Audit Committee Guide

2021 Edition

KPMG Audit Committee Institute

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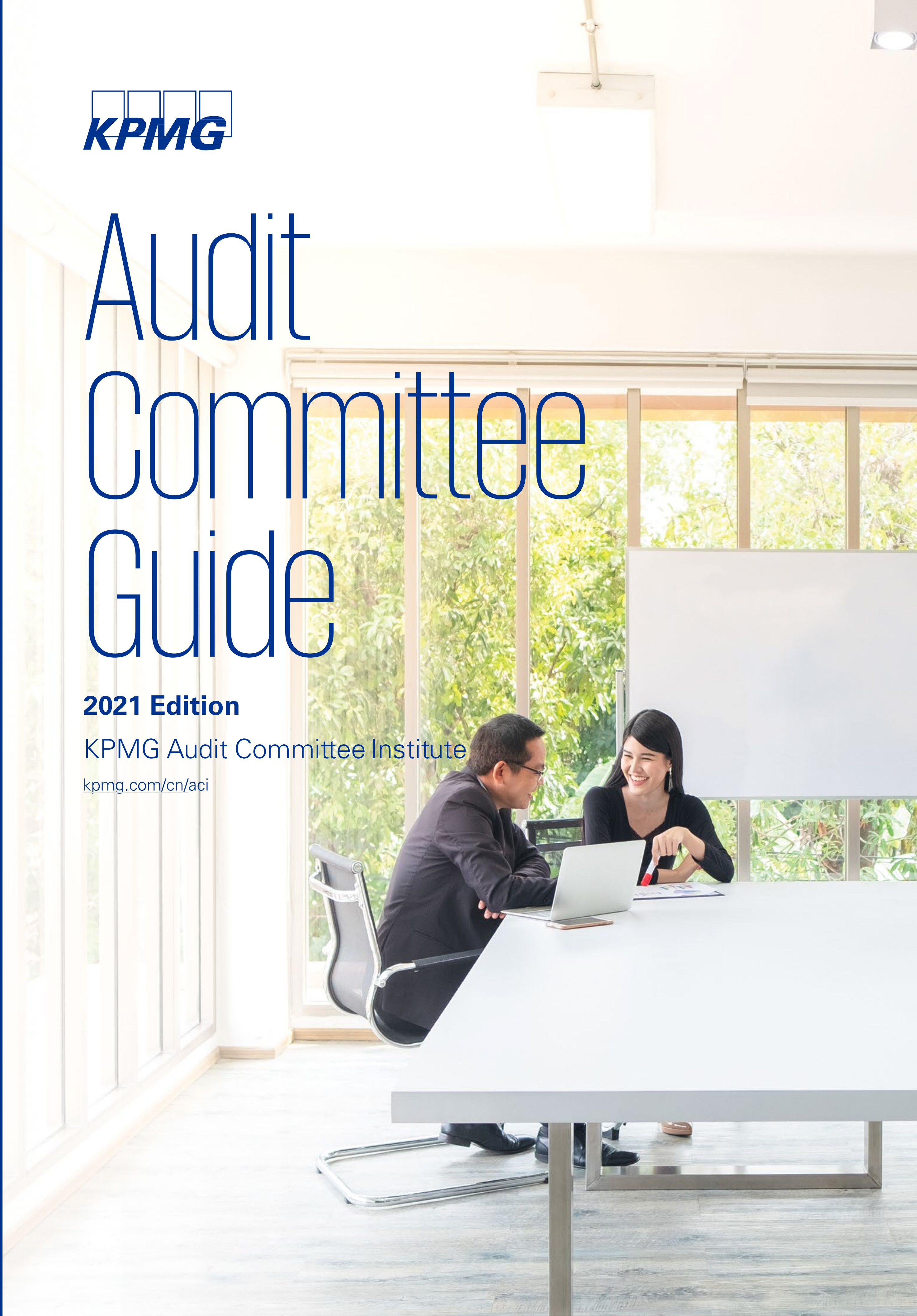

About the KPMG Audit Committee Institute

As part of the KPMG Board Leadership Centre, the Audit Committee Institute (ACI) provides audit committee and other board members with practical insights, resources, and peer-exchange opportunities focused on strengthening oversight of financial reporting and audit quality, and the array of challenges facing boards and businesses today—from risk management and emerging technologies to strategy, talent, and global compliance. Learn more about ACI at **kpmg.com/cn/aci**.

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Using this guide

The KPMG Audit Committee Guide (the Guide) draws on insights from our interactions with thousands of audit committee members, audit and governance professionals, and business leaders across the country and around the world.

The Guide is intended to be a practical, user-friendly reference for both new and seasoned audit committee members, and for the management and audit teams who work with the audit committee. To that end, the Guide 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 for the needs of companies listed on Hong Kong stock exchange (HKEX) and can also serve as a resource—to the extent applicable—for audit committee members of private companies, non-Hong Kong companies, and nonprofits.

Some of the issues covered in the Guide—e.g., risk oversight, cybersecurity and the impact of emerging technologies, long-term performance, shareholder activism, and environmental, social, and governance (ESG) issues—are clearly matters that require the full board's attention. These and other broader issues are included, however, as the audit committee may have an important role to play in helping to ensure that key issues—particularly those related to risk and compliance—are being addressed appropriately.

Of course, no one size fits all; the practices discussed in this Guide should be considered in the context of each audit committee's needs and circumstances. In the appendices, we provide examples of various audit committee materials—including a sample audit committee charter, annual agenda calendar, and audit committee and auditor assessment tools—for consideration and tailoring as appropriate.

Maintaining the committee's effectiveness requires strong leadership, prioritizing the committee agenda, monitoring its oversight processes, and periodically reassessing its skills and composition. The audit committee, in discussion with the full board, should also periodically reconsider whether its risk oversight responsibilities still make sense as the risk landscape evolves.

Our hope is that this Guide will help audit committees continue to fine-tune their oversight and governance processes and drive robust conversations as they help guide their companies forward.

— KPMG Audit Committee Institute

Audit committee's role and responsibilities—An overview

Audit committees have governance responsibility for the quality of financial reporting and play a pivotal governance role in relation to a listed entity's external audit. They are influential in setting expectations for their auditors and challenging the quality of their audits.
—Interim Inspection Report (11 December 2020), Financial Reporting Council

The audit committee is a standing committee of the board of directors, charged with overseeing the company's financial reporting processes and internal control over financial reporting (ICFR) and the audits of the company's financial statements. Given the crucial role that the committee plays in the corporate governance process—which is the cornerstone of shareholder protection—the committee must be independent of management.

The Hong Kong Stock Exchange (HKEX) Listing Rules prescribe the audit committee's purpose, formation and responsibilities.

In the subsequent chapters of this Audit Committee Guide, we discuss in more detail the committee's responsibilities and, importantly, how audit committees carry out these responsibilities—including leading practices we see audit committees employing.

In general, and at a minimum, the audit committee must assist the board in its oversight of the following:

- The issuer's financial reporting system, risk management and internal control systems
- The issuer's financial information including quarterly (if relevant), half-yearly and annual results
- Relationship with the issuer's auditors and their independence and objectivity
- The issuer's internal audit function.

In addition (as discussed in Chapter 5), most boards delegate to the audit committee a number of responsibilities for oversight of risk management. We also discuss how boards are allocating responsibility for risk oversight among the full board and its standing committees, including the audit committee, and emphasize that the audit committee's role can vary widely depending on a number of factors, including the size and complexity of the business and the industry.

The focus by investors and regulators on how the audit committee carries out its oversight responsibilities and related demands for disclosure continue to intensify. This increasing scrutiny—along with the growing complexity of the business and risk environment—is prompting audit committees (and boards) to take a hard look at the committee's workload and activities as well as its composition and leadership—all of which we discuss at some length in this Audit Committee Guide.

