



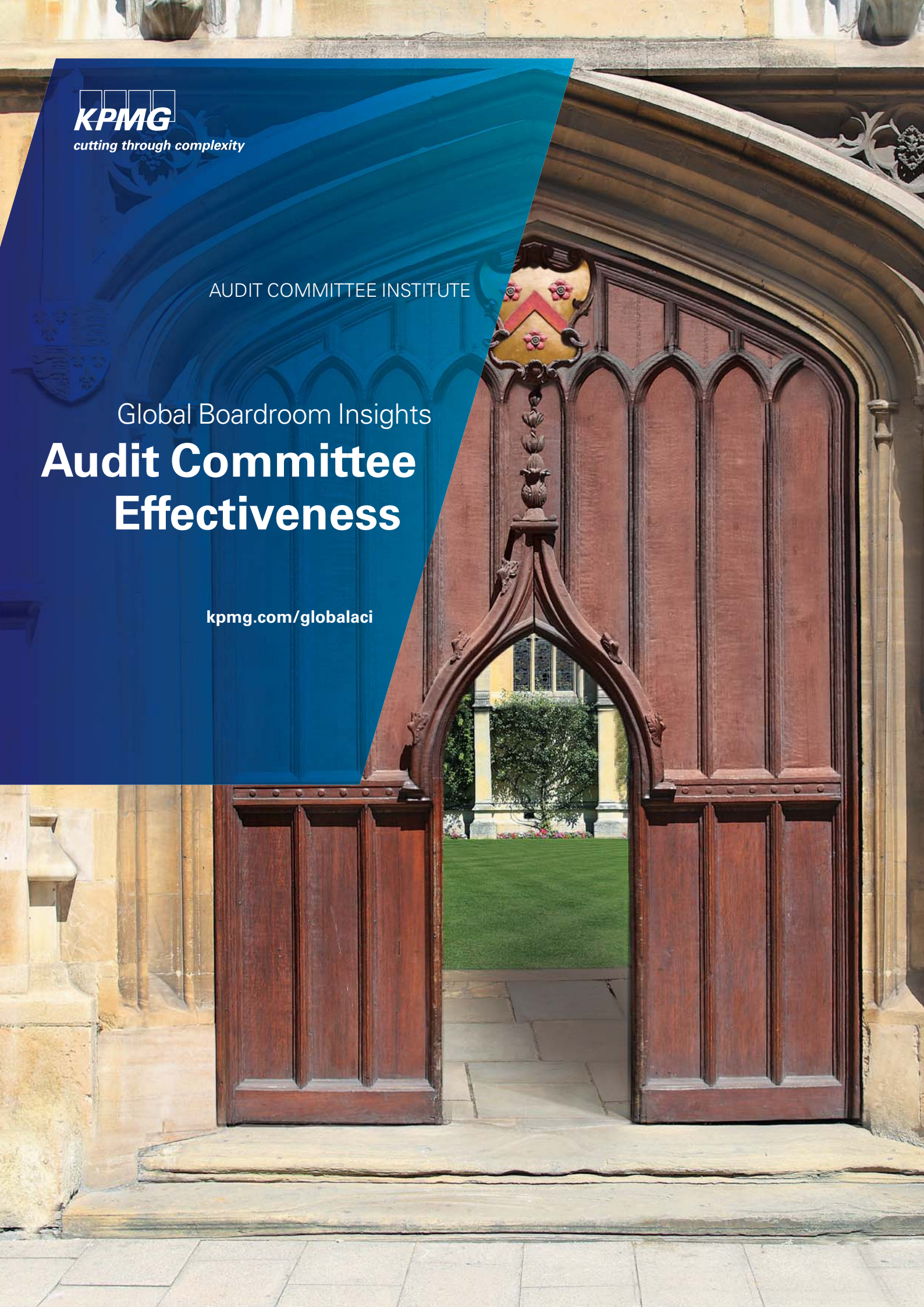
cutting through complexity

AUDIT COMMITTEE INSTITUTE

Global Boardroom Insights

Audit Committee Effectiveness

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About

KPMG's Audit Committee Institutes

Sponsored by more than 30 member firms around the world, KPMG's Audit Committee Institutes (ACIs) provide audit committee and 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 and global compliance.

To learn more about ACI programs and resources, contact us at:

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A note from KPMG's ACIs

If you're on an audit committee—or work closely with one—you know the committee's workload isn't getting any lighter, and the job isn't getting any simpler.

In addition to their “core” duties—oversight of financial reporting and internal and external auditors, which are a substantial undertaking and time commitment—many audit committees also oversee a host of major risks facing the company: From cyber security, emerging technologies and social media, to compliance risks posed by increased government regulation and stepped-up enforcement efforts globally, many audit committee agendas today could even be mistaken for a “risk committee's” agenda.

Perhaps not surprisingly, about half of the nearly 1,500 audit committee members responding to our *2014 Global Audit Committee Survey* said it is becoming “increasingly difficult” to oversee major risks in addition to the committee's core responsibilities. To be sure, an overloaded audit committee is a less effective audit committee.

Audit committee effectiveness clearly hinges on some fundamentals, including the right committee composition and dynamics; an up-to-date charter with well-defined responsibilities; a risk-based approach to setting the committee's agenda; an understanding of current and emerging issues; and proactive, engaged oversight—beyond the boardroom.

In this issue of *Global Boardroom Insights*, we revisit the fundamentals of audit committee effectiveness with seasoned audit committee chairs of leading global companies around the world; but we've gone a step further to explore the practices and nuances that these audit committee chairs consider vital to being *truly effective* in a complex and rapidly changing environment.

Our sincere thanks to those who shared their time and insights with us—Yves-Thibault de Silguy, Douglas A. Warner III, Nicolas C. Allen, Mike Wareing, John Cyran and Hong-Chang Chang.

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Global fundamentals of audit committee effectiveness

While the structure and operations of audit committees may vary by country (and company), it is interesting to note common themes that emerged from ACI interviews with audit committee chairs from around the world. Audit committee effectiveness, they all said (in their own words), ultimately hinges on getting these things right:



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.



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



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



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 organization.



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.

Yves-Thibault de Silguy Louis Vuitton Moët Hennessy (LVMH) Group and Vinci (France)



Yves-Thibault de Silguy is chairman of the audit committee of LVMH group. He also acts as vice-president and lead director for Vinci, where he is in charge of corporate governance, and as non-executive director for Solvay and VTB Bank. He served 20 years as a top-ranking civil servant (notably at the French Department of Foreign Affairs and for the Prime Minister's office) and European Commissioner for Economics, Financial and Monetary Affairs (1995-1999), before joining industry (working for Suez as CEO in the early 2000s and Vinci as chairman of the board during 2006-2010).

