking/debt arrangements
- Tax structures

### Corporate Business Development

- Information about recent acquisitions including copies of accounting papers on the accounting for the acquisition, valuation of intangibles, SPAs, due diligence papers and integration and integration plans



## Appendix 18

# Evaluation of the external auditor

**This assessment process focuses on your personal perception of the external audit – it does not seek to evaluate individuals and their personalities.**

The audit committee chairman should determine who is asked to complete the questionnaire. It is not unusual for it to be completed by audit committee members, the CFO; the heads of major business units/subsidiaries and others who have regular contact with the external auditor. The internal auditor may also be asked to comment.

The questionnaire takes about 10 minutes to complete and should be completed in the following manner:

- Using a scale of 1 (low) to 10 (high), complete each question by placing your score in the two boxes beside the question. 'Actual' is your view of the current position of the external audit function on that issue. 'Ideal' is the score that you would like to see. The difference can be used to determine the relative priority of each issue.
- You may wonder why there is a choice of score on the Ideal position as you may think it should always be a ten (the maximum). This may often be the case; however, there may be occasions where you feel an area is of less importance and therefore may merit an Ideal score lower than ten. We would stress that the main reason for asking for the two scores is to see where the biggest gaps are between Actual and Ideal as this identifies where any development priorities lie.
- There is a space for comments beside each question. You are not obliged to make comments; however, comments do improve the quality of the review and therefore are to be encouraged.
- 'N/A' can be used where you don't have a view on the matter in question.
- All responses will be treated as anonymous unless the individual completing the questionnaire wishes otherwise.

### Typical answers might look like this:

	Actual	Ideal	N/A	Comments
1. The audit partner maintains contact with the audit committee on an informal basis 'between meetings'?	8	10		<i>I do not see the audit partner as regularly as I would like</i>
2. The audit firm provide appropriate technical support through seminars and publications?	5	5		<i>I do not look to the auditor (other than the audit team) for my 'professional development'</i>

### A. Calibre of external audit firm

	Actual	Ideal	N/A	Comments
1. The external audit firm has a strong reputation?				
2. Recent or current litigation against the firm will not have a significant adverse impact on the audit firm's reputation?				
3. The audit firm has a strong presence in this industry?				
4. The external audit firm has the size, resources and geographical coverage required to audit this company?				

## B. Quality processes

	Actual	Ideal	N/A	Comments
1. The audit firm has strong internal quality control processes in place? (Factors to be considered include the level and nature of review procedures, the approach to audit judgements and issues, independent quality control reviews and the external audit firms approach to risk.)				
2. The remuneration and evaluation arrangements of audit partners and other key audit individuals do not impair the external auditor's objectivity and independence?				
3. Relevant and qualified specialists are involved in the audit process?				

## C. Audit team

	Actual	Ideal	N/A	Comments
1. Audit team members have appropriate qualifications for their roles?				
2. Audit team members have sufficient industry experience for their roles?				
3. Audit team members understand our business and its issues?				
4. Audit team members are proactive in their approach?				
5. Audit team members are responsive to our requests?				

	Actual	Ideal	N/A	Comments
6. Audit team members are consistent in their approach to matters?				
7. There is sufficient continuity of staff to ensure a smooth audit?				
8. The engagement partner's and other senior personnel's involvement in the audit is appropriate?				
9. There is a strong audit team that works together effectively?				

#### D. Audit Scope

	Actual	Ideal	N/A	Comments
1. The audit plan appropriately addresses the areas of higher risk?				
2. The audit team communicated their audit plan in advance of the audit?				
3. The audit team comprised an appropriate number and level of staff?				
4. Partners and managers were involved sufficiently throughout the audit?				
5. Appropriate specialists are involved in the audit process (IT, tax, Treasury etc.)?				
6. Are all significant operations covered by the external audit?				

	Actual	Ideal	N/A	Comments
7. The audit approach is consistent across the team and audit locations?				
8. The audit team work to appropriate materiality levels?				
9. The audit team complete their work in line with the agreed timetable?				
10 The external audit team's approach to seeking and assessing management representations is appropriate?				
11. The audit team has an effective working relationship with internal audit?				

## E. Communications

	Actual	Ideal	N/A	Comments
1. All communications from the audit team are clear and relevant?				
2. Issues are discussed on a timely basis?				
3. The audit committee/ auditor relationship operates on a 'no surprises' basis?				
4. The external audit firm has open lines of communication with the audit committee?				

	Actual	Ideal	N/A	Comments
<b>5. The audit partner maintains contact with the audit committee on an informal basis 'between meetings'?</b>				
<b>6. Communications accurately detail the issues encountered during the audit and their resolution; including:</b>				
a. the business risks relevant to financial reporting objectives, the application of materiality and the implications of their judgements in relation to these for the overall audit strategy, the audit plan and the evaluation of misstatements identified? and audit locations?				
b. the propriety of significant accounting policies (both individually and in aggregate)?				
c. the propriety of management's valuations of the material assets and liabilities and the related disclosures provided by management?				
d. the effectiveness of the system of internal control relevant to risks that may affect financial reporting (including any significant weaknesses)?				
e. other risks arising from the business model and the effectiveness of related internal controls (to the extent, if any, the auditor has obtained an understanding of such matters)?				
f. other matters relevant to the board's determination of whether the annual report is fair, balanced and understandable?				

	Actual	Ideal	N/A	Comments
7. Audit differences are discussed and resolved efficiently?				
8. There is good communication and coordination between local audit teams and the 'head office' audit team?				
9. The external auditor advises the audit committee about new developments regarding risk management, corporate governance, financial accounting and related risks and controls on a timely basis?				
10. The audit team seeks feedback on the quality and effectiveness of the audit?				

## F. Technical expertise

	Actual	Ideal	N/A	Comments
1. Audit team members have sufficient technical experience for their roles?				
2. The audit team responds to technical questions with a definitive answer within an agreed time frame?				
3. The audit team's advice reflects our commercial considerations in an appropriate manner?				
4. The audit firm provides appropriate technical support through seminars and publications?				