Composition, onboarding, and role of the chairman

The HKEX listing rules require that an audit committee must comprise non-executive directors (NED) only — with a minimum of 3 members — and at least one of whom is an independent non-executive director (INED) with appropriate professional qualifications or accounting or related financial management expertise.

Given the majority of the audit committee members as well as the audit committee chairman must be INEDs of the issuer, factors which can affect an individual's time commitment to the issuer should be made aware of, such as an INED for multiple boards and a number of significant commitments at government or non-profit making bodies. Under the HKEX listing rules, if the proposed INED will be holding their seventh (or more) listed company directorship, the issuer should explain why the board believes the individual would still be able to devote sufficient time to the board.

Independence

The HKEX listing rules have set out a number of non-exhaustive criteria for assessing the independence of a NED. In general, a director is "independent" if these criteria are fulfilled. Where a proposed INED fails to meet any of these criteria, the listed issuer must disclose the reasons why such person is considered to be independent in the appointment announcement and next annual report.

Each INED shall submit to the HKEX a written confirmation of independence and inform the HKEX as soon as practicable of any subsequent change of circumstances affecting his independence. The listed issuer must also obtain an annual confirmation of independence from each INED and confirm in its annual reports such receipt and whether it still considers the INED to be independent.

Accounting or financial management expertise

The HKEX requires that at least one member of the audit committee must be an INED with appropriate professional qualifications or accounting or related financial management expertise. The HKEX would expect the person to have, through experience as a public accountant or auditor or as a chief financial officer, controller or principal accounting officer of a public company or through performance of similar functions, experience with internal controls and in preparing or auditing comparable financial statements or experience reviewing or analysing audited financial statements of public companies. The board should determine the candidate on a case-by-case basis and must evaluate the totality of the individual's education and experience.

Onboarding

Whether directors are joining their first audit committee or their fifth, the stronger the onboarding process, the more quickly a new audit committee member will be able to add value. Some boards assign new directors with the required background to the audit committee to provide them with a deeper understanding of the company. The onboarding process should be designed to help the new audit committee member quickly get up to speed on:

- The role and responsibilities of the committee
- The business — its strategy, financial status, operations, leadership, and key opportunities and risks—as well as unique industry issues and trends
- Financial reporting issues, including any specific to the company's industry
- The culture and dynamics of the committee and the board
- Background on current and emerging issues.

For directors joining their first audit committee, an orientation regarding the core role and responsibilities of the audit committee — including a review of the terms of reference regarding their authority and duties — is essential.

While every audit committee of a public company has the same core set of responsibilities, there is significant variation among audit committees regarding the scope of the committee's involvement in oversight of risk. And the number and types of risks overseen by audit committees, such as culture, continue to increase. For both new and experienced directors, the audit committee onboarding process should help the director understand the scope of the audit committee's role in the oversight of risk.

Although this may be described in the committee terms of reference or the company's public filings, often these documents are too general to be helpful on this point, and the company secretary or committee chairman should be consulted.

Onboarding should also cover the basics—what the company does, how it makes money, where it is headed, its significant opportunities and risks, and its control environment. How much information a new audit committee member needs will, of course, vary depending on the complexity of the company and the director's knowledge about the company and its industry. Meetings with the leaders of each of the company's key businesses and others—the chief financial officer (CFO), chief information officer, general counsel, chief compliance officer, chief risk officer, head of investor relations, head of internal audit, and external auditor—can help new audit committee members gather valuable information about the company.

To the extent that new audit committee members have not reviewed them as part of their due diligence prior to joining the board, the following materials are essential reading as part of any onboarding process:

- The company's HKEX filings during the past two years—annual, half-year and quarterly financial reports, and other disclosures
- Other public communications containing financial disclosures and/or projections, including profit warning/alert, presentations made to groups of analysts or shareholders, press releases, media interviews
- Audit committee meeting minutes and materials
- Materials relevant to company strategy, including the current and previous strategic plan as well as scorecards or other materials that are used to track progress against the plan
- Materials relevant to risk, including the company's enterprise risk management activities or program (if it has one), how risk oversight is allocated among the board's standing committees, risk reports or analyses as applicable, summaries of the company's business continuity, and crisis management plans
- Materials relevant to compliance, including:
  - The code of conduct and whistle-blowing policy (if any)
  - A summary of whistle-blower complaints and how they were handled (if any)
  - Contacts by regulators
  - Significant investigations and litigation
- Internal audit plan for the current year and report for the prior year
- External auditor reports and written communications.
- Information on the company's use of nonfinancial measures, such as those relating to ESG.

In order to develop a well-rounded understanding of the company, new audit committee members should include information from external sources as part of their onboarding. In addition to information provided by the external auditor, a new director may find valuable insight into the company's risks by reviewing stock analyst reports, social media chatter, research on consumer perception of brand value, and public disclosures that discuss risks faced by other companies in the same industry. And go beyond the corporate headquarters—visit factories, retail outlets, and offices out in the field. The key is to obtain information that will show the company from a number of different vantage points, including perspectives of the company's critics as well as its fans.

Finally, if there is a new committee chairman, in addition to any other onboarding activities, consider whether the transition of committee chairmen presents an opportunity for the new chairman to use the onboarding period to gather information relevant to the effectiveness of the committee itself, to look at the committee with fresh eyes, and to make changes as appropriate to ensure that the committee is keeping pace. In addition, the onboarding of a new chairman is a good time for the committee to review its succession plan.

Continuing education

HKEX listing rules require companies to address director induction and continuous professional development in the corporate governance code. Audit committees may want to consider offering members access to education programs to help them keep current on recent developments, emerging issues, leading practices, or any gaps in their knowledge. Universities, corporate governance and industry groups, nonprofits, and professional services providers offer a variety of programs that can be customized to the committee's requirements.

Role of the chairman

Beyond the committee’s qualifications and responsibilities set forth in the listing standards and legal/regulatory requirements, the audit committee chairman’s leadership—in setting the committee’s tone, work style, and agenda—is vital to the committee’s effectiveness and accountability, and cannot be overstated.

In our experience, the most effective audit committee chairmen are fully engaged—recognizing that the position may require their attention at any time and beyond regularly scheduled meetings; they set clear expectations for committee members, management, and auditors; and they ensure that the right resources are being employed to support quality financial reporting.

To provide effective leadership, the audit committee chairman must have a clear understanding of the committee’s duties and responsibilities, be able to commit the necessary time (which will vary depending on the size and complexity of the business), be readily available on urgent matters and in times of crisis and have the requisite business, financial, communication, and leadership skills.

In particular, the audit committee chairman 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—quality accounting and financial reporting and effective internal controls
- Making sure the audit committee has the information, resources, and support to do its job and to handle the expanding portfolio of issues it is being asked to manage
- Periodically reviewing and refining the audit committee’s terms of reference, including working with the board chairman and committee chairmen 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
- Helping ensure the finance organization has the talent and resources to maintain quality financial reporting
- Setting clear expectations for external and internal auditors
- Assessing whether members have the expertise to oversee the additional risks delegated to the audit committee and getting input from experts as appropriate

Oversight of financial reporting and internal control over financial reporting (ICFR)

Quality financial reporting starts with the CFO and finance organization. Management is responsible for the preparation of the company's financial statements and related disclosures, as well as maintaining effective ICFR and disclosure controls and procedures. The audit committee has oversight responsibility for these areas and is actively engaged in the financial reporting process, including:

— Reviewing financial communications, including financial statements and disclosures

— Overseeing management's system of ICFR and its disclosure controls and procedures.