“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 and clearly-defined roles together in harmony.”

ACI: *What are the “must-do’s” for an audit committee, and audit committee chair, to be truly effective?*

Yves-Thibault de Silguy: Before broaching the topic of “must-do’s, it is important to discuss the “must-haves” or “must-be’s” for audit committees. Members must: (1) have common sense, (2) be questioning and independently-minded, (3) be hard-working and (4) have appropriate financial expertise.

ACI: *And in terms of “must-do’s”?*

Yves-Thibault de Silguy: In my view, audit committees have three main areas of responsibility: (1) financial reporting issues, (2) internal control and risk management and (3) various “other matters” that are increasingly tabled at the top of audit committee agendas, such as CSR, corporate tax and insurance coverage.

Audit committees need to allocate time efficiently to cover all these issues, and here the committee chair has a vital role to play.

There are no hard and fast rules, but in my experience a “50%-30%-20%” breakdown of time is close to the norm.

One of the greatest challenges for audit committees and boards is handling a large number of key issues in a limited time (audit committees in Europe meet on average only four or five times each year).

To be efficient, each meeting needs to be well prepared. Again, the chair plays a key role. It means ensuring that audit committee members receive supporting working documents sufficiently in advance. More importantly, it is vital for the chair to interact regularly with the CFO, his main contact.

Other key contacts for audit committees are the external auditors. With their professional insight and know-how of accounting and financial issues, they provide assurance to the Group’s management, audit committee, board and stakeholders.



Their assurance covers compliance with accounting standards and regulations, and the reliability (consistency and relevance) of the financial statements and financial information as a whole.

The external auditors' presentation to the audit committee of the audit plan, the main risks identified, and their findings and recommendations, is of paramount importance, so it needs to be carefully planned and structured.

ACI: *Are there certain things that your audit committee does particularly well (e.g., practice or behaviour) that other audit committees might consider?*

Yves-Thibault de Silguy: Before discussing financial aspects, which are the traditional "core duties" of audit committees, I would like to share my experience of good practices in the other two areas I mentioned earlier.

First, with regard to internal control and risk management, it is essential for the head of Group internal control to provide the audit committee with a presentation of the annual audit plan, a summary of the main findings (with detailed reports if needed) and follow-up on action points previously identified.

In terms of risk management and mapping, risks should be clearly identified and ranked, with the most significant highlighted and closely monitored. As you know, too much information leads to information overload!

It may seem like a good idea to prepare highly-detailed, sophisticated risk maps, but if they are difficult to use and monitor, then they are inappropriate for providing input to management and governance bodies.

The audit committees I chair pay close attention to such pragmatic aspects.

Getting a global view of the Group is good, but having a detailed presentation at operating division level is even better. I believe that it is of utmost importance that the heads of operating and financial divisions and branches present their activities, main challenges and internal control and risk management systems to the audit committee, on a rotating basis. I've introduced this practice in the Groups where I work. It provides the audit committee with valuable insight, while forcing management of the major operating divisions to step back and review their operations. While putting a healthy degree of pressure on managers of the major divisions and branches, it also brings them into the limelight. So it's a "win-win" situation for the entire Group.

For the "other matters" handled by the audit committee that I mentioned earlier, if there are no specific Group committees to deal with them, they are almost naturally submitted to the audit committee for oversight and critical review. They include issues relating to CSR, sustainable development, safety at work (monitoring workplace accident rates), cash and debt management policies, tax policy, insurance coverage, and even ethics. In my opinion, a good practice is to have the heads of the departments and units concerned "appear" before the audit committee periodically to present a brief overview of their activities, functional organisation, challenges and risks, along with the policies implemented to manage them. If ad hoc committees are in place, the audit committee may simply liaise with them to obtain the information it requires. Such interaction may be coordinated by the committee chairs directly or a non-executive chair, or the lead director or secretary of the board (I do this in one of the Groups, where I act as lead director in charge of governance).





ACI: *Let's move on to financial aspects.*

Yves-Thibault de Silguy: I mentioned earlier that the audit committee and its chair have two key contacts: the CFO and the external auditors.

One key to success, over and above formal meetings, is for the audit committee chair to have frequent, candid discussions with the CFO, based on mutual trust.

While being responsible for oversight, the audit committee chair may also play an “advisory” role, as the CFO may call on him, in all confidence, to discuss specific issues or projects in the pipeline. Such situations require tact, but they put the audit committee chair in a strong position to fulfill his role and optimise the audit committee’s work.

I find it useful to have informal meetings with the external auditors at least annually in addition to the formal ones, without management present (personally, I do so over lunch with the engagement partners), to openly discuss and hear their impressions and views on the main issues affecting the Group. It is also the opportunity for them to express their opinions freely and directly—in addition to their written reports—on sensitive issues for the Group.

Finally, if the Group has a lead director, it is essential for the chair of the audit committee to regularly interact with him.

ACI: *Specifically related to the audit committee’s top priority—financial accounting and reporting oversight—what are critical success factors in your view?*

Yves-Thibault de Silguy: First—and it can never be emphasized enough—effective communication between

management (the CFO in particular) and the audit committee chair is crucial for the success of the audit committee’s work.

It is also important to have discussions with the external auditors (the audit engagement partners) to enable the audit committee to assess the quality of the processes implemented to prepare the financial statements, and the relevance of the financial disclosures.

From a practical viewpoint, I would also like to highlight a point that I believe is an essential part of the audit committee’s work: The “hindsight” analysis of completed operations and transactions—with the finance department—in order to assess how well the Group’s operational and finance staff made forecasts and planned and managed control processes. Hindsight analysis also assesses management’s ability to implement corrective action in complex situations and learn from past experience.

By exercising their right to seek explanations and constructively challenging the Group’s finance department, the audit committee and its chair are instrumental in enhancing the effectiveness of Group governance.

Finally, a last comment on financial communication, including press releases, which are always closely scrutinized by the market. It is vital for the audit committee to receive draft Group press releases as early as possible, especially those concerning the quarterly, half-year and annual results. Unfortunately, this is not always possible due to tight deadlines, but it’s a pity because the reaction of audit committee members, given their knowledge of the Group and their individual perspectives, is often a good indicator of how financial analysts and market players in general may react.





Personally, I pay close attention to the tone, title and brief of press releases, as well as the paragraph on the company's outlook.

ACI: With regulators globally advancing an array of initiatives focused on auditor independence, objectivity, and professional scepticism, what would you recommend to audit committees in their efforts to ensure audit quality?