## G. Audit governance and independence

	Actual	Ideal	N/A	Comments
1. External audit partners and staff demonstrate a high degree of integrity in their dealings with the audit committee?				
2. The external audit firm discusses their internal process for ensuring independence with the audit committee?				
3. Management respects the external auditors as providers of an objective and challenging audit process?				
4. The level and nature of entertainment between the external audit firm and management is appropriate?				
5. The nature of non-audit services is appropriate and adequate safeguards exist to preserve audit objectivity and independence?				
6. The external auditor's relationship with both the audit committee and management is appropriate?				

## H. Audit Fee

	Actual	Ideal	N/A	Comments
1. The external audit fee is appropriate given the scope of the external audit? (Consider how the audit fee compares with other similarly sized companies in this industry – a fee that is either too high or too low can be of concern.)				
2. Differences between actual and estimated fees are handled appropriately?				
3. The relationship between audit and non-audit fees is appropriate?				



**I. Comparison of XYZ’s external audit experience with other external audits you may have experience of:**

Issue	Comments

## Appendix 19

# Example policy on employment of former employees of the external auditor

As part of its remit, the audit committee keeps under review the objectivity, independence and effectiveness of the external auditor. The committee approved on [ ] a policy on employment of former employees of external auditors. Under this policy:

- On an ongoing basis, the audit committee agrees with the external auditors which members of the audit team are categorised as the 'key audit partners' and 'other key team members.'
- Key audit partners will not be offered employment by the company or any of its subsidiary undertakings within two years of undertaking any role in the audit.
- Other key team members will not be offered employment by any group company within six months of undertaking any role in the audit.
- Other audit team members who accept employment by any group company must cease activity on the audit immediately and tender their resignation to the audit firm.

Any offer of employment to a former employee of the audit firm, within two years of the employee leaving the audit firm, must be pre-approved by the audit committee when the offer is made for a senior executive position. Between meetings, the audit committee chairman has delegated authority to deal with such appointments at his discretion. Any such interim approval must be ratified at the next meeting of the committee.

## Appendix 20

# Example policy on the provision of non-audit services by the external auditor

XYZ's approach to engaging the external auditor for the performance of audit and other services ensures that those services:

- Are approved by appropriate levels of XYZ management.
- Do not impair the independence of the external auditor.
- Are regularly reported to the XYZ audit committee.

Any engagement of the external auditor must satisfy applicable rules and legislation. The external auditor does not have a preferred supplier status for the provision of other services and is to be appointed only when they are best suited to undertake the work and do not have a conflict of interest due to a relationship with another entity.

### *Independence considerations*

The directors of XYZ must satisfy themselves that the services provided by the external auditor do not compromise external auditor independence. Factors that the directors should consider include:

- The level of fees paid for the provision of other services as a proportion of total fees paid to the external auditor.
- Whether the compensation of individuals employed by the external auditor who are performing the audit of XYZ is tied to the provision of other services and, if so, whether this impairs or appears to impair the external auditor's judgement or independence.
- Whether the individuals performing the audit would also be involved in providing other services.
- Whether the audit fees are sufficient to adequately compensate the external auditors or whether the audit fees are at a level that could increase the need for the external auditor to perform other services to make the external audit commercially viable.
- The external auditor's independence declaration which is required to identify whether there have been any contraventions of external auditor independence requirements.

### Reporting

- All non-audit services provided by the external auditor must be reported every quarter to the audit committee by the external auditor.
- Details of fees paid to the external auditor must be disclosed in the annual report as specified by applicable financial reporting standards and corporate governance codes.
- The annual report should address the approval framework and explain how auditor objectivity and independence is safeguarded.

### Approval process

XYZ protects the independence and objectivity of the external auditor by mandating an approval process for engaging the external auditor. The audit committee has defined the services that may not be provided by the external auditor; refer to the section Prohibited non-audit services. No approval can be given under any authority for the provision of prohibited services. The audit committee has identified specific types of services that are considered to be pre-approved (see section Pre-approved audit and other services). Whether or not pre-approved by the audit committee, all engagements of the external auditor for the provision of other services are subject to the following approval requirements.

### Approval requirements

- Approval must be obtained before the engagement of the external auditor for other services.
- The external auditor must provide a written statement of independence for all engagements, approved by the appropriate authority within the audit firm (typically the principal engagement partner).
- All engagements requiring approval by the CFO or the audit committee must be described in a written recommendation setting out the:
  - Nature and scope of the proposed services.
  - Supplier selection process and criteria.
  - Chosen supplier and rationale as to selection of that supplier.
  - Relationship of individuals within the firm to perform the proposed other services with those within the firm undertaking audit work.
  - Fee estimate, identifying the total cost expected for the current financial year.
  - Category of pre-approved service where relevant.
- Where audit committee approval is required, it must be communicated to the Head of Group Reporting and be noted in the minutes of the next audit committee meeting.

### Approvals

XYZ has established monetary approval thresholds as follows:

	Approval required
Hiring staff from the external auditor	Audit committee
External audit fee	Audit committee
Services not previously pre-approved regardless of fee	Audit committee
Any engagement > EUR 50.000	Audit committee
Pre-approved services between EUR 10.000 and EUR 50.000	CEO or executive committee member
Pre-approved services < EUR 10.000	Direct report to the executive committee

Where the nature or scope of an engagement changes such that the prior approval obtained is insufficient, subsequent approval of the revised engagement must be obtained. For example, if a pre-approved service with a fee estimate of EUR 10.000 increases in scope to EUR 50.000, the approval of the audit committee must be obtained.

#### *Prohibited non-audit services*

The external auditor must not provide services that impair, or appear to impair, their independence as external auditor. Generally, services that are prohibited include those where the external auditor:

- Participates in activities that are normally undertaken by management.
- Is remunerated by way of success fees, contingent fees or commissions.
- Acts in an advocacy role for XYZ.
- May be required to audit their own work.