Reviewing financial communications

There is little in law or regulation regarding the audit committee's responsibility to oversee financial communications; however, under HKEX listing rules, the audit committee is required to:

— Monitor integrity of the financial statements and annual report and accounts, half-year report and, if prepared for publication, quarterly reports, and review significant financial reporting judgments contained in them

— Liaise with the board and senior management and meet at least twice a year with the auditors

— Consider any significant or unusual items that are, or may need to be, reflected in the report and accounts

The audit committee should focus particularly on:

— Any changes in accounting policies and practices;

— Major judgmental areas;

— Significant adjustments resulting from audit;

— Going concern assumptions and any qualifications;

— Compliance with accounting standards; and

— Compliance with the Listing Rules and legal requirements in relation to financial reporting.

It is critical for the audit committee and external auditor to maintain robust, two-way communications about a range of financial reporting, control, and risk-related issues that may have implications for the company's financial statements and disclosures.

We should emphasize the increasing focus by regulators, investors, audit committees, and boards on disclosures. Different investors have different expectations for disclosures, with varying appetites for the level of disclosure they want. Generally, however, investors want to have an understanding of the state of the business—"what's important?"—as well as some sense of "what's going on in the boardroom." An ongoing consideration for every audit committee and board is whether disclosures can be improved—perhaps going beyond what is required—to better tell the company's story, as well as the audit committee's/board's governance story. HKEX's annual report on Review of Issuers' Annual Report Disclosure provides guidance to issuers on specific areas when preparing annual reports.

Internal control over financial reporting and disclosure controls and procedures

Internal control over financial reporting

ICFR is a process designed by management to provide "reasonable assurance" regarding the reliability of the company's financial reporting and preparation of financial statements in accordance with the Hong Kong Financial Reporting Standard and Hong Kong Accounting Standard.

Under HKEX Listing Rules, the Audit Committee should review the risk management and internal control systems covering the financial controls. Such review should include the adequacy of resources, staff qualifications and experience, training programmes and budget of the accounting and financial reporting function as well as the financial and accounting policies and practices.

The audit committee must disclose how it met its responsibilities in its review of the risk management and internal control code systems in the Corporate Governance Report.

COSO frameworks

The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Internal Control-Integrated Framework (2013) describes five components of internal control—the control environment, risk assessment, control activities, information and communications, and monitoring activities—as well as 17 "principles" and "points of focus" for each principle to help companies better understand and evaluate the effectiveness of internal control. The COSO 2013 Framework also emphasizes the role of the board—and by delegation, the audit committee—in overseeing internal control.

In COSO's 2015 Leveraging COSO Across the Three Lines of Defense, building on COSO's Internal Control-Integrated Framework, the first line (frontline operating management) owns and manages risk and control; the second line (risk, control, and compliance functions put in place by management) monitors risk and control in support of management; and the third line (internal audit) provides independent assurance to the board and senior management concerning the effectiveness of management risk and control.

Financial reporting red flags and fraud risk factors

The pressures on management and employees to engage in financial reporting fraud vary both in kind and intensity, depending on a number of factors. The audit committee must be vigilant and maintain a healthy skepticism about the risk of financial reporting fraud throughout the organization. To this end, the audit committee should have a general understanding of the incentives and pressures that may encourage management to engage in financial reporting fraud, and some of the common red flags. Pressure points for organizations often include:

— Meeting analysts' earnings estimates

— Meeting business plan and budget targets

— Complying with debt covenants

— Meeting incentive compensation targets

— Managing significant and often stressful organizational changes, such as job cuts, acquisitions, divestitures, etc.

— Managing a crisis.

The audit committee's first priority is the integrity of our financials, so if there's pressure that could affect the integrity of the company's financials, the audit committee needs to be actively engaged and really integrated into the rhythm of the organization to stay on top of that.

— Audit committee chairman

Disclosure requirements

The Audit Committee should be aware of the disclosure requirements under the HKEX Listing Rules including financial information, corporate governance, environmental and social matters and other continuing disclosures. The board should also present a balanced, clear and understandable assessment in annual and interim reports and other financial disclosures, as well as for reports to regulators and information disclosed under statutory requirements.

Earnings releases and other financial communications

The audit committee should pay close attention to the company's other financial communications. Under the Inside Information Disclosure Regime, issuers should assess whether profit alert or warning announcement is required before financial period end or when preparing the financial results. It should be specific, meaningful and quantitative to enable investors to assess the financial impact. Material information (e.g. trading updates) and responses to media's enquiry or market rumours should also be made by way of a formal announcement.

Accuracy and consistency across all financial communications is essential. Maintain a “big picture” perspective of the company’s financial communications (i.e. are tone, messages, and information consistent across the earnings releases and other communications, and do they position the company appropriately?).

Short-term results and long-term value

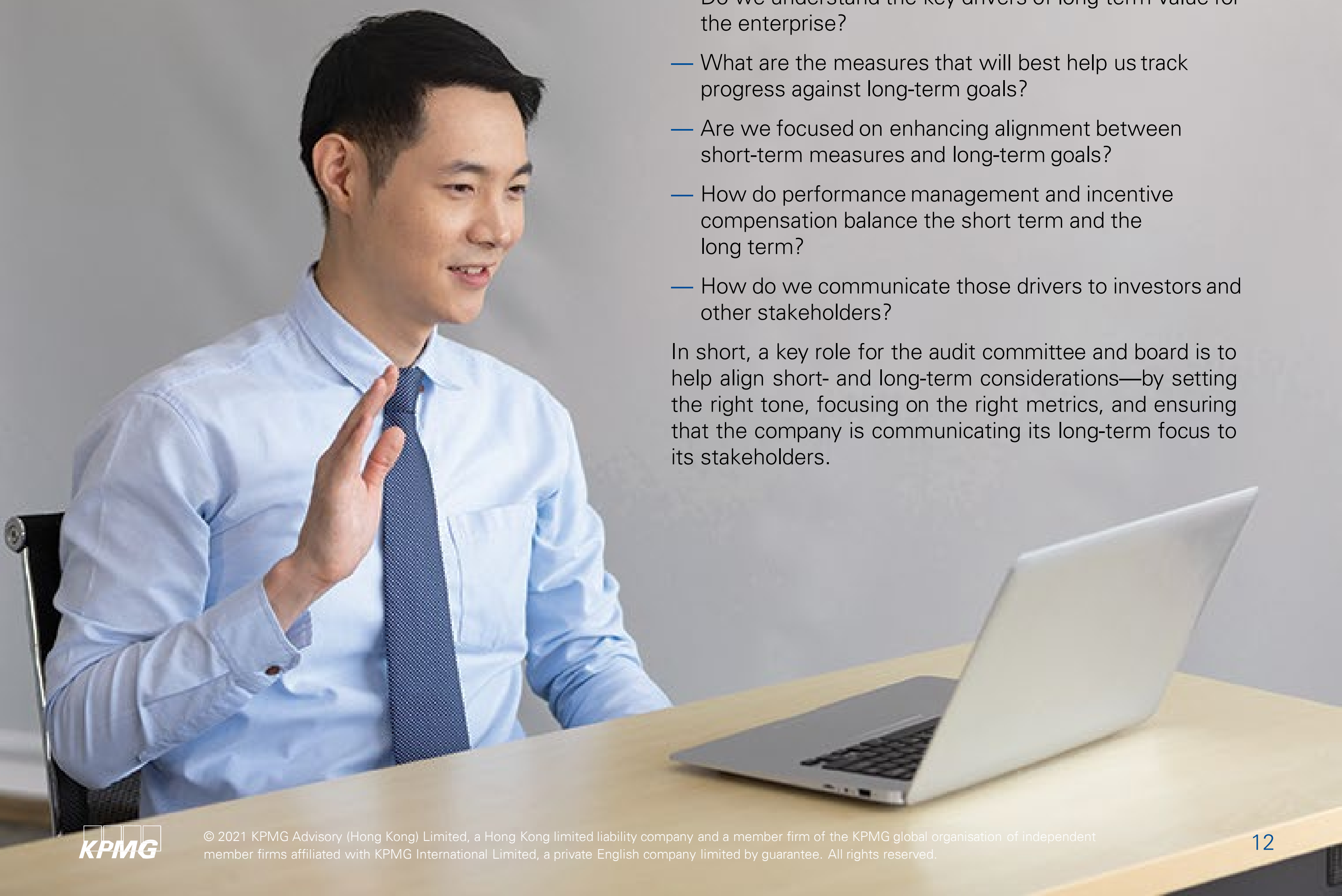
Companies and boards are sharpening their focus on the company’s drivers of long-term value creation. And while financial health is vital—cash flow, growth in revenues and profits, are key—these short-term measurements may provide little, if any, insight about the company’s likelihood of achieving long-term 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, including those related to ESG.