Yves-Thibault de Silguy: I think that above and beyond compliance with the rules set by various regulators—particularly the mandatory rotation of audit firms and partners—external auditors' independent thought and professional scepticism are fundamental. Combined with professionalism and in-depth knowledge of accounting standards and regulations—which are increasing in both number and complexity—such qualities are clearly valuable for the audit committee and the best safeguard the company can have.

Of course, we could envisage setting up a system to assess the quality of the audit and external auditors, on condition that objective assessment criteria are used, but it is not an easy task.

ACI: How can audit committees best leverage (and support) the internal audit function?

Yves-Thibault de Silguy: I've already mentioned the need for coordination between the head of the internal audit function and the audit committee and its importance in assessing the internal control and risk management systems.

If their communication is well structured, as I mentioned earlier, I do not personally feel the need to have "a direct

reporting line" with the head of internal audit, as may be the case in some Groups. However, as audit committee chairman, I am always willing to discuss directly with the head of internal audit, if he so wishes.

Having said that, the audit committee and its chair are extremely attentive to internal audit findings, to how management uses them and to any corrective measures and action plans implemented.

ACI: Given all the changes in technology, regulation, and the global risk environment, do you envision the audit committee's agenda changing significantly in the years ahead?

Yves-Thibault de Silguy: Companies now operate in an extremely complex global environment where they constantly face new challenges.

As a result, in addition to the core duties of audit committees that I mentioned earlier, I think we will soon be addressing risks that are not currently focused on, only touched on or insufficiently addressed by some audit committees. I refer, in particular, to risks relating to cyber security and data theft. We also need to pay special attention to Group tax policies and compliance with ethical rules in this respect.

To conclude, 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 and clearly-defined roles together in harmony. It is the best means of ensuring high-quality internal control and financial reporting systems and transparency. And undoubtedly, audit committees will be assuming even more duties in future. ❖





Douglas A. Warner III General Electric (U.S.)



Douglas “Sandy” Warner is the audit committee chair at General Electric (GE). Following graduation from Yale University in 1968, Mr. Warner joined Morgan Guaranty Trust Company of New York, a wholly owned subsidiary of J.P. Morgan Chase & Co. (formerly J.P. Morgan & Co.). He was elected president and a director of the bank and its parent in 1990, serving as chairman and chief executive officer from 1995 to 2000, when he became chairman of the board of J.P. Morgan Chase & Co., The Chase Manhattan Bank and Morgan Guaranty Trust Company until his retirement in 2001. Mr. Warner has also served as a director at Anheuser-Busch Companies, Inc., Motorola Inc., and Motorola Solutions Inc.

“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 organization.”

ACI: *What are some “must-do’s” for audit committees to be effective in today’s environment—versus five or 10 years ago?*

Sandy Warner: The biggest change—and this is a fundamental difference today versus yesterday—is the degree of engagement. Today, the breadth and depth of the audit committee’s engagement has made oversight a full-time activity. While technically not a full-time job, I can’t imagine being effective in this role if I had another executive job and couldn’t be actively engaged and readily available to deal with issues as they come up.

ACI: *Can you elaborate on that—the difference between full-time engagement, while not being a full-time job?*

Sandy Warner: Well, the difference is that I didn’t have on my calendar this morning talking to GE at all. But I had a call from the head of the GE Capital audit group on a regulatory matter that just came up and they wanted

to brief me on it. And then I had another discussion with the general counsel on other issues—and it won’t do to say ‘I’m not available until next week.’ This is about being engaged and available, even when it’s not planned.

ACI: *Are there other practices that differentiate effective audit committees today?*

Sandy Warner: Another thing that’s different, and really important at GE—and I expect at other companies as well—is that this job used to be 90 percent inside the building. We still have meetings at headquarters where we have people come in and present, and we look at metrics and discuss the information we’ve reviewed or that’s being presented. But today, 70 percent of the GE audit committee’s time on the job—and this is not just the chair, it’s the full committee’s time—is spent outside the building, visiting GE locations, going out and seeing things and talking to people on their own, in their own offices and workplaces.



And we do this all over the world. Tomorrow I'm going to a GE facility to hear about cyber security issues. We just got back from Brazil. We've been in Puerto Rico doing some work there. We were recently in China, and Houston, and Milwaukee. We're everywhere that GE is—and that never used to be the case.

I would respectfully offer that you can't do this job well sitting at headquarters. To be truly effective, the audit committee needs to get up and out of the corporate headquarters.

ACI: *What kinds of information and insights are you getting from your visits to facilities and interactions with employees?*

Sandy Warner: One is that you see the whole team, not just the senior folks who present regularly to the committee or the board. You see a whole team in their own setting—which is where non-routine things happen. They can't script the day, so you see how the organization works and holds together. You see how the controllership function fits with the other pieces of the business puzzle in a way that isn't possible when you're listening to a prepared presentation. You see them without senior management present because when we go on these trips we don't take the CFO and the controller and other senior management. We go on our own.

Another benefit is that you develop your own, first-hand point of view, and you can ask unconventional people questions about audit-related matters. From an audit perspective, we're able to bring our impressions back and say to our auditor, you might want to be thinking about this, or we're thinking more about this risk and you need to consider that when you're auditing. This is really a big deal. It's a big change in how an effective audit committee functions today, particularly in a global operating environment.

When you start getting on the plane and spending two or three days in China or in Brazil with the local management team, having lunches and dinners with them, you become integrated into the controllership framework in a way that you don't in the sterile headquarters setting, listening to PowerPoints. It just changes the dynamic completely.

Local contact also creates important relationships and opens lines of communication. Based on my travels and interactions, I get notes from employees in far-flung locations, like Timbuktu. "Dear Mr. Warner, Chairman of the Audit Committee, I thought you'd be interested in this..." It's incredibly valuable.

Again, audit committees are most effective when they integrate themselves into the rhythm of the company. Management and employees know that you're engaged, that you're watching, that you bring something to the party.

ACI: *What type of mix do you look for in terms of finding the right audit committee composition?*

Sandy Warner: It's paramount to have the right people on the committee. In GE's case, we have a fantastic group—two former CEOs who are also former CFOs, so they're seasoned financial professionals who have seen it from on-high. That's a terrific combination. We also have a member with a solid financial accounting background—there isn't much in accounting that he hasn't seen or thought about.

We also have someone with a lot of great experience in financial risk, and another member who brings different industry perspectives to the table. I think that's a well-suited, well-balanced mix and thoughtfully put together.