The following services must not be provided by the external auditor:

- To take any managerial decision, or to take part in any managerial decision-making.
- The provision of bookkeeping services, i.e. the preparation of client accounting records or financial statements.
- The design, development, implementation and management of financial information technology systems.
- To make any valuations that are subsequently incorporated in the financial statements.
- Participation in internal audits. Certain types of internal audit engagements are however permissible.
- To act for the client in the resolution of litigation, including tax litigation.
- To participate in the recruitment of senior management for financial, administrative or management functions, or of members of legal entities of the company (board, etc.).

#### *Pre-approved audit and other services*

Only the audit committee is permitted to grant pre-approval for specific types of services. All specific pre-approved services are prescribed below. Any proposed engagement that is not specifically identified in below or which calls on judgement to be exercised as to whether it is included below, must be treated as not pre-approved. All such engagements require specific approval by the audit committee.

#### *Pre-approved audit services*

Pre-approved audit services is work that constitutes the agreed scope of the statutory audit (including interim reviews or audits) of the Group consolidated financial report and the financial reports of all subsidiaries and affiliates of the Group. (The audit committee monitors the audit services engagements, and approves, if necessary, any changes in terms and conditions resulting from changes in audit scope, Group structure or other relevant events.)

- Statutory audit engagements for the company, the group and each subsidiary and affiliate as required by applicable legislation.
- Financial statement audit engagements for any group entity, incremental to the audit work required for the purpose of the consolidated financial statements, where required by applicable laws or regulations, or as requested to meet internal management requirements for audited financial statements.
- Audits of selected financial information as required by applicable laws or regulations for the purpose of the group satisfying self-insurance and workers compensation arrangements.
- Reviews of interim financial reports of the group as required by applicable companies and securities legislation.
- Audits of management certifications as to the adequacy of internal controls where such audits are mandated by applicable companies and securities legislation.

### *Pre-approved audit related and other assurance services*

Pre-approved audit related and other assurance services comprise work that is outside the required scope of a statutory audit, but is consistent with the role of the statutory external auditor. This category includes work that is reasonably related to the performance of an audit or review and is a logical extension of the audit or review scope, is of an assurance or compliance nature and is work that the external auditors must or are best placed to undertake.

- Audits of financial statements of Group entities for the purpose of inclusion in prospectuses and other forms of offering documents relating to the issuance or registration of debt or equity securities of Group entities.
- Conduct of agreed procedures to permit the issuance of comfort letters in connection with prospectuses and other forms of offering documents referred to above.
- Financial statement audits of employee benefit plans as required by applicable legislation.
- Agreed-upon procedures, extended audit procedures and regulated attest engagements applied to selected accounting financial and non-financial information or financial statements required to respond to or comply with financial, accounting, or regulatory reporting matters, including audits of royalty, emissions and similar returns.
- Audits of reports containing financial or non financial information prepared to meet Group governance objectives, such as the annual Sustainability Report.
- The audit of selected financial information of Group entities in support of disposal and borrowing transactions.
- Consultations on the accounting treatment or disclosure requirements of transactions or events including discussions, research consultations and auditing procedures relating to unusual or non-recurring transactions, including assistance in responding to regulatory comment letters on the Group's financial reports.
- Consultations on the accounting treatment or disclosure requirements emanating from new or proposed rules, standards or interpretations by regulatory or standard setting bodies.
- Assistance with financial due diligence investigations pertaining to potential business acquisitions/dispositions and other major transactions and events (excluding valuation services, appraisals or fairness opinions) including the review of financial statements and other financial data and records and discussions with counterparty finance and accounting personnel.
- Translation of audited financial reports into another language for filing with a national regulator, or to satisfy other financial reporting requirements of a Group entity or affiliate.

### *Pre-approved tax services*

Pre-approved tax services comprise work of a tax nature that does not compromise the independence of the external auditor. Items of such work are typically confined to advisory- and compliance-related services and must not extend to services involving tax-related investments or transactions. None of these services are pre-approved where they would contain elements of assistance or advice on matters of a strategic tax planning or structuring nature.

- Acting as agent of Group companies in the lodgement of income tax returns pursuant to federal, state and local tax legislation.
- Assistance in the preparation of tax returns but with no authority for making elections or determining amounts declared therein.

- The provision of advice concerning the filing of tax returns and the handling of specific items in those returns and in connection with responding to queries in relation to those returns from the tax authorities.
- Advice and assistance with respect to transfer pricing matters, including preparation of reports used by the Group to comply with taxing authority documentation requirements regarding royalties and inter-company pricing and assistance with tax exemptions.
- Compliance reviews and advice on compliance in the areas of tariffs and classification, origin, pricing, and documentation, including assistance with customs audits.
- The provision of independent opinions containing interpretations of taxation legislation as it applies to specific transactions executed or proposed by Group entities, where those opinions are complementary to the external auditor's examination of the relevant financial statements.
- The provision of independent opinions containing interpretations of taxation legislation in connection with tax audits, negotiations with or appeals before federal, state, local and foreign tax agencies.
- Valuation services pertaining exclusively to tax compliance matters.
- The provision of general news and information regarding statutory, regulatory or administrative taxation developments.

#### *Pre-approved other services*

Pre-approved other services is work of an advisory nature that does not compromise the independence of the external auditor. Items of such work are typically confined to risk management, funding or investigative advisory services.

- Review of operational effectiveness of Treasury operations relating to cheque clearing and float-management practices and recommendations regarding potential areas of improvement.
- Conducting internal investigations and fact finding in connection with alleged improprieties, other than where they relate to potential accounting irregularities.
- Review of actuarial reports and calculations to assist the Group in understanding the various processes surrounding actuarial valuations and the potential impact of plan changes or changes in accounting standards.
- Review of compliance by Group companies with local statutory regulations concerning incorporation of entities, constituent documentation (such as constitutions and articles of association) and lodgement of statutory filings with regulatory bodies.
- Assistance in the registration of pension plans as and when required by country specific regulations.
- Risk management advisory services in the assessment and testing of security infrastructure controls.
- Financial and legal due diligence services.