Every company needs to identify the drivers of long-term value based on its particular strategy, risk profile, strengths, and weaknesses. These drivers may be quantitative and qualitative, financial and nonfinancial.

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?
- 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 those drivers to investors and other stakeholders?

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 its stakeholders.



Oversight of external and internal auditors

Because external and internal auditors play a vital role in the financial reporting process, effective oversight of auditors is at the core of the audit committee's responsibilities.

External auditor

The audit committee is "directly responsible for the appointment, remuneration, and oversight" of the external auditor and the external auditor "reports directly to the audit committee". In short, the audit committee should expect to be treated as the external auditor's "client."

HKEX Listing Rules govern the audit committee's relationship with the external auditor.

Generally, the audit committee's oversight responsibilities for the external auditor include:

- Making recommendations to the board on the appointment, reappointment and removal of the external auditor
- Approving the remuneration and terms of engagement of the external auditor, and any questions of its resignation or dismissal
- Reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process in accordance with applicable standards
- Discussing with the auditor the nature and scope of the audit and reporting obligations before the audit commences
- Developing and implementing policy on engaging an external auditor to supply non-audit services
- Determining the scope and extent of the interim review.

The audit committee should meet at least twice a year with the auditors.

In our experience, the following practices (developed in collaboration with the NACD's Blue Ribbon Commission On the Audit Committee) can help the audit committee carry out its oversight responsibilities and build a strong relationship with the external auditor:

Build a strong working relationship between the audit committee chairman and the lead audit engagement partner. A good working relationship between the audit committee chairman 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 premeeting materials together, to discussing important developments on a real-time basis, informal conversations between the audit committee chairman and the lead audit engagement partner are critical to the effectiveness of the audit committee.

The audit committee chairman plays an important role in maintaining the effectiveness and accountability of the audit committee. Likewise, the lead audit engagement partner plays a similar role for the engagement team. A strong relationship—of trust and confidence—between the chairman and the audit partner lays the foundation for productive communications between the engagement team and the audit committee as a whole.

> **Let the external auditor know that you're serious about their objectivity. We need it and we want it. I mean, we (the audit committee) need them, and we hire them. Hopefully we never have to fire them, but it's our responsibility to have a strong relationship so that if we start feeling that there are any issues with the support we're getting from an audit or technical perspective, we can have a productive and professional dialogue to address the concerns.**
>
> — Audit committee chairman

Develop a clear plan for audit partner rotations, as well as rotations for key members of the engagement team. Under normal circumstance, lead audit engagement and engagement quality review partners shall be subject to rotation every seven years.[1] In order to provide continuity and avoid disruptions, audit committees should ensure that the audit firm has developed a clear schedule and timeline for partner rotations—in effect, a succession plan—as well as a process to identify new partners to assume these positions.

Make sure the right people are working on the audit. This requires advance planning, particularly in connection with the rotation of the lead audit engagement partner.

Consider how the audit committee can most effectively carry out its "direct responsibility" for oversight of the external auditor given management's extensive interactions with the engagement team, often on a daily basis. For example, what should be the role of the audit committee versus management in negotiating audit fees? Depending on the unique facts and circumstances, management may be able to help the audit committee during fee negotiations; but in all cases, the audit committee—not management—has direct and final responsibility for determining the auditor's fees. Financial management might initially develop a fee estimate in concert with the external auditor and then propose an overall plan to the audit committee for its consideration. Of course, the audit committee needs to consider and balance management's inherent bias to reduce the auditor's time and fees, and the external auditor's bias to increase audit fees. If this is a concern, the audit committee might take a more active role in the process.

Similarly, the audit committee should consider its role (versus financial management's) in other key areas, such as evaluating the auditor's performance, partner rotation, and reviewing audit plans. In all of these areas, management works closely with the engagement team, and certainly has important insights and knowledge that can help the audit committee carry out its direct responsibility for oversight of the external auditor.

Audit quality initiatives

The Audit Committee shall communicate with the auditors on matters of audit quality, five fundamental elements of which are set out below:

- Culture within an audit firm
- Skills and personal qualities of audit partners and staff
- Effectiveness of the audit process
- Reliability and usefulness of audit reporting
- Factors outside the control of auditors

[1] Code of Ethics for Professional Accountants, "Audit Clients that are Public Interest Entities"

Internal audit

Under HKEX listing rules, the issuer should have an internal audit function (in absence of such function, disclosure of reasons is required). The audit committee should oversee the internal audit function, including:

- Ensure co-ordination between the internal and external auditors
- Ensure that the internal audit function is adequately resourced with appropriate standing within the issuer
- Review and monitor the effectiveness of internal audit function, and disclose how it met this responsibility.

The board's annual review should also ensure the adequacy of resources, staff qualifications and experience, training programmes and budget of the internal audit functions.

As part of their responsibilities, audit committees typically also review the internal audit plan and results of internal audit's work. However, as audit committees have come to rely on internal audit (and the head of internal audit) as one of their primary resources in the oversight of financial reporting and risk management processes, a number of leading practices for oversight of internal audit have evolved. Today, many audit committees play an important role in three key areas:

- Helping to define or clarify internal audit's role and helping to ensure that it has the skills and resources to be successful
- Defining the reporting relationships for internal audit
- Working with the chief audit executive to help identify the risks that pose the greatest threat to the company's reputation, strategy, and operations and helping to ensure that internal audit is focused on these key risks and related controls.

Internal audit's role and resources

At a time when audit committees are wrestling with heavy agendas—and issues like cybersecurity and global compliance are putting risk management to the test—internal audit should be an indispensable resource to the audit committee and a crucial voice on risk and control matters.

This often means focusing not just on financial reporting and compliance risks, but critical risks to the business—key operational and technology risks, and related controls. Does internal audit have the stature—and a direct line to the audit committee—to ensure that its voice is heard and valued? "High-performing departments stand apart in their mindset and how they approach their work," says one seasoned internal audit executive. "They grasp the importance of delivering value, and they are seen by stakeholders as an indispensable resource."

As noted above, an important role for the audit committee is to help clarify and define the role of internal audit in the organization. Do the internal auditor, CEO, CFO, and audit committee have a shared view of the role of internal audit in the organization? Recognize that there are competing demands on internal audit—from the CEO, CFO, business unit leaders, and risk and IT officers—and that the lack of a shared view can undermine internal audit's effectiveness.

Clarify internal audit's role in connection with risk management—which is not to manage risk, but to provide added assurance regarding the adequacy of risk management processes. To this end, are internal audit plans focused on the most significant risks to the business, including strategic and operational risks? Do we have the right controls around these risks? Are the controls functioning properly? Is the audit committee obtaining assurances regarding mitigation of the strategic and operational risks?