You really need to focus on the right talent in these jobs for the audit committee to deliver a quality contribution. There's no substitute for it.



ACI: *Many audit committees indicate that their agendas are very heavily loaded, if not overloaded, with compliance activities as well as a host of other risks, which makes it challenging to be efficient and effective.*

Sandy Warner: That's very true. We used to have one committee that covered risk and audit. Now risk and audit are two separate committees, and that was an important change for us.

In terms of being efficient and focused, the audit committee sets the agenda. We finalize our agenda in December for the coming year, based on our assessment of controllership and compliance risks, and input from the corporate audit staff and from the internal audit and financial groups, and others. We take advice from a lot of people, but at the end of the day we say, 'these are the risks, the controllership vulnerabilities, the issues that we want to focus on in the year ahead,' and we lay out a schedule for the year based on that assessment.

During the year, we'll make adjustments as things come up that are higher priority, but the broad outline of the agenda is our own and it's risk-based. We set aside a certain amount of time for routine consideration of metrics or audit output and so on—but again, I would emphasize that the agenda is our own.

I think the most ineffective audit committee I was ever on had an agenda that was driven by the controller of the company based on what he thought we should be looking at. That wasn't good.

ACI: *How do you know whether your audit committee is functioning really well or if it's not functioning all that well—are there signs? And how does the self-evaluation factor-in?*

Sandy Warner: A good self-evaluation is important. Our approach is to have a third-party come in and interview members of the committee and the board to get a candid assessment of how we're doing.

As you know, the audit committee is a delegated responsibility, so the people that need to be happy with our work are the other board members who are not part of the audit committee. They need to have confidence that their delegation of audit committee responsibilities was handled thoroughly and effectively.

Aside from the results of the self-evaluation, I would say that at the end of the day, our 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? And perhaps most importantly, are we being given early warning of things that are brewing?

There's also an important soft measure—and this goes back to something I mentioned earlier—which is the importance of being genuinely in the rhythm of the company's financial management and controllership. One of the first things our people say when something happens is, let's be sure the audit committee knows



about it. Call up, or get an email to them, but make sure the audit committee is apprised and kept up to date. That's the culture you want.

So the question for audit committees today is, are we in the game? Are we genuinely in the game? The audit committee shouldn't simply be parked over in a corner someplace as merely a necessary governance vehicle.

ACI: *GE is known for having a world-class internal audit group—which the audit committee must take great comfort in. But many audit committees indicate that while they rely on internal audit quite a bit, they're wrestling with how to get the most value from the internal audit function.*

Sandy Warner: GE, I think, is unique. Others have looked closely at what we're doing and some have even tried to emulate it. It's very hard to do because it takes two or three generations of CEOs to embed the kind of confidence that people, broadly within GE, have in the Corporate Audit Staff. Many of our senior executives have had tours of duty in the Corporate Audit Staff, so CAS holds a lot of credibility here—and it's a massive resource. I think we have about 700 auditors now, worldwide. They're highly competent people, and they're respected and valued in the company without exception.

ACI: *How would you describe the audit committee's relationship with GE's internal audit group and how that affects the committee's effectiveness?*

Sandy Warner: The auditors at GE report to me—both the industrial Corporate Audit Staff and the internal audit for GE Capital. I meet with the heads of the corporate

audit staff and GE Capital audit regularly. We always cover a lot of ground, and I stay current on the work they're doing.

That's part of the deeper engagement that I mentioned. It's just not possible to be actively engaged if you don't sit with these people and understand what they're working on, what they're finding, and trends they're seeing—and pushing back, challenging, probing.

ACI: *Do you see the audit committee playing a role in supporting the CFO and the finance organization in terms of balancing long-term performance and relieving pressures for near-term results, like quarterly earnings?*

Sandy Warner: I would say that quarterly earnings pressure is always on the radar—it has to be. The audit committee's first priority is the integrity of our financials, so if there's controllership pressure or compliance pressure that could affect the integrity of the company's financials, the audit committee needs to be aware of that and on top of it. And if there are any questions about the integrity of our financials, the corporate audit staff's time will be redirected to that—exclusively, if necessary.

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 organization. ♦

Nicholas C. Allen Lenovo and Hysan Development (China)



Mr. Nicholas C. Allen is an independent non-executive director of three listed companies on the Hong Kong Stock Exchange: Lenovo Group Limited, CLP Holdings Limited and Hysan Development Company Limited. Mr. Allen is the audit committee chairman for Lenovo and Hysan Development and a member of the audit committee for CLP Holdings. Mr. Allen is also an independent non-executive director of VinaLand Limited (London Stock Exchange AIM listed) and Texon International Group Limited. Mr. Allen received a Bachelor of Arts degree in Economics/Social Studies from Manchester University, United Kingdom. He is a Fellow of the Institute of Chartered Accountants in England and Wales and a member of the Hong Kong Institute of Certified Public Accountants. Mr. Allen has extensive experience in accounting and auditing and was a partner of PricewaterhouseCoopers until his retirement in June 2007.

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

ACI: *What are some “must-do’s” for an audit committee, and an audit committee chair, to be truly effective?*

Nicholas C. Allen: To be truly effective, it is crucial for an audit committee chair to be ‘hands on’ and active between meetings and to develop his awareness of the company through those that have a deeper knowledge of the company’s operations. The audit committee chair should have a direct relationship with the key executives within the organization and ensure he meets with them, internal audit, external audit, the legal counsel and other audit committee members privately well in advance of each audit committee meeting. This will help to limit unpleasant surprises and the presence of any unresolved issues at the audit committee meeting itself, with the intention that the audit committee meeting becomes the ratification of a cadence of discussions and any debate can be conducted by committee members who are well informed.

The second “must-do” is for the audit committee and audit committee chair to have a critical focus on the “tone at the top” and to consider how management responds to control failures and inappropriate behavior. The audit committee can encourage the development of an appropriate tone by challenging management when issues arise (i.e. not letting people off lightly when indiscretions occur) and can encourage a control mindset by ensuring executive meetings have controls as a standing item on their agendas. To help encourage the ownership of controls by management and ensure that control weaknesses are addressed promptly, it is useful to mandate that an overdue item must be explained to the audit committee in person by the executive responsible for its remediation.

Thirdly, it is essential that the audit committee has control of its own agenda and isn’t “managed.” This also involves considering the number of meetings that are held during the year, and whether the themes for the meeting are appropriate. For example, it is not advisable to have the internal audit plan tabled in the same meeting that the annual report is considered, as

sufficient attention is unlikely to be given to both items. Rather, they should be the primary focus of their own respective meeting.