## Appendix 21

# Specimen audit management letter

Dear ABC

### **Audit of XYZ for the year ended DAY MONTH YEAR**

The purpose of this report is to set out certain matters that came to our attention during the course of the interim audit of the financial statements of XYZ for the year ended 31 December.

Our objective is to use our knowledge of the business gained during our routine audit work to make useful comments and suggestions for you to consider. However, you will appreciate that our routine audit work is designed to enable us to form an opinion on the financial statements of the business and it should not be relied upon to disclose all irregularities that may exist or to disclose errors that are not material in relation to the financial statements.

Our report is designed to include useful recommendations that may help improve performance and avoid weaknesses that could lead to material loss or misstatement. It is your obligation to take the actions needed to remedy those weaknesses and should you fail to do so we shall not be held responsible if loss or misstatement occurs as a result.

The report is provided on the basis that it is for the information of directors and management of the business; that it will not be quoted or referred to, in whole or in part, without our prior written consent; and that we will accept no responsibility to any third party in relation to it.

This report is set out in three sections. The first section addresses our observations from this year's audit and our recommendations in each area. These matters have been discussed with management and their response is included as appropriate. The second section is a summary of the matters previously raised in management reports that have not yet been implemented/resolved and their current status. The third section is a summary of matters previously raised in management reports that have been addressed during the current financial year.

We have graded our management report observations:

- Grade 1 observations are those where there is a risk of a significant financial impact on the business that must be addressed immediately.
- Grade 2 observations are those where there is a risk of moderate financial impact on the business, for example a control failure or the absence of a control in an area of moderate risk.
- Grade 3 observations are those that relate to minor control deficiencies or enhancements in control efficiency.

Please do not hesitate to contact me if you have any questions about this report.

Yours faithfully,

**Mr. Brown**  
Partner



## Grade 1 points

### Title of point

#### **Observation**

This section should give a brief description of the point, with any necessary background information, and should highlight the specific risks associated with the observation. It is important that such risks are given, and that they are relevant and realistic.

#### **Recommendation**

This section should give a brief description of our recommendations, which should be clearly stated and which must be viable in a business context. It should also state the benefits of implementing the recommendations.

#### **Management response**

This must be agreed with management.

#### **Action**

This section should give an action plan for the implementation of the agreed recommendations, naming the member of operating unit staff responsible for implementing the recommendation and the date by which he/she intends to do so.

## Grade 2 points

[Included in the same format as for grade 1 points]

## Grade 3 points

[Included in the same format as for grade 1 points]

## Appendix 22

# Specimen Audit Committee statement

As audit committee chair, I consider the key role of the committee to be in providing oversight and reassurance to the board, specifically with regard to the integrity of the company's financial reporting, audit arrangements, risk management and internal control processes and governance framework.

Fundamental to this role is the committee's access to both information and local management. I believe the presentations and reports received during the year from management and the auditor have been sufficient, reliable and timely; and have enabled the committee to fulfil effectively its responsibilities. Committee meetings are always attended by the chief financial officer, chief risk officer, head of group internal audit, and often by the chief executive and chairman. Individual managers join meetings for specific topics, e.g. treasury or business continuity planning. In total, 13 different managers attended one or more meetings during the year. In December, the committee met with the company's chief information officer and director of digital strategy to discuss our approach to technology risk management, including cyber security. The committee will continue to operate in this manner during the next financial year, and is planning to meet local management in at least two regular committee meetings.

Also fundamental to the role of the committee is its relationship with both the internal and external auditors. The committee has a healthy interaction with internal and external auditors and both have direct access to the committee to raise any matter of concern and to report on the results of work directed by the committee. Both the external auditor and the head of internal audit attend all our regular committee meetings and meet privately with the audit committee, in the absence of management, when required.

### **Mr. Blue**

Audit Committee Chair

### The members

The board has reviewed the audit committee's composition during the year and is satisfied that the committee's members have the broad commercial knowledge and extensive business leadership experience, having held between them various roles in major business, government, financial management, treasury and financial function supervision and that this constitutes a broad and suitable mix of business and financial experience necessary to fulfil effectively the committee's responsibilities. The board has determined that Mr. Pink and the audit committee chairman, Mr. Blue, are the designated 'financial experts' and have relevant expertise in accounting and auditing and relevant financial expertise. Both are fellows of the Institute of Registered Accountants Mr. Blue also serves as audit committee chairman for XYZ and ABC NV/SA. The qualifications and relevant experience of the other committee members are detailed on page XX. The committee as a whole has sufficient relevant expertise in accounting, auditing and finance and has an understanding of the following areas:

- the principles of, and developments in, financial reporting including the applicable accounting standards;
- key aspects of the company's operations including corporate policies and the group's internal control environment;
- matters which may influence the presentation of accounts and key figures;
- the principles of, and developments in, law, sector-specific laws and other relevant corporate legislation;
- the role of internal and external auditing and risk management; and
- the regulatory framework for the group's businesses.

Audit committee appointments are for a maximum period of four years after which they are subject to annual review, and can be re-appointed so long as they continue to be independent.

Committee members	Meetings	
	Eligible to attend	Attended
<b>Mr. Blue</b>	4	4
<b>Mr. Pink*</b>	3	3
<b>Mr. White</b>	4	4
<b>Mr. Orange</b>	4	4

\* Mr. Pink joined the committee on DAY MONTH YEAR

### Our role

The committee has written terms of reference which clearly set out its authority and duties. These are reviewed annually and are available on our website.

*Corporate reporting:* We review the published financial results; the Annual Report and other published information for statutory and regulatory compliance and report our views to the board to assist in its approval of the results announcements and the annual report.