The audit committee can help internal audit add value to the organization by:

— **Making sure internal audit has the necessary skills.** Given its evolving responsibilities, internal audit may require different staffing and/or skills, including operational knowledge (supply chain, shared services, outsourcing), IT experience, cross-cultural training for global organizations, knowledge of emerging markets, risk management and evaluation, cybersecurity, blockchain, data analytics, fraud detection, local language skills, and more.

— **Reinforcing internal audit's stature within the organization and its accountability to the audit committee.** As internal audit becomes more involved in helping the organization manage risk and achieve strategic objectives, there is a greater need for the audit committee to help ensure the objectivity of the internal audit function. Direct and open lines of communication between the audit committee and the head of internal audit become more important. Also, leverage internal audit as a barometer of the company's financial and operational health—helping the audit committee understand the quality of financial and operational controls, processes, and people.

Cosourcing of internal audit

Many organizations do not have internal audit professionals with the technical skills and/or industry experience to meet the demands of the business; or they may not have a large enough staff—with language skills and knowledge of local cultures—to meet the audit-related needs of a company operating internationally. As a result, they may cosource internal audit services to support specific areas of the internal audit function.

In these cases, the audit committee should be involved in any proposal to cosource internal audit activities and should continue to provide oversight of the cosourced services.

The audit committee should ensure that the company's head of internal audit has management responsibility for the cosourced function— including adequate resources to manage the cosourced services effectively—and that there are appropriate controls around the cosourced function.

Reporting relationships for internal audit

There's an inherent tension in the internal auditor's role: the head of internal audit is an important member of the company's management team, while at the same time responsible for reviewing management's conduct and performance. This is a difficult position, and the challenge for the audit committee is to establish a relationship that helps the head of internal audit and internal audit staff operate effectively in its dual management/monitoring role.

The Institute of Internal Auditors (IIA) and others suggest that internal audit report "functionally" to the audit committee and "administratively" to executive management, creating a direct line of communications between the chief audit executive (CAE) the CEO or other C-level executive— e.g., the CFO, general counsel, or other C-level—who can effectively serve as the "internal audit champion."

What is the role of the audit committee versus management in this reporting relationship—e.g., reviewing and approving internal audit's plan, budget, and resources; hiring or firing the head of internal audit; conducting a performance review and determining compensation? Each organization will need to structure the head of internal audit's reporting relationships and oversight roles according to its unique needs and circumstances; however, in many cases it will make sense for both the audit committee and the internal audit champion to be jointly responsible for overseeing internal audit.

Management is in a good position to review the internal auditor's audit plans, budget, and resources and to recommend appropriate compensation and hiring or terminating the head of internal audit. All of these issues, however, should be subject to the audit committee's approval—a "review and consent" model.

Under no circumstances should internal audit's findings and reports be "filtered" before they are presented to the audit committee, and the audit committee should set a clear expectation for the internal auditor to report any concerns regarding sensitive matters, including issues involving senior management, directly to the audit committee. A relationship built on trust and confidence is essential to ensuring that internal audit will bring important, sometimes controversial, issues to the audit committee's attention without hesitation.

Oversight of risk—Considering the audit committee's role

Regulators and investors are keenly focused on what boards of directors are doing to oversee risk management. HKEX listing rules require a review of the effectiveness of the risk management and internal control systems to be conducted at least annually covering all material controls, including financial, operational and compliance controls. The annual review should, in particular, consider:

- Changes in nature and extent of significant risks, and ability to respond to changes in business and external environment
- Scope and quality of management's ongoing monitoring of risks and of the internal control systems
- Extent and frequency of communication of monitoring results to the board or board committee
- Significant control failings or weaknesses identified and the extent of unforeseen outcomes or contingencies to a material impact on financial performance or condition
- Effectiveness of processes for financial reporting and Listing Rule compliance.

Issuers should disclose how they have complied with the risk management and internal control code provisions during the reporting period, such as the risk assessment process, annual review process and main features of the risk management and internal control systems.

While risk oversight should be a full board function, HKEX listing rules also state that the audit committee has responsibility for reviewing the financial controls as well as the risk management and internal control systems, as well as disclosing how it met such responsibility.

Risk management processes

Oversight of the company's risk processes can be a significant undertaking, which generally requires an understanding of the company's processes to identify, assess, mitigate, manage, and communicate about risk throughout the enterprise. While risk oversight is a full board responsibility, some boards task their standing committees with oversight of specific risks. For example, in addition to financial reporting risk, the audit committee may also oversee cybersecurity risk. Among the questions to be addressed:

- How rigorous are management's processes to identify and assess the risks to the business? Who is involved? How far down in the organization does it go? Where/who does the information come from?
- Is there a good understanding of the risks inherent in the company's strategy, and a process in place to monitor changes in the environment that might alter key assumptions?
- Is the organization taking the "right" amount of risk?
- Does the company have the right controls around risk? Are controls reassessed based on changes in the risk environment?
- Does internal audit provide added assurance regarding the adequacy of risk management systems?

Audit committee effectiveness

I would say effectiveness as a committee is best measured by controllership and compliance within the company. Is controllership well managed? We're always going to have compliance problems, but are we informed of them? Do we understand them? Do we investigate them promptly and fully? Do we take action when we find something we don't like?

— Audit committee chairman

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—from operational and compliance risks posed by globalization and the extended organization (partners, suppliers, vendors, etc.) to culture, cybersecurity, data privacy, and other risks related to emerging technologies. Prioritizing this heavy audit committee workload is a challenge for most audit committees.

We see audit committees 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. Keeping pace 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 (including new and emerging issues) while taking care of "must do" compliance activities. And, perhaps most importantly, understanding the tone, culture, and rhythm of the organization by spending time outside of the boardroom—visiting company facilities, interacting with employees and customers, and hearing outside perspectives.

Here are some guiding principles that seasoned audit committee chairmen have told us are critical to keeping their audit committee's "eye on the ball":

Focus on those few things with the greatest impact. The audit committee 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 chairman told us, "If you try to focus on everything equally, you'll 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, not just data—from business and functional leaders as well as internal and external auditors. 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 premeeting materials that highlight issues for consideration and expect them to be read. Limit management presentations and the use of PowerPoint.

Understand that it can't all be done at the formal committee meetings; "between meeting" work is essential. 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. As one audit committee chairman said, "To be truly 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 chairman—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."

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 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.

Audit committee mechanics and practical considerations

Underlying the guiding principles noted above are some practical mechanics, which we describe here in some detail. Of course, no one size fits all, and each audit committee needs to apply these mechanics based on its own needs and circumstances.

Setting the agenda

To help the audit committee stay focused and efficient, a leading practice is to create a formal "responsibilities checklist and calendar" for the coming year—aligned with the audit committee's terms of reference—as well as a strawman agenda for each audit committee meeting scheduled in the year ahead. (See Appendix B: Sample Audit Committee Meeting Planner.)

Given the array of issues that will need to be addressed at each meeting—e.g., the company's financial reports and disclosures, control environment, risks, audit processes, whistle-blower complaints (if any), and legal and regulatory compliance—the audit committee chairman should prepare a focused agenda that devotes sufficient time to the company's key financial reporting risks, as well as other items that require the audit committee's attention. The agenda should also have the flexibility to address other matters that may arise.

The audit committee should be proactive in setting its agendas. While input from management and the internal and external auditors is essential, the audit committee should not merely react to an agenda developed by management. In our experience, the following considerations can help the committee develop an effective agenda:

— Have someone in management who serves as the audit committee's primary support—such as the CFO, controller, head of internal audit, or corporate secretary—draft an initial agenda as a starting point.

— Discuss the agenda with the CFO, the lead audit engagement partner, the head of internal audit—and perhaps others—to obtain their suggestions on key issues and topics for the agenda, including the time allotted to each item, and who should participate in the discussion of each topic.

— Share a draft agenda with audit committee members for their input (and encourage them to suggest agenda and follow-up items for future committee meetings).