Finally, it is imperative for the audit committee chair to have a clear one-on-one channel to both the board chair and the CEO. I’m also a believer in the role of internal audit to act as a consultant to the business, rather than a policeman, within the appropriate context and framework. A good relationship between the head of internal audit and the audit committee chair is very important to ensure that both are able and available to have productive discussions on appropriate areas.

Underpinning these “must-do’s” is the requirement for the audit committee chair to have credible expertise that is relevant to the company. It is also important to acknowledge that whilst a career in a professional firm is good preparation for the role, a director’s skill set is unique and must be developed.

ACI: *Are there certain things that your audit committee does particularly well (e.g., practices or behaviours) that other audit committees might consider?*

Nicholas C. Allen: There are a number of good practices that I’d recommend to other audit committees. Two I’ve already raised, namely to put control issues on leadership agendas and to have management attend audit committee meetings when there are issues relevant to their departments.

It’s also very useful to have a good line of sight into the management representation process. The CEO and CFO can’t make their representations in isolation and representations must be cascaded into the business to ensure that there is good awareness and ownership of risk and control. When an issue arises, it is useful to follow the cascade and identify areas that need to be tightened up and to use this to provide management with continuous feedback and education on the importance of their roles. In this regard, it is not a bad

thing to have a few exceptions from time to time to encourage a risk and control mindset. Internal audit should also be involved to help advise on the design of effective controls.

It is important for senior management to attend audit committee meetings and for the audit committee to provide feedback to management and to place emphasis on management's responsibility. It is also worth bearing in mind that the responsibility that the board has delegated to the audit committee is not negative assurance and is not management by exception. The absence of comments from external audit or internal audit does not equate to good controls.

Site visits are also a useful way for an audit committee to develop its understanding of the business, whilst at the same time engagement with management and reminding management of the audit committee's role.

ACI: Specifically related to the audit committee's top priority—financial accounting and reporting oversight—what are critical success factors in your view?

Nicholas C. Allen: There are a number of critical success factors for financial accounting and reporting oversight. The first is to ensure that there is accounting expertise on the audit committee. The audit committee should also seek to anticipate potential issues that are on the horizon, to discuss the potential impact of these issues and decide upon a course of action early.

It is also important for the audit committee to have early sight of drafts in order to consider them within an acceptable timeframe. Quality of earnings reporting is very important for the audit committee to be made aware of changes in provisions and other assumptions made by management.

And finally, it is important to conduct private meetings with the external auditor to ensure that the audit committee can consider their views.

ACI: With regulators globally advancing an array of initiatives focused on auditor independence, objectivity, and professional skepticism, what would you recommend to audit committees in their efforts to ensure audit quality?

Nicholas C. Allen: When considering audit quality, it's worth remembering that the audit committee is the main supporter of external audit and should therefore be supportive to the external auditor to ensure that both fees and scope are sufficient for the auditor to perform the job properly.

It's also the audit committee's responsibility to ensure that external audit isn't exclusively overseen by management. The external auditor should have a line of reporting to the audit committee.

With regards to maintaining auditor independence, there are certain activities other than the statutory audit where the engaging the external auditor is generally a natural fit. These are generally assurance related, and broadly include examples such as due diligence activity or as part of a debt raising. To preserve independence, it is my preference to engage firms other than external audit to provide non-assurance type work. Audit committees of different companies will have their own preferences, but it in all cases it is good practice to clearly set out permissible and prohibited services and as well as monetary approval thresholds.

ACI: How can audit committees best leverage (and support) the internal audit function?

Nicholas C. Allen: Effective leverage and support for the internal audit function starts with effective succession planning for the head of internal audit. One of the competencies that shouldn't be overlooked is the networking skills of the head of internal audit. When a head of internal audit becomes successful at demonstrating the benefits of internal audit activity across the business, issues won't just come up from audits conducted but also from management volunteering areas of concern.

The audit committee can encourage internal audit to be smart on internal audit planning and scoping. This can be done by challenging the risks and controls that internal audit activity will cover and ensuring appropriate prioritization and coverage with no duplication of effort.

Assurance mapping is also useful to map risks against the various control comfort sources within the business, including management oversight/separation of duties. This will help internal audit to focus its activity on the key controls.

There needs to be an appropriate balance of specials versus standard work, but this should always be prioritised according to risk factors.

ACI: Given all the changes in technology, regulation, and the global risk environment, do you envision the audit committee's agenda changing significantly in the years ahead?

Nicholas C. Allen: Whilst the fundamental purpose of the audit committee won't change, I do see changes to audit committee agendas in the years ahead. Issues arising from social media and cyber security will become more prevalent and the nature of audit reporting will also change as continuous auditing becomes more widely adopted.

The way companies report is also changing, with the drive towards integrated reporting gaining momentum. This type of reporting will perhaps be more relevant and provide more insight, but it will mean that controls and assurance over non-financial data will become increasingly important and will have to be considered by the audit committee ❖

Mike Wareing Wolseley Plc, Cobham Plc and Intertek Group Plc (U.K.)



Mike Wareing CMG is the senior independent director and audit committee chairman of Cobham Plc and Intertek Group Plc; and the audit committee chairman of Wolseley plc. He has major international and board level knowledge gained during an extensive global career at KPMG (and predecessor firms), including being Global Chief Executive Officer of KPMG International from October 1, 2005 to September 2009. He is, and has been, closely involved with a number of charities/public bodies, including his appointment in 2007 as the Prime Minister's Special Envoy for the reconstruction of Southern Iraq and UK Government Commissioner and Chairman of the Basra Development Commission. He is also the International Investment Advisor to the Ministry of Mines and Petroleum, Islamic Government of Afghanistan.

"One of the big challenges for audit committees today is simply finding the time to do justice to all the issues on the audit committee agenda."

ACI: What are the essential elements of an effective audit committee?

Mike Wareing: First you need the right people around the table and that means having the right mix of experiences and backgrounds rather than just finance people. This is particularly true where the role of the audit committee has expanded beyond the traditional finance role into a wider risk oversight role where you clearly benefit from having people who are well grounded in operational and other issues.

Having the right internal and external audit team is imperative and then I think the other thing which is becoming increasingly important is getting the right people to talk to the committee in specialist areas, such as cyber security or environmental risk and other issues.

I find it useful to have a formal twelve month rolling forward agenda programme which addresses not only the more obvious financial issues that align with the financial reporting calendar and the various updates from the audit and compliance functions; but two other important areas as well. First, I try to group connected issues together. By this I mean that I try to look at (say) the forward plan for internal audit at the same time that we are looking at the forward plan for external audit and, if there are any other assurance functions within the group, the future plan for that as well. In this way the total assurance is visible to the committee in a way that is not possible with a piecemeal approach.