*External audit:* We recommend the appointment and re-appointment of the external auditors and consider their resignation or dismissal, recommending to the board appropriate action to appoint new auditors. As part of this process, we assess the performance of the external auditors annually by seeking views on their performance from key stakeholders across the group. We also discuss with the auditors the scope of their audits before they commence, review the results and consider the formal reports of the auditors and report the results of those reviews to the board.

As a result of regulatory requirements, or to ensure efficiency and quality of delivery, it may be necessary to employ the external auditors for certain non-audit services. In order to safeguard the independence and objectivity of the external auditors, the audit committee has determined policies as to what non-audit services can be provided by the external auditors and the approval process related to them.

*Internal audit:* We review internal audit and its relationship with the external auditors, including plans and performance. Additionally we monitor, review and report on risk management processes and the standards of risk management and internal control, including the processes and procedures for ensuring that material business risks, including risks relating to IT security, fraud and related matters, are properly identified and managed. On behalf of the board, we review the group's risk profile, endorse a programme of testing of the risk mitigations and controls that underpin the group's assessment of residual risk and review the group's current risk exposure and capability to identify new risks.

*Internal controls and risks:* We review the process relating to the identification and evaluation of significant risks; and the design and operation of internal controls. We also receive reports on the processes for dealing with complaints received by the company regarding accounting, internal accounting controls or auditing matters. This includes the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters, ensuring arrangements are in place for the proportionate, independent investigation and appropriate follow up of such matters.

*Audit Committee Charter:* Our terms of reference are reviewed annually and drive the work carried out by the committee. After the last review, the terms of reference were amended to formally acknowledge the committee's role in advising the board on whether appropriate processes are in place to ensure the annual report and accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the company's performance, business model and strategy.

The committee has unrestricted access to company documents and information – as well as to employees of the company and the external auditors – and may take independent professional advice on any matters covered by its terms of reference at the company's expense. During the year, the only independent professional advice sought by the committee was the regular presentations from external sector specialists including an independent economist. The committee engage such specialists to guard against asymmetric information risk.

The committee's effectiveness is reviewed on an annual basis as part of the board's performance evaluation process (see page XX) and the committee confirms that it has fulfilled its responsibilities under its terms of reference.

## Summary of responsibilities

In accordance with its terms of reference, the committee is authorised by the board to:

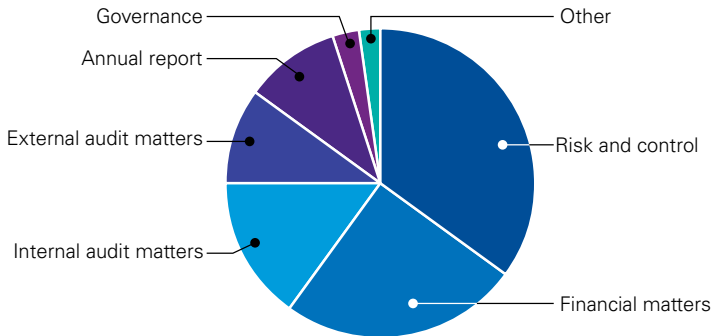
- Monitor the integrity of the group's report and accounts and any formal announcements relating to the group's performance;
- Oversee the relationship with the group's external auditors including reviewing their objectivity and independence;
- Monitor and review the role and effectiveness of the group's internal audit function;
- Oversee the effectiveness of the risk management and internal control systems; and
- Oversee the group's whistle-blowing arrangements.

The full terms of reference of the audit committee are available on the Company's website.

### What we have done

The audit committee met four times during the year and has an agenda linked to events in the group's financial calendar. The chart below shows how the committee allocated its time.

### Where we spent our time



At every meeting, the committee considered reports on the activities of the group internal audit function, including the results of internal audits, risk reviews, project assurance reviews and fraud and whistle-blowing reports.

The committee also monitored the company's financial reporting, internal controls and risk management procedures and considered any significant legal claims and regulatory issues in the context of their impact on financial reporting. Specifically, the committee considered the following matters during the course of the year:

- The current year preliminary announcement and the annual report and accounts (including the associated analyst briefings and investor presentations);
- The accounting principles, policies and practices adopted in the group's financial statements and proposed changes to them; including a review of important accounting issues, areas of complexity and significant financial reporting judgements;
- Whether the annual report provided the information necessary for shareholders to understand our business model, strategy and performance;

- Compliance with regulatory requirements;
- Assessment of the effectiveness of the group's internal control environment and review of the related disclosure in the annual report;
- Reappointment, remuneration and engagement letter of the external auditors;
- Cyber security and IT risk management;
- The risks inherent in senior management reward and incentive arrangements;
- Review of the interim financial statements and announcement;
- Re-approval of the internal audit mandate and annual internal audit plans;
- Reviews of the effectiveness of the audit committee, the external auditors and the internal audit function;
- Review of the committee's terms of reference;
- Review of company risk returns (including Social, Ethical and Environmental risks); and
- Annual review of treasury policy.

### *Financial reporting*

After discussion with both management and the external auditor, the audit committee determined that the key risks of misstatement of the group's financial statements related to provisions for doubtful debts and the assessment of goodwill and intangible assets for impairment, in the context of current market conditions.

These issues were discussed with management during the year and with the auditor at the time the committee reviewed and agreed the auditors' group audit plan, when the auditor reviewed the half year interim financial statements and also at the conclusion of the audit of the financial statements.

*Provisions for doubtful debts* – As further explained in note XX to the financial statements, our approach to estimating bad debt provisions on trade receivables was amended in the second half of last year resulting in an additional provision of EUR 5 million, giving total provisions at the current year-end of EUR 30 million. Management confirmed to the committee that the new approach had been applied consistently during the current year and none of the committee's other enquiries, nor the auditor's work, identified any errors or inconsistencies that were material in the context of the financial statements as a whole.