— Ensure that the agenda allocates sufficient time to the issues that will most likely require the most discussion and then address any other required items.

We recommend that the audit committee structure its annual calendar so that time is allocated to a focused look at each of the company's major issues that are within the scope of the committee's responsibilities. Taking a deep dive into a key issue—e.g., accounting judgments and estimates, tax, cybersecurity (if allocated to the audit committee)—can help deepen the audit committee's understanding and oversight of management's approach to the risks facing the company.

Above all, the audit committee's agenda should dedicate sufficient time to the committee's primary focus: financial reporting risk. The audit committee chairman should remain acutely sensitive to "mission creep" and be ready to discuss (with the board and other committee chairmen) the practicality of reallocating certain risk oversight responsibilities to better balance the workload.

> **In my view, the audit committee has to develop a high level of comfort with both management and the external auditor that the basic mechanics of the company's financial reporting and controls are, in fact, under control. And while we don't want to give short shrift to that part of it, we want to be in a position that I would call 'process routine,' so that we can apply most of our work capacity and our focus as a committee to those things which could be more material and important to the fate of the company going forward. But this approach means that you have to have good processes in place and the right people in the finance function. You need to feel confident about that.**
>
> — Audit committee chairman

Making the most of meetings

The efficiency and effectiveness of audit committee meetings hinges largely on the preparation and engagement of committee members, as well as on the dynamics among committee members and other participants in the meeting. Generally, we have found the following practices to be helpful, if not essential, to making the most of the audit committee's time together:

- Insist on quality premeeting materials that highlight issues for consideration and expect them to be read in advance of the meeting.
- Consider using a "consent agenda" to address items that are routine and do not require discussion—for example, approval of meeting minutes (assuming all members agree). This approach allows for more meeting time to be allocated to issues that would benefit more from discussion.
- Take time at the beginning of every committee meeting to review the agenda. Based on the committee members' review of meeting materials, does the amount of time allocated to each agenda item still seem appropriate?
- Consider addressing the most difficult issues first, so that they get the appropriate airtime.
- Allow time for forward-looking discussions on strategy and risk, rather than solely focusing on retrospective matters.

Updates between meetings can help streamline committee meetings. To help alleviate some of the pressure on the audit committee's agenda, some audit committee members—usually the chairman—will communicate informally with management and auditors to stay up to date and deepen their understanding of certain issues and developments.

We caution, however, that an efficient meeting does not necessarily equate to an effective, quality meeting. Regardless of the agenda topics or time allocations, audit committee meetings should foster an atmosphere of openness and transparency and provide the time and opportunity for committee members, management, and auditors to pose questions and express their views.

Gaining exposure to key management and others

Audit committee meetings provide a valuable opportunity to see the company's talent "in action"—including members of the CFO's team (treasurer, controller, head of investor relations, et al.) as well as the chief information/technology/security officer and managers a level or two below these executives. The challenge here is two-fold: providing the audit committee with exposure to numerous individuals without having committee meetings become unnecessarily large and ensuring that there is a clear purpose for their attendance at the meeting. To this end, the audit committee chairman should work with the CFO, the head of internal audit, and others to develop a schedule and cadence that makes sense.

Reports to the board

The audit committee's report to the full board is often the primary method to keep the board apprised of the audit committee's activities and, importantly, to help ensure the coordination of the audit committee's activities with other committees of the board.

The HKEX corporate governance rules require the audit committee to report to the board on the matters set out in the code provision.

Some audit committee chairmen will take the extra step of communicating periodically with other committee chairmen to provide each other with a fuller understanding of the issues, concerns, and activities of the committees— particularly with respect to oversight of risk.

Typically allocated 10 to 15 minutes on the board agenda (including time for Q&A), the audit committee chairman's report should inform directors about the committee's work and, importantly, help them focus on key issues and recommendations that may benefit from their input and perspective. The audit committee chairman may look to the corporate secretary or CFO to draft an outline, for their reference, of the important issues discussed in the committee meeting.

Meeting minutes and documentation

The audit committee's meeting minutes are essential to documenting the processes the committee followed in carrying out its oversight responsibilities. How much detail should be included in the minutes is a matter of debate. Some attorneys recommend more detail, some less. The audit committee should seek the advice of counsel regarding the content and level of detail that is appropriate. As with other board committees, the minutes of audit committee meetings should be maintained by the company's corporate secretary and distributed to the full board on a timely basis.

Given the sensitivity of the information addressed in audit committee meetings, many companies advise directors to avoid or minimize note-taking (before or during meetings). The company may also limit the number of copies of materials distributed at the meeting and will dispose of paper and electronic notes and materials after the meeting, in line with the company's record retention policies and applicable law. Companies using board portals may disable the note-taking function or delete notes promptly after meetings as part of their regular processes.

In addition, directors should consult corporate counsel regarding the potential electronic trails that may be discoverable in the event of litigation. (For example, if board materials are distributed electronically, there may be a request to produce evidence regarding the amount of time the director spent reviewing the materials online before the meeting or electronic evidence that a director was not engaged during discussion of a critical topic at the meeting, for example, by showing the committee member was sending or receiving unrelated emails at the time.)

Appendices

Appendix A

Sample audit committee terms of reference

Purpose

The audit committee (the committee), appointed by the board of directors (the board), assists the Board to fulfil its oversight responsibilities relating to:

- financial statement preparation and integrity
- risk management and internal controls (in relation to financial, operational and compliance controls)
- external audit (qualifications, independence, engagement, fees and performance)
- annual audit of the financial statements
- internal audit (resources, performance and scope of work)
- company compliance with legal, regulatory requirements and compliance policies.

Effective corporate governance depends on the active and collaborative participation of the committee, board of directors, external auditors, internal auditors, other assurance providers and management. Ensuring that this collaboration occurs effectively and efficiently is fundamental to the committee's success.

The existence of the committee does not diminish the board's responsibility to ensure the integrity of the financial reporting.

Authority

The board has authorised the committee, within the scope of its duties and responsibilities set out in this charter, to:

- investigate any activities within this Terms of Reference to address its responsibilities and make recommendations to the board
- seek any information it requires from any employees in order to perform its duties
- obtain external professional advice and invite outsides with relevant experience and expertise if deemed necessary
- have separate and independent access to senior management and information to make informed decisions
- meet with the external auditor, at least annually, in the absence of management to discuss specific audit-related matters
- invite executive directors and external auditors to attend a particular committee meeting in order to answer specific points or concerns.

Membership

The Board shall appoint an audit committee that has sufficient and relevant expertise to fulfil its role effectively.

The committee shall consist of the following:

- at least three members
- be composed exclusively of non-executive directors
- have a majority of its members, including the chairman appointed by the full board, as independent.

As good practice the members should possess necessary skills and experience to tackle complex financial, operating and other issues. At least one member shall have financial or accounting expertise.

The members shall also have a clear understanding of the company's business, its internal environment and the external environment.

Committee member rotation is encouraged. Wherever possible, the board ensures that changes in committee membership are staggered to maintain continuity.

The company secretary shall be the committee secretary.

Education

The company will assist the committee in maintaining appropriate financial literacy. The company is responsible for providing new members with an appropriate induction programme and educational opportunities, and the full committee with educational resources relating to accounting principles and procedures, current accounting topics pertinent to the company, and other resources, as reasonable requested by the committee.

Meetings

The committee shall meet at least [insert number] times per year and whenever deemed necessary. If a member is unable to be physically present, they may participate by video or tele-conference.

A notice of at least [insert number] days should be given of a regular meeting to each committee member confirming the date, time and venue. The agenda and accompanying board papers should be sent at least 3 days before each meeting.

The Finance Director, the Head of Internal Audit, and a representative of the external auditors shall normally attend meetings. At least once a year the committee shall meet with the external and internal auditor without executive board members present.