The second important area is to make sure that there is enough time to cover all the other issues that fall outside the traditional finance oversight areas, for example cyber security, health and safety, business continuity and all the other issues that audit committees seem to increasingly have to deal with nowadays. As with the board itself,

one of the big challenges for audit committees today is simply finding the time to do justice to all the issues on the audit committee agenda. So, being quite thoughtful about how the committee spends its time outside of the two "reporting" meetings (or four if you are on a quarterly reporting cycle) is actually very important.

ACI: What about the time commitment between meetings?

Mike Wareing: To have effective audit committee meetings you really have to put the time in between meetings. It's essential and I really don't think that you can do the job properly nowadays unless you put quite a bit of time in between meetings.

You have to understand what the issues are and to go through things before they actually come to the committee to make sure the papers are right and that things have been properly thought through. But also, you have to make sure you are exposed to the right individuals within the organisation so making sure you actually have a constructive relationship with (say) the head of internal audit is really important. Such individuals need to be able to feel that they can talk freely to you about any issue they feel uncomfortable about - and that clearly can only be outside of a formal committee meeting.

I would say exactly the same about the lead partner from the external audit firm as well. I spend quite a bit of time with them deliberately outside of times when I have to be with them, obviously with everything that has been happening on the audit committee agenda regulation wise in the last two or three years, there has been plenty to talk about and there is plenty to keep updated on from both a technical and regulatory point of view - and that's actually been a good opportunity to engage and build relationships with people like the lead partner from the external audit firm as well.



ACI: *To what extent do you get exposure of the audit team below the lead partner?*

Mike Wareing: I tend to see the number two person quite a lot. Usually that would be the second partner but it's often helpful to speak to someone a bit further down the audit team (a director or a manager) if there are issues where quite detailed granular knowledge is important. In such cases, I encourage that person to speak-up. I think meetings full of people that just sit there is not a good use of anyone's time and there are so many people around the table in an audit committee nowadays that not actually having the contribution from everyone around the table is a mistake.

The other thing which I am finding is increasingly important is access to both specialists on the audit team and those responsible for auditing significant geographies or segments. In the case of the latter, it is useful for them to attend the full year results meeting (at least every two years if not every year) because it makes enormous sense to give the audit committee the opportunity to eyeball the person who is the lead partner for a significant part of the group and to ask them very open questions about matters like the style of the management culture and the robustness of internal controls – as well as about the year-end numbers.

ACI: *And in addition it also gives you a better idea of audit effectiveness across the whole group rather than just at the top of the pyramid?*

Mike Wareing: Absolutely, and I think from a succession point of view—especially with all the tender discussions going on—it's very important to have relationships that go wider than just the individual lead partner.

As an audit committee chair it is really quite striking just how important the relationship is with the lead

individual—particularly from a point of view of trust. You need to be confident that they will tell you the truth as it is and not try to dress it up in any way. It's almost impossible to over-emphasize how important that is. You see some companies that have an extremely strong relationship with their audit firm and very often you find it's because there is an extremely high level of trust in the individual leading the audit engagement—and in turn you will find that the individual has a history of talking very candidly about difficult or sensitive issues such as control weaknesses and the quality of the finance function. It may not be very comfortable for the CEO/CFO but actually it's essential to have the trust in the relationship that you can have that kind of dialogue.

ACI: *As someone who has been both an audit partner and an audit committee chairman, do you have any hints or tips to help build strong relationships - or is it just a matter of the chemistry between two people?*

Mike Wareing: Chemistry helps because it is human being to human being but I think there is a lot that can be done outside of that. One of the things that strikes me is that non-executive board members have a genuine appetite and hunger for insights into the business—both good and not so good. Getting the auditor to give you insights into what's really going on is important even if the issues raised are based on a gut feeling or hunch. I think boards and audit committees really value this because it helps them focus their own oversight activities.

ACI: *And that would extend beyond the numbers and to the wider business environment?*

Mike Wareing: Yes, and to leadership style and culture too. Any concerns around (say) the culture being overly aggressive—maybe pushing at achieving the numbers above all other things even though the numbers appear to be okay—is of great value to the audit committee.

I think one area where auditors can be stronger is in providing insights into the systems and controls beyond any matters associated with major control breakdowns. One of the most difficult things for boards, let alone audit committees, is in understanding the subtleties of the audit approach and the choice between a controls and substantive approach to audit testing. Auditors need to be really clear on this point because I think that most audit committees don't readily appreciate that the auditor may have chosen not to rely on the control framework and the consequences that might have in a wider governance context.

ACI: Not relying on a control should send a very strong message to the audit committee and ultimately management?

Mike Wareing: Exactly, but then it gets worse if there is a breakdown or fraud which crystallises the fact that the controls are weak. That's not a good time for the auditor to be telling the audit committee for the first time that they didn't rely on those controls because they thought that they were weak. I think this is an area where all the major audit firms need to reposition themselves a bit and give more insights and more information about systems and controls issues.

ACI: Is there a piece here around auditors better articulating the audit methodology?

Mike Wareing: I think there are two issues here. The first is an inadequate explanation at the front end of the audit around the audit approach and whether or not the systems and controls will be relied on. If the audit committee don't really understand why controls are not being relied on then that's potentially a problem in waiting.

The second thing is the quality of feedback from the auditor at what is always a busy time of the year. What did all their work yield? Even if there is a good detailed explanation of the audit approach (including the work done on the systems), typically the feedback is heavily focussed on the year-end numbers and not the system and control issues. I consciously ask the auditor to talk

about the systems and controls, but the level of insight and the depth that you get from that is frankly quite often a bit of a struggle.

ACI: Do you think this is because the regulations and standards are pointing the auditors at the wrong things?

Mike Wareing: It might be partially that but I think to some extent there is an issue with the sheer number of separate reports within the annual reporting package and the tendency to get the audit firm to provide some comfort on each one or in some cases even to formally report on them.

There is certainly an argument in favour of the additional assurance an auditor can provide, but the worry is that it takes the attention away from the core job which is financial reporting and behind that the systems and controls.

There is often quite a lot of dialogue with management about improving all of these things—the controls, the financial systems, reporting, offshoring to low cost centres or processing centres, having regional processing centres and all of that kind of thing—but I feel that external audit firms could be on the front foot a lot more on these topics.

Twenty years ago many companies were asking their audit firms for more benchmarking insights and sadly today a lot of companies are still asking for the same thing. I know from my own experience how difficult it can be to provide such information and in many ways the structure of the Big 4 audit firms isn't necessarily set up to provide it—but actually its very much something that audit committees want and expect.