Management informed the committee that it had monitored the recovery of those debts against which provision had been made at year-end and concluded that just EUR 0,1 million (2%) of the amounts provided has been recovered in the period. No significant amounts had subsequently become irrecoverable against which no amounts were provided.

The auditor explained to the committee the work they had conducted during the year, including how their audit procedures were focused on those businesses where debt recovery risk was greatest due to depressed economic conditions or other reasons. On the basis of their audit work, the auditor reported no inconsistencies or misstatements that were material in the context of the financial statements as a whole; and in our view this supports the appropriateness of our methodology.

Further information about our exposure to credit risk and the quality of our receivables is set out in note XX.

*Impairment of goodwill and intangible assets* - As more fully explained in note XX, the total carrying amount of goodwill and intangibles at the current year-end was EUR 800 million. During the year management assessed the carrying value of goodwill and intangible assets (including detailed calculations of Value in Use for those Cash Generating Units whose recoverable amount is not significantly greater than its carrying amount) to ensure the carrying values are supported by future discounted cash flows. This resulted in an impairment of EUR 50 million with respect to one Cash Generating Unit 1.

The auditor explained the results of their review of the estimate of Value in Use, including their challenge of management's underlying cash flow projections, the key growth assumptions and discount rates. On the basis of their audit work, no additional impairments that were material in the context of the financial statements as a whole were identified by the auditor.

In respect of the EUR 200 million of goodwill related to Cash Generating Unit 1, management's estimated Value in Use of EUR 150 million is based on growth assumptions and a discount rate of 15%. As explained in note XX, this resulted in an impairment of EUR 50 million which has been recognised in the current year.

Management concluded that the growth rate and appropriate discount rate were significant judgements and have explained those judgements in the notes to the financial statements. Based on the growth rate used, the auditor considered that a discount rate between 14% and 23% would be appropriate for similar businesses. Based on their work, the auditor did not identify any further impairment and agreed that it was appropriate for the financial statements to disclose the growth and discount rates as key assumptions and to provide appropriate sensitivity analysis in respect of them. This is set out on page XX.

With regard to the EUR 150 million of goodwill related to our Spanish business, management's estimated Value in Use was EUR 153 million. This was also based on growth assumptions and a discount rate of 15%. The calculation was reviewed by the auditor and, though the headroom is small, in the light of our informed discussions no provision has been recognised in the current year. The key assumptions and sensitivity analysis is set out on page XX.

*Misstatements* – Management confirmed to the committee that they were not aware of any material misstatements or immaterial misstatements made intentionally to achieve a particular presentation. The auditors reported to the committee the misstatements that they had found in the course of their work and no material amounts remain unadjusted. The committee confirms that it is satisfied that the auditors have fulfilled their responsibilities with diligence and professional scepticism.

After reviewing the presentations and reports from management and consulting where necessary with the auditors, the audit committee is satisfied that the financial statements appropriately address the critical judgements and key estimates (both in respect to the amounts reported and the disclosures). The committee is also satisfied that the significant assumptions used for determining the value of assets and liabilities have been appropriately scrutinised, challenged and are sufficiently robust.

### *External audit*

The audit committee is responsible for the development, implementation and monitoring of policies and procedures on the use of the external auditors for non-audit services, in accordance with professional and regulatory requirements. These policies are kept under review to meet the objective of ensuring that the group benefits in a cost-effective manner from the cumulative

knowledge and experience of its auditors whilst also ensuring that the auditors maintain the necessary degree of independence and objectivity.

Typically, the committee will approve the use of the external auditors to provide: accounting advice and training; employee benefit plan audits; corporate responsibility, IT and other assurance services; due diligence in respect of acquisitions and disposals; certain specified tax services including tax compliance, tax planning and related implementation advice; and certain other services when it is in the best interests of the company to do so and they can be undertaken without jeopardising auditor independence.

The company has a policy that any recruits hired directly from the external auditors must be pre-approved by the group HR director, and the group finance director or group financial controller. Recruits into senior positions must be approved by the audit committee.

The audit committee has formally reviewed the independence of its auditor and the auditor had provided a letter confirming that they believe they remain independent within the meaning of the regulations on this matter and their professional standards.

To fulfil its responsibility regarding the independence of the external auditors, the audit committee reviewed:

- changes in the audit plan for the current year;
- a report from the external auditors describing their arrangements to identify, report and manage any conflicts of interest; and
- the extent of non-audit services provided by the external auditors.

To assess the effectiveness of the external auditors, the committee reviewed:

- the external auditors' fulfilment of the agreed audit plan and variations from it;
- reports highlighting the major issues that arose during the course of the audit; and
- feedback from the businesses evaluating the performance of each assigned audit team.

The audit committee holds private meetings with the external auditors after each committee meeting to review key issues within their sphere of interest and responsibility.

To fulfil its responsibility for oversight of the external audit process, the audit committee reviewed:

- the terms, areas of responsibility, associated duties and scope of the audit as set out in the external auditors' engagement letter for the forthcoming year;
- the external auditors' overall work plan for the forthcoming year;
- the external auditors' fee proposal;
- the major issues that arose during the course of the audit and their resolution;
- key accounting and audit judgements and estimates;
- the levels of errors identified during the audit; and
- recommendations made by the external auditors in their management letters and the adequacy of management's response.



The auditor periodically changes its audit partners at a group, divisional and country level in accordance with professional and regulatory standards in order to protect independence and objectivity and provide fresh challenge to the business. Such changes are carefully planned to ensure that the group benefits from staff continuity without incurring undue risk or inefficiency.

Mr. Brown completed his six-year term as lead audit partner, as specified by auditing standards, at the conclusion of the audit last year. His successor, Ms. Black, will continue as lead audit partner.

The total fees paid to the auditor for the current financial year were EUR 1 million of which EUR 0,1 million related to non-audit work. Further details of audit and non-audit fees are set out on page xx.