The external auditor or internal auditor may request a meeting if considered necessary. The committee chairman, the board chairman or any other committee members may also call a meeting of the committee.

The committee may invite members of management (e.g. CEO, executive directors), any employees, internal and external auditors or other non-executive directors to attend meetings of the committee. A standing invitation shall be issued.

Two independent non-executive directors will constitute a quorum.

Minutes

The committee secretary or delegate should prepare the minutes of the committee meeting within a reasonable time after the meeting. Draft and final versions of the minutes should be sent to all committee members for their comment and records, and shall lastly be circulated to the other board directors.

Full minutes should be kept by the secretary and open for inspection at any reasonable time on reasonable notice by any director.

Communication

The committee is expected to maintain free and open communication with the external auditor, the internal auditor and management.

Duties and responsibilities

In assisting the board to fulfil its responsibilities, the duties of the committee are as follows:

Assessment of financial information

Review all published interim and annual financial statements of the company, which require the approval of the board, based on the recommendation of the committee, and hold discussions regarding the financial statements with the external auditor and management before submission to the board.

Assess and challenge, where necessary, the accuracy, completeness, fairness and consistency of financial information and disclosures, focusing particularly on:

- any changes in accounting policies and practices;
- major judgmental areas;
- significant adjustments resulting from the audit;
- the going concern assumption;
- compliance with accounting standards; and
- compliance with stock exchange and legal requirements

External auditors

Recommend to the board the appointment, evaluation and removal of the external auditor, and consider any questions of resignation or dismissal.

Review and approve the external auditors' proposed audit plan and audit approach, including materiality levels.

Review and agree the terms of engagement and the audit fees for the external auditors prior to the commencement of each audit.

Review the independence and objectivity of the external auditors and their compliance with all relevant independence requirements including:

- relationships between the company and the audit firm
- hiring employees or former employees of the external auditors
- the level of non-audit services provided
- the rotation of audit partners.

Review the external auditor's management letter detailing the results and significant findings from the audit and management responses.

Meet with the external auditor, at least annually, in the absence of management, to discuss issues arising from the audit and any matters the auditor may wish to raise

Obtain from the audit firm annually, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including those for rotation of audit partners and staff.

Internal auditors (if any)

Approve the appointment, remuneration and removal of the head of internal audit.

Review the internal audit charter to ensure the appropriate organisational structure, authority, access and reporting arrangements are in place. Ensure appropriate resourcing of the internal audit function.

Approve and review progress against the internal audit work plan:

- review the internal audit coverage and annual work plan, and monitor progress of the work plan

- advise the board on the adequacy of internal audit resources to carry out its responsibilities, including completion of the approved internal audit plan
- oversee the co-ordination of audit programs conducted by internal and external audit respectively
- review significant internal audit reports and findings.

Review progress on management actions. Monitor progress against the annual work plan, including any significant changes to it, any difficulties or restrictions on the scope of activities and any significant disagreements with management.

Discuss issues with internal audit in the absence of management.

Consider the major findings of the internal audit reports and review management's response in terms of content and timeliness. Monitor management's implementation of internal audit recommendations. Periodically review the performance of internal audit.

Risk management and internal controls

Approve the company's risk management and internal control policies and oversee the risk management and internal control systems, including the risk management and internal audit functions and their resourcing.

Approve and monitor the company's risk profile developed by management, covering the principal enterprise-wide risks, including strategic, operational, legal and financial.

Review the operational effectiveness of the policies and procedures relating to risk and the company's internal control environment.

Consider major investigation findings on risk management and internal control matters as delegated by the board and management's response to these findings.

Compliance

Review the effectiveness of the company's approach to achieving compliance with laws, regulations, industry codes and company policies.

Review compliance with the company's values and related behaviours and the code of conduct. Review and monitor the effectiveness of policies, procedures and processes for complying with continuous disclosure requirements.

Obtain regular updates from management, legal counsel and the company secretary regarding compliance matters that may have a material impact on the company's activities. Review any correspondence from regulatory bodies regarding significant issues.

Other responsibilities

Ensure that there is a process in place for the board chairman and committee chairman to be immediately informed of any issue of significant non-compliance or litigation. Oversee the process for the receipt, retention and treatment of information received from the internal whistleblower policy and procedures, and from external complainants regarding matters relating to audit, the financial statements, internal controls or possible fraud.

Review any fraud reports. Review and discuss any reports concern any breach of fiduciary duty. Hold regular executive sessions with the CEO, CFO and other senior management to discuss private matters with the committee.

Act as a forum for communication between the board and senior management and internal and external audit. Review the effectiveness and level of cooperation between management, the internal auditor (if any), the risk management function (if any) and the external auditors. Review reports to the shareholders on the role and responsibilities of the committee. Conduct special investigations (if required). Perform any other duty of undertaking that the board may request from time to time.

Review, for potential conflict of interest situations, and pre- approve related party transactions on an ongoing basis.

Reporting

In addition to providing the board with a copy of the minutes of its meetings, the committee will ensure that:

- the committee chairman reports to the board on committee meetings, regarding all relevant matters and appropriate recommendations, in a written report (with supporting material) for noting or approval by the board
- the committee addresses any other reporting responsibilities.

Reviews

To ensure that the committee is fulfilling its stewardship duties to the board, the committee will:

- review, at least annually, the Terms of Reference and recommend to the board any appropriate amendments for approval
- review the annual agenda incorporating any changes in the Terms of Reference
- conduct an annual assessment of its performance against its Terms of Reference duties and responsibilities and provide a report of the findings to the board
- conduct an annual assessment of each committee member (the committee chairman should provide a report of the findings to the board chairman).

Sample audit committee meeting planner

Audit committee meeting planner

The following meeting planner has been prepared for use by the chairman of the audit committee (the Committee) of [______] (the Company). This meeting planner can be used to coordinate with members of the internal audit department, independent auditors and management.

Item No.	A = Annually; Q = Quarterly; P = Periodically	Frequency			Period to be completed			
		A	Q	P	Q1	Q2	Q3	Q4
Foundation								
1.	Review audit committee terms of reference and annual agenda							
2.	Assess committee's independence, financial literacy, skills and experience							
3.	Determine number of meetings for forthcoming financial year							
4.	Committee chairman to determine meeting agenda and required attendees, including management and assurance providers							
5.	Enhance financial literacy – update on current financial events							
6.	Review of ongoing audit committee member education plans							
7.	Conduct an assessment of the committee's performance against its terms of reference and provide a report to the board							
8.	Conduct an assessment of the individual member's performance							
9.	Consider committee member rotation and succession planning							
Assessment of financial information								
10.	Review significant accounting and reporting issues							
11.	Review financial matter affecting the half year							
12.	Review and approve half year financial statements							
13.	Review financial matters affecting the year end							
14.	Review and approve annual financial statements							
15.	Review with management its evaluation of internal control structure and procedures for financial reporting, including any significant deficiencies or material weaknesses							
16.	Annually review and discuss with management and the external auditors, management's assessment of the effectiveness of internal control structure and procedures for financial reporting							
17.	Review and discuss any reports concerning evidence of material violation or breaches of fiduciary duty							