ACI: That certainly resonates with a number of surveys that the ACI have done over the years. Clearly the extent to which the audit firm is delivering on these things impacts your assessment of audit quality. Are there other things you look at when you are thinking about audit quality?



Mike Wareing: We tend to always get bottom up feedback as well as the views of the committee itself. So, it would be normal to be asking questions right the way across the finance organisation of the companies themselves—the group CFO, but also on a regional or divisional CFO basis as well. I think the assessment of audit quality is going to be a very interesting area over the next two or three years—especially as a lot more audits are tendered.

In my view, the audit firms underestimate how much the audit committee and the board want to understand about how the audit is done and what it covers; and what's being validated and what isn't—and there is a little bit of a black art to this. No one really speaks about how the work is actually delivered and what's actually done - even in a fairly high level way.

When the auditor is in front of a new company pitching for the audit there is a lot of focus on leadership and the team and all of those sorts of things—which is, of course, very important. However, there is rarely enough focus on what the auditor is actually going to do if appointed. What's the audit approach? Where are they going to go? What are they going to cover and what are they not going to cover? How will you assess that? How does the audit plan map across to where the risks are? I think there is simply not enough focus on the “real meat” behind what's going to be done. It's almost an unspoken thing.

I think one of the dangers is that there is a perception within the big audit firms that it's very hard to differentiate - and yes I can remember in my years as an audit partner being one of those that said that - but actually it is a self inflicted wound. It will always be difficult to differentiate if you don't set out to articulate what you are going to do and how you are going to do it.

ACI: *That's interesting. I think the days of the audit methodology being a “black box” which is of no interest to audit committees have passed. How do you see the audit committee role changing over the short to medium term?*

Mike Wareing: I think in the last few years the focus on what you might call enterprise wide risk has increased enormously and that is having an impact on the role of the audit committee (or board risk committee where there is one). So, the trend for audit committee oversight to extend beyond financial reporting risk is set to continue.

One of the things I like to do is to take the published statement on the key risks and uncertainties facing the group (this is in the annual report but there is always a big process behind it) and mapping it to the controls in place and, most importantly, the assurance the group has over the operation of those controls. Sometimes you come across big risks and/or important controls over which there is a frighteningly low amount of assurance—and in some cases no independent assurance at all. To be clear, I don't just mean assurance from internal and external audit, but also all the other sources of assurance from independent experts in areas like health and safety, environmental issues, cyber security and IT systems. I find it extremely helpful to have all this information in one place—on a fairly large piece of paper if possible. This is not just for the benefit of the audit committee, but also so management can understand the holistic position and direct (sometimes scarce) assurance resources to where they are most needed.

One thing we all struggle with at the moment is how deep and wide should the involvement of internal audit be? And what skills and expertise you need within your internal audit function and what needs to be brought in from outside the organisation. Having something that lays this out is also very useful in terms of understanding how deep and wide internal audit should get and where external input should be sought.

This whole area of risk, risk control (or risk mitigation) and assurance is an area which will almost certainly grow. What I hope is that this is market led and not dictated by regulation. ❖





John Cryan Deutsche Bank and Temasek (Germany)



John Cryan is chairman of the audit committee of Deutsche Bank. At Temasek International Pte Ltd., Singapore, he is President Europe, Head of Africa, Portfolio Strategy and Credit Portfolio. Prior to Temasek, he was the Group CFO with UBS AG, where he has held other senior roles including Global Head of the Financial Institutions group at UBS's Investment Bank and CEO of UBS Limited. He had also served as chairman and CEO at UBS AG (Europe, Middle East & Africa). Mr. Cryan has more than 20 years of experience in providing strategic and financial advice to a wide range of companies in the financial services sector globally.

"Finding out the topics that matter most and setting the right agenda is the key responsibility of the audit committee chair."

ACI: *What is in your opinion essential for an audit committee chair to lead an effective audit committee?*

John Cryan: To be effective, an audit committee should never be a box-ticking exercise. Finding out the topics that matter most and setting the right agenda is the key responsibility of the audit committee chair.

Deutsche Bank is currently in a special situation with a significant number of legal proceedings ongoing. That situation is very demanding for an audit committee. Setting the right agenda for an audit committee in that situation goes far beyond all the formal work that an audit committee is required to perform. Finding the right balance regarding the information that an audit committee needs to know and the critical distance to the business issues requires a considerable amount of preparation.

Particularly relevant are the different roles between the single and two-tier board systems. There is an inherent conflict between the SEC requirements and expectation—requiring strict oversight by the audit committee—versus the German corporate and banking law that requires a critical distance to management and the business issues.

According to our terms of reference, employee representatives are part of the audit committee. The complexity of the issues that our audit committee has to deal with is already difficult to understand for a financial expert, and all shareholder representatives of our audit committee are financial experts, but it is even more difficult for employee representatives. The preparatory meetings that our external auditor is organizing with each of the members of the audit committee are therefore very helpful in improving the effectiveness of the audit committee.



ACI: *What does the Deutsche Bank audit committee do particularly well?*

John Cryan: Besides the audit committee, Deutsche Bank has—amongst others—a risk committee, an integrity committee and a compensation control committee. At Deutsche Bank we have been able to avoid overlaps between the various committees through intense discussion and preparation with the individual chairmen.

The audit committee also benefits from the general attitude implemented by the chairman of the supervisory board which can be described as “*Führen durch Fragen*” (“management by inquiry”) that has resulted over time in more transparency with regard to difficult topics.

ACI: *What are the critical success factors in the oversight of financial reporting and the supervision of the work of external auditors?*

John Cryan: An audit committee should look not only at the financial statements but also at the effectiveness of the processes leading to those financial statements. Both internal and external auditors play an important role in understanding the quality of the processes leading to the financial statements. The audit committee at Deutsche Bank spends a significant amount of time looking at process weaknesses and their timely remediation.

The assessment of both the independence and quality of external auditors has become increasingly important. In the last year, the audit committee reviewed those aspects and the set-up of the audit team.

ACI: *What are the best leverages regarding the internal audit function?*

John Cryan: At Deutsche Bank there is an intense interaction with the internal audit department in line with German regulations. The internal audit department is a well-balanced combination of internationally experienced and excellently trained individuals. The work of the internal audit department has shown that the quality of internal audit also has an impact on the quality of external audit.

ACI: *Will the audit committee agenda change significantly in the years ahead?*

John Cryan: In an ideal world most of the controls should be automated and the audit of financial statements would result in a technical audit of the automated preparation of those financials.