### *Internal audit*

The audit committee assists the board in fulfilling its responsibilities relating to the adequacy of the resourcing and plans of internal audit. To fulfil these duties, the committee reviewed:

- internal audit's reporting lines and access to the committee and all members of the board;
- internal audit's plans and its achievement of the planned activity;
- the results of key audits and other significant findings, the adequacy of management's response and the timeliness of resolution;
- statistics on staff numbers, qualifications and experience and timeliness of reporting;
- the level and nature of non-audit activity performed by internal audit; and
- changes since the last annual assessment in the nature and extent of significant financial risks and the group's ability to respond to changes in its business and the external environment.

The key areas of internal audit focus during the year were our strategy setting process and governance procedures, whistle-blowing arrangements, accounts payable and receivable, project velodrome, regulatory compliance, data security and fraud risk.

The key control issues identified by internal audit during the year concerned our procedures to embed our anti bribery and corruption policies in the Far East and our IT data protection controls in our US operation. The committee is satisfied that no loss has occurred as a result of these control weaknesses and that management has taken appropriate action to address these issues in a timely fashion (see page XX).

### *Internal controls and risks*

In fulfilling its responsibilities relating to the adequacy and effectiveness of the internal control and risk management systems, the committee reviewed:

- the external auditors' management letters and audit committee reports;
- internal audit reports on key audit areas and significant deficiencies in the financial control environment;
- in conjunction with the remuneration committee, the remuneration structures and incentives for senior executives;
- reports on the systems of internal financial controls and risk management; and
- reports on fraud perpetrated against the group.

The interaction between executive remuneration and risk management has been a particular area of focus during the year and the audit committee chairman, Mr. Blue, has regularly attended meetings of the remuneration committee to familiarise himself with the executive remuneration arrangements and how various financial and other metrics are used in the company's incentive arrangements. The committee has also, in conjunction with the remuneration committee, considered the appropriateness of the incentive structure and whether it contributes to increased fraud risk; and whether adequate and appropriate focus is being paid to the remuneration of officers and directors, including the appropriate use of corporate assets. The committee has concluded that the remuneration policies and practices for top executives, key business unit leaders and senior finance, control and risk management personnel are appropriate for maintaining a robust control environment consistent with good stewardship.

The group's whistle-blowing policy contains arrangements for the company secretary to receive, in confidence, complaints on accounting, risk issues, internal controls, auditing issues and related matters for reporting to the audit committee as appropriate.

The group's anti-fraud policy has been communicated to all employees and states that all employees have a responsibility for fraud prevention and detection. Any suspicion of fraud should be reported immediately and will be investigated vigorously.

A description of the group's principal risks and uncertainties, the main features of the system of internal control and the process by which the board have reviewed the effectiveness of the group's risk management and internal control system is given on page XX. The committee confirms that appropriate actions have been or are being taken to remedy any significant failings or weaknesses identified from the reviewing the system of internal control.

#### *How we keep up to date*

The committee receives regular technical updates from management, the auditors and KPMG's Audit Committee Institute, as well as specific or personal training as required. To guard against information bias and to broaden the scope of the audit committee's thinking, the committee also receives regular presentations from external sector specialists including an independent economist.

Committee members also meet with local management on an ongoing basis in order to gain a better understanding of how group policies are embedded in operations.

The committee's effectiveness has been reviewed as part of the board's performance evaluation process (see page XX). The process involved a review of information provided to the audit committee followed by confidential interviews with the audit committee members, the chairman of the board, CEO, CFO, company secretary, head of risk management and both internal and external auditors.

The outcome of the evaluation has confirmed that the audit committee has a good balance of skills, is working well and continues to be refreshed, with the appointment of Mr. Pink during the year. The committee feels well-informed and key issues are well-managed, with sufficient opportunity for challenge and debate. However, recognising that there is always room for improvement, the process also identified a number of areas for focus in the coming year, including improving:

- the committee's access to local management by increasing the number of presentations that will be made to the committee by operational managers;
- the focus on risk management by restructuring meetings to distinguish between the 'business as usual' agenda and the risk management agenda. Reporting to the committee on significant risk matters will be enhanced.

Furthermore, a revision to the timings of audit committee meetings to improve the timing of information flows has been implemented; however, the number of audit committee meetings is a subject which the committee intends to keep under review.

#### *Further questions*

Mr. Blue, the audit committee chair, will be present at the annual general meeting to answer questions on this report, matters within the scope of the committee's responsibilities and any significant matters brought to the committee's attention by the external auditors.

## Appendix 23

# Audit committee disclosure checklist

The following checklist has been extracted from 'Audit Committee Reports: Global Disclosure Guidelines' published by the Enhanced Disclosure Working Group of the Global Auditor Investor Dialogue<sup>1</sup>.

Guideline 1 - Substance not Form	
1. Does the report use non-boilerplate language?	<input type="checkbox"/>
2. Does the report provide a useful and engaging account of the audit committee's activities, providing specific information about the work the audit committee has done?	<input type="checkbox"/>
3. Does the audit committee report give informative emphasis to key audit issues and how they are managed?	<input type="checkbox"/>
Guideline 2 - Audit Committee Charter	
4. Has reference been made to the annual review of the audit committee charter?	<input type="checkbox"/>
5. Have any changes to the audit committee charter been disclosed and explained?	<input type="checkbox"/>
6. Does the audit committee confirm that it has fulfilled its responsibilities under the charter?	<input type="checkbox"/>
7. Does the audit committee confirm that its charter permits it to obtain independent external advice at the company's expense?	<input type="checkbox"/>
8. Has the audit committee disclosed whether or not it obtained independent external advice?	<input type="checkbox"/>

<sup>1</sup> The Global Auditor Investor Dialogue is an informal forum whose members comprise the major global auditing networks and leading global investors and share owners. The Global Disclosure Guidelines may or may not represent the views of the individual Dialogue members.