Item No.	A = Annually; Q = Quarterly; P = Periodically	Frequency			Period to be completed			
		A	Q	P	Q1	Q2	Q3	Q4
18.	Review and discuss any reports submitted by the external auditor detailing any instances of fraud or possible illegal acts on the part of senior management							
19.	Review process, policies and procedures for continuous disclosure obligations							
20.	Review conflicts of interest and related party transactions							
External auditors								
21.	Recommend appointment, evaluation and removal of the external auditors							
22.	Review audit plan and scope of audit work and any changes thereto							
23.	Recommend terms of engagement and audit fees							
24.	Consider policy in relation to non-audit services							
25.	Review and pre-approve non-audit services							
26.	Consider objectivity/independence and obtain independence declaration from external auditor							
27.	Review external auditors' report and findings and progress on management actions							
28.	Discuss implications of any significant changes in accounting standards							
29.	Discuss appropriateness of accounting policies, estimates and judgments							
30.	Discuss external auditors' view on control environment, including fraud and risk management							
31.	Resolve any disagreement between management and the external auditor in the financial reporting and report any significant issues to the board							
32.	Discuss issues with auditor in the absence of management							
33.	Ongoing communication (written/oral) between the external auditor with the committee							
34.	Review report from external auditor on quality control procedures							
35.	Review the external auditors process for rotation and approach for managing transition							
Internal auditors								
36.	Approve appointment and review performance							
37.	Review internal audit charter							
38.	Review internal audit plan and any changes required to the plan including any resource issues							
39.	Review progress against the audit plan							
40.	Review significant internal audit reports and findings							
41.	Review progress on management actions							
42.	Discuss issues with the internal auditor in the absence of management							
43.	Review the performance of internal audit1, including organisational structure, qualifications and independence.							

Item No.	A = Annually; Q = Quarterly; P = Periodically	Frequency			Period to be completed			
		A	Q	P	Q1	Q2	Q3	Q4
Risk management and internal controls								
44.	Review risk management policy and risk management system							
45.	Review risk profile							
46.	Review internal controls and report to the board							
47..	Review operational effectiveness of risk policies and procedures and internal control environment							
48..	Review the effectiveness of the company's insurance activities							
49..	Ensure effective remuneration risk and controls are linked to the overall risk profile							
Compliance								
50.	Review legal and regulatory matters that may have a material impact on the company							
51.	Review compliance report from management, and correspondence (if any) from regulatory bodies							
52.	Review any correspondence from regulatory bodies							
53.	Review compliance with company values and related behaviours, and the code of conduct							
54.	Review compliance with continuous disclosure requirements							
Other responsibilities								
55.	Review whistleblowing arrangements and reports							
56.	Review fraud report							
57.	Hold regular executive sessions with senior management							
58.	Review level of cooperation between management, internal auditor and external auditor							
59.	Review report to the shareholders on the role and responsibility of the committee							
60.	Conduct special investigations and perform other activities, as appropriate							
Reporting								
61.	Maintain minutes and report to the board							

Oversight of external audit—Fundamental and leading practices

Considerations in the appointment of the external auditor

— Background and experience of principal members of the engagement team, including the lead engagement partner, tax partner, quality control review partner, senior manager(s), and any specialists (such as actuarial, valuation, and employee benefits specialists) who perform a significant role in connection with the audit.

— Audit firm's technology used in the audit, and expectations regarding the use of the work of the company's internal auditors and other third parties—and how this will impact the external auditor's work and fees.

— Audit firm's quality control system and how it is managed to provide reasonable assurance regarding consistent audit quality throughout the firm.

— Audit firm's other clients—as an indication of the audit firm's industry experience (including nonaudit services), experience with companies of similar size, as well as the audit firm's footprint of operations domestically and internationally.

— If the company has significant international operations, the extent and quality of audit resources outside Hong Kong that will be used by the audit firm and whether the international resources are subject to the same audit approach and quality control standards as the audit firm.

Establish clear expectations for the external auditor

— Develop and maintain a rigorous, iterative process—involving the audit committee, management, and the external auditor—to establish clear expectations for the external auditor.

— Expectations should be company-specific, but likely include:

- Audit requirements
- Communications (with management and the audit committee)
- Audit team resources, key roles, and the use of specialists
- Issue resolution—process and use of national office
- Progress reporting, audit coordination
- Reasonableness of fee, given scope of audit
- Other services, and preapproval process
- Auditor's support of the audit committee
- Benchmarking (e.g., comparison of company's audit committee, finance, and internal audit functions with those of the audit firm's similar clients).

— Be clear that audit committee will evaluate auditor performance against these expectations.

Discuss the external auditor's audit plan and monitor performance

— Review and discuss external auditor's audit plan, including:

- Adequacy of audit scope to address financial reporting risks facing the company
- Planned audit procedures and approaches to address these risks (given audit firm's knowledge of company and industry)
- Use of specialists in such areas as taxation, valuation, pensions, etc.
- Reporting processes for subsidiary audit teams
- Control of overseas audits
- Working relationship with internal audit.

— Engage in frequent dialogue throughout the course of the audit regarding the progress of the audit and any difficulties encountered by the auditor in executing the audit, including the reasonableness of the timeframe within which the audit must be completed, and any impact of the timing on the approach to the audit.

- At each audit committee meeting, discuss audit progress and significant issues and concerns, including:
  - Significant accounting, auditing, and internal control over financial reporting issues identified by the auditor, and how those issues may impact the quality of the company's financial reporting.
  - Critical accounting policies, judgments, and estimates—whether accounting treatment is conservative or aggressive
  - Other company, industry, and economic changes that may significantly impact the audit—e.g., the company's revenue generating activities, including new products; regulatory initiatives, including new taxes; supplier vulnerabilities; domestic and international trends and developments; accounting standard changes that impact company's financial reporting.
- Discuss audited and interim financial statements.

Maintain robust communications with the external auditor

- A strong relationship, including frequent, informal communications, between the audit committee chairman and the lead engagement partner are critical.
  - Providing input on committee agendas, walking through premeeting materials, discussing developments on a real-time basis, and promoting an understanding of key matters from the perspective of the external auditor.
- Conduct an executive session with external auditor at each formal meeting—to gain insight into the strengths and weaknesses of the company's financial reporting and control processes.
- Maintain robust, two-way communications with external auditor about a range of financial reporting, internal control, and risk-related issues that may impact the company's financial reporting and internal controls.
  - Consider the audit firm's full range of capabilities.
- Determine audit firm's succession plans for key engagement team members (audit, tax, and specialists at both the partner and senior manager level).

Monitor the external auditor's independence

- Approve audit and nonaudit services
- At least annually, discuss with the engagement partner the external auditor's compliance with independence requirements.

Evaluate the external auditor's performance

- An ongoing process throughout the year—not simply an annual event.
  - Use periodic touchpoints—whether formal audit committee meetings and executive sessions or informal discussions between the engagement partner and the audit committee chairman—as opportunities to provide feedback and discuss auditor performance.
- Develop a formal, structured process to evaluate external auditor's performance against expectations on an annual basis.
  - Obtain input from audit committee members, other directors, the CEO, finance executives, the internal auditor—as well as the external auditor.
- Discuss evaluation results with the audit engagement partner and other partners who may be involved in the audit.
  - How did the auditor perform against expectations? What are the auditor's views?
  - How can the external auditor improve?
  - How should expectations be changed for the coming year?
- Agree on a plan for external auditor's continuous improvement.

Additional resources

Financial Reporting Council Interim Inspection Report (11 December 2020)

HKEX Listing Rules Chapter 3

HKEX Listing Rules Appendix 14

HKEX Listing Rules Appendix 16

HKEX Guidance for Boards and Directors (July 2018)

HKEX Implementation of Inside Information Disclosure Regime (March - April 2014)

HKICPA Code of Ethics for Professional Accountants (Revised February 2018)

HKICPA Audit committees and audit quality

About the KPMG Board Leadership Centre

The KPMG Board Leadership Centre offers support and guidance to non-executive directors, whether managing a portfolio non-executive career or embarking on a first appointment. Membership offers you a place within a community of board-level peers with access to topical and relevant seminars, invaluable resources and thought leadership, as well as lively and engaging networking opportunities. We equip you with the tools you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business.

Learn more at kpmg/cn/boardleadership

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