The audit committee would therefore have the time to discuss strategic issues such as the impact of cyber security or regulatory changes.

In practice, though, audit committees still devote a reasonable amount of time to review whether financial statements are correct in how they represent the economic situation of the company.

There is a risk that audit committees spend too much time trying to understand technical accounting issues and to a certain extent get involved like the auditors. Like when reading Shakespeare, you do not look at each word individually but at what the words express as a whole. ❖

Hong-Chang Chang Fubon Financial Holdings (Taiwan)



Hong-Chang Chang is the chair of the audit committee of Fubon Financial Holdings. He also serves as independent director at Taipei Fubon Commercial Bank and Fubon Securities. After serving as Dean of the College of Management at the National Taiwan University, Hong-Chang Chang is now Professor Emeritus at the Department of Accounting at the National Taiwan University.

“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.”

ACI: *What makes truly effective audit committees?*

Hong-Chang Chang: The most important factor that makes truly effective audit committees is its membership. To this, the role of the board chair is critical, together with his attitude and determination as he is the person in the driving seat to decide on appropriate audit committee membership. Although the management theory promotes the segregation of ownership and management, a board without enough ownership might disregard the importance of the monitoring function of audit committees easily.

ACI: *What are some “must-do’s” for an audit committee, and an audit committee chair, to be truly effective?*

Hong-Chang Chang: Besides the statutory responsibilities of the audit committee, the audit committee should seek to ensure that appropriate independent assurance and advice is obtained in areas such as compliance, risk management, performance monitoring and evaluation, relevant parliamentary committee reports and recommendations. To this, it is a must to maintain routine meetings and effective communication lines with the management team, external auditors, and internal auditors.

From a best practice perspective, I suggest that the audit committee should establish and maintain lines of communication cross-functionally between the board, internal audit, financial, legal, compliance, and risk management departments.

Furthermore, 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. Due enthusiasm and care is crucial in ensuring that the members of the audit committee take in sufficient information from all available resources – media, informal sources or even from rumors – to raise informed and probing discussions to ensure that the major risks to the company are properly identified, mitigated and monitored.

ACI: *Are there certain things that your audit committee does particularly well (e.g., practices or behaviours) that other audit committees might consider?*

Hong-Chang Chang: During my tenure as audit committee chair, the reorganization of the internal audit function was one of my major achievements. As a result of rapid growth of the company at hand, several internal auditors were responsible for several branches, reporting directly to the branch management team. Of course, this structure was likely to put pressure on internal auditors to disclose material issues which might affect branch managers’ performance and also blocked the transparency of the internal audit reporting for the individual branch to the head office and the audit committee. I ensured that all internal auditors relocated to the head office, reporting directly to the head office management and also to the audit committee and the chair of the board. Also and most importantly, performance evaluation for internal auditors was allocated to head office management.

Emphasizing the responsibility of mid-level management and a carefully designed delegation of authority, documentation and authorization are critical to drive the effectiveness of internal control. Most documentation is prepared by employees and approved by mid-level managers in turn. Without cautious verification by mid-level managers at every decision point set by the delegation of authority, effective and efficient internal control will be very costly.

ACI: *Specifically related to the audit committee’s top priority—financial accounting and reporting oversight—what are critical success factors in your view?*

Hong-Chang Chang: Ex-ante involvement is always more efficient and effective than ex-post monitoring. My audit committee is always involved in the external audit process from planning stage. The audit partner is required to timely provide audit planning documentation and illustrate the fit between identified significant risks and the audit approach and methodology applied

to these risks. Taking time to examine the audit plan in-depth to make sure that the audit procedures are adequate is a must.

Also, poor quality financial reporting can easily result from the failure of an audit committee to adequately question management's selection of accounting methods. As a member of an audit committee, it is crucial to spend sufficient time assessing and challenging accounting policies and accounting treatments in financial reporting and to make sure that a strong internal control system is designed and implemented in this respect.

ACI: *With regulators globally advancing an array of initiatives focused on auditor independence, objectivity, and professional scepticism, what would you recommend to audit committees in their efforts to ensure audit quality?*

Hong-Chang Chang: The audit committee should conduct a detailed and formal review of the external auditor's performance at least annually. It is important that the audit committee reviews the performance of the external auditors with the same diligence as the audit firms review management's internal controls and financial statements. I don't mean the same level of effort, just the same professional skepticism and objectivity.

Crucial questions for audit committees to assess and challenge external auditor's work include the following: Does the audit team spend too much time on lower risk areas (as opposed to high risk areas)? Are all areas with higher risk of a material misstatement covered by sufficient audit procedures? Is the external auditor's professional skepticism and objectivity at an appropriate level? Does the audit team have a sufficient knowledge and understanding of the business, its processes, organization, and people? Does the audit team work well with the internal audit team, respecting their insights into the quality of internal control and the areas of greater risk? Does the audit firm continuously improve?

ACI: *How can audit committees best leverage (and support) the internal audit function?*

Hong-Chang Chang: Audit committees and internal auditors have common goals. A good working relationship with internal auditors is crucial for the audit committee to be able to fulfill its responsibility to the board of directors, shareholders, and other outside parties.

Internal auditors shall examine and evaluate the adequacy and effectiveness of the organization's systems of internal control. This results of internal audit's work in this respect is to be used to the fullest extent as a source of information to the audit committee on major frauds or irregularities as well as company compliance with laws and regulations. To ensure that internal auditors

carry out their responsibilities, the audit committee should periodically review the internal audit department's objectives and goals, audit schedules, staffing plans and budgets. The head of internal audit should inform the audit committee of the results from the audits, highlighting significant audit findings and recommendations.

To improve the effectiveness of internal audit, the audit committee is to promote and emphasize the importance of internal audit towards management and the company. As a chair of the audit committee, I attend internal auditors' routine meetings in person to be as up to date on the status of important issues as I can and to assist internal auditors to solve problems. Most importantly, the results of internal audit findings should be linked directly to the personnel reward system, and hence, people will really pay attention to execution of internal controls.

ACI: *Given all the changes in technology, regulation, and the global risk environment, do you envision the audit committee's agenda changing significantly in the years ahead?*

Hong-Chang Chang: Companies face a variety of risks such as technology, financial, and regulatory risk. Audit committees have to learn more about all such new and/or emerging risks. Besides increasing our professional knowledge, further specialization in the audit committee might be advisable to ensure that the committee remains effective in overseeing that efficient and effective monitoring systems are in place in all these areas. ❖



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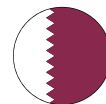
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