<b>Guideline 3 - Audit Committee Membership</b>	
9. Has the board confirmed that it has reviewed the audit committee's composition during the year and that it is satisfied that the audit committee has the expertise and resource to fulfil effectively its responsibilities, including those relating to risk and controls?	<input type="checkbox"/>
10. Has the board provided a convincing and informative explanation to support its opinion that the audit committee has not only recent and relevant financial and audit experience but also commercial, financial and audit expertise to help it assess effectively the issues it has to address?	<input type="checkbox"/>
11. Have any changes to the composition of the audit committee been disclosed and explained?	<input type="checkbox"/>
<b>Guideline 4 - Information flows to the Audit Committee</b>	
12. Has the audit committee confirmed that it has received sufficient, reliable and timely information from management and the external auditors to enable it to fulfil its responsibilities?	<input type="checkbox"/>
<b>Guideline 5 - Risk and Internal Controls</b>	
13. Has the board, audit committee or other relevant board committee disclosed what steps it has taken to satisfy itself that the risk and control framework and processes are operating properly?	<input type="checkbox"/>
14. Is a summary of the process that has been applied in reviewing the operations of the system of internal controls been disclosed?	<input type="checkbox"/>
15. Has confirmation been provided that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from reviewing the system of internal control?	<input type="checkbox"/>
<b>Guideline 6 - Valuation of Assets and Liabilities</b>	
16. Does the audit committee provide an assurance that the significant assumptions used for determining values have been scrutinised and challenged by it?	<input type="checkbox"/>
17. Has the audit committee confirmed that it has satisfied itself that the markets and/or models to which the valuations are marked have liquidity and transaction profiles that are adequate and sufficiently robust?	<input type="checkbox"/>
18. Does the audit committee disclose that it is satisfied that there is meaningful disclosure of critical judgements and key estimates?	<input type="checkbox"/>
19. Has the audit committee provided an unbiased explanation of the factors which account for any significant deviation from previously reported values?	<input type="checkbox"/>
20. Does the audit committee disclose that it is satisfied that the auditors have brought an appropriate degree of professional scepticism to bear?	<input type="checkbox"/>

**Guideline 7 - Write-downs and Impairment Provisions**

21. Has the audit committee provided an informative discussion of the factors which it has taken into account and the considerations it has made when fulfilling its responsibilities in respect of endorsing material write-downs and impairment provisions?

22. Has the audit committee confirmed that it is satisfied that the auditors have fulfilled their verification responsibilities with diligence and professional scepticism?

**Guideline 8 - Securitisation, off-balance Sheet and Contingent Liabilities**

23. Has the audit committee provided a meaningful description of the work it has undertaken to:

- Satisfy itself that all material securitisation arrangements, off-balance sheet liabilities and contingent liabilities have been identified and disclosed in sufficient detail in the financial statements?
- Critically assess and, when appropriate, challenge the valuations ascribed to these liabilities, and the methodologies used to determine them?

**Guideline 9 - Internal and External Auditors**

24. Has the audit committee disclosed when and how periodic formal evaluations of the internal and external auditors were undertaken and the key conclusions arising there from?

25. Has the audit committee provided a convincing, informative and non-boilerplate explanation which supports its choice of auditor?

26. Has the audit committee provided an informative account regarding the controls relating to the provision of non-audit services?

27. Has the audit committee provided a commentary on the level and nature of non-audit services provided?

28. Has the audit committee stated how long the audit firm has been retained as auditor to the company?

29. Has the audit committee set out its policy of putting the audit out to tender and confirmed that it has complied or otherwise with that policy?

30. If there has been a change, or a change is proposed, to the external auditor, has the board or the audit committee disclosed the change promptly to the market and provided in the audit committee report an informative and convincing explanation of the reasons for the change?

<b>Guideline 10 - Audit Planning and Main Audit Issues</b>	
31. Has the audit committee provided an engaging and informative account of how it has fulfilled its responsibilities in respect of audit planning by:	<input type="checkbox"/>
— the internal auditors; and	<input type="checkbox"/>
— the external auditors	<input type="checkbox"/>
32. Has the audit committee disclosed whether or not it has met with the auditors of the key subsidiaries and/or joint ventures?	<input type="checkbox"/>
33. Has the audit committee reported, subject to issues of commercial confidentiality, on the nature and resolution of the main audit issues arising?	<input type="checkbox"/>
34. Has the audit committee confirmed that it has considered the internal control and risk issues that have been brought to its attention by the internal and external auditors?	<input type="checkbox"/>
35. Has the audit committee provided an indication as to the nature of the control and risk issues that have been brought to its attention by the auditors?	<input type="checkbox"/>
36. Has the audit committee disclosed that it is satisfied that management has addressed the internal control and risk issues that have been brought to its attention, or has plans to do so?	<input type="checkbox"/>
<b>Guideline 11 - Executive Compensation &amp; Risk</b>	
37. Has the audit committee provided:	<input type="checkbox"/>
— a brief but informative description of its interaction with the compensation or remuneration committee?	<input type="checkbox"/>
— comfort that the compensation policies and practices for top executives, key business unit leaders and senior finance, control and risk management personnel are appropriate for maintaining a robust control environment consistent with good stewardship?	<input type="checkbox"/>
38. If the above disclosure (#35) has been provided by the compensation or remuneration committee, has the audit committee referred to this in its report?	<input type="checkbox"/>

# Audit Committee Handbook



“The audit committee is not a supervisory board, despite attempts to make it one.

The audit committee is a committee of the board and should not usurp or take on the board’s role and authority.”

Audit Committee Chair

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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## **Audit Committee Handbook**

This Audit Committee Handbook articulates the principles underlying the audit committee's role and provides a vast amount of nonprescriptive guidance to help audit committees and boards gain a better understanding of the processes and practices that help build and sustain effective audit committees in the current business environment.

The handbook is supplemented with a complete set of ready-to-use appendices that are intended to provide practical support to audit committee.