



cutting through complexity

AUDIT COMMITTEE INSTITUTE

The Audit Committee's Oversight Role on Financial Reporting 2013

"Are the Numbers Too Good To Be True?"

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Foreword

The issue of corporate governance has continued to gain widespread prominence in businesses today. Shareholders' expectations of corporate governance, including financial reporting, have never been higher, and the scrutiny by regulators and investors never more stringent.

As a consequence, the role of the Audit Committee is rapidly increasing in prominence and scope. Today, Audit Committees are being asked to assume responsibilities well beyond their traditional duties. The most effective Audit Committees are not only clearly aware of their responsibilities but also need to completely embrace them, and recognize what are necessary to fulfill them effectively as consequences are dire when Audit Committees do not meet such expectations.

Effective corporate governance depends on the active and collaborative participation of all its principal champions – the Audit Committee, board of directors, independent external auditors, internal auditors and management. Ensuring that this collaboration occurs ergonomically, efficiently and effectively is fundamental to an audit committee's success. Its functions and responsibilities, which are approved by the board of directors, vary from organization to organization, but each committee's key responsibilities are essentially the same as they are set out in Bursa's Listing Requirements.

In light of this, for year 2012, the ACI Malaysia organized several Roundtable discussions entitled "The Audit Committee's Oversight Role on Financial Reporting 2013 – Are the numbers too good to be true?" to shed light on how organizations and their Audit Committee discharge their roles in the financial reporting process. Our survey questions essentially elicited the thoughts of participants and analysed their responses against the industry's better practices.

I hope the contributions of participants at the various Roundtable sessions, and comments will prove to be insightful and beneficial in understanding the market's perception on the Audit Committee's role in Financial Reporting. We certainly enjoyed the participation from various breakfast Roundtable discussions with our Audit Committee participants, and we certainly hope that you all will continue to support our future events under the Audit Committee Institute umbrella.



Peter Ho
Chairman
Audit Committee Institute Malaysia

The Audit Committee's Oversight Role on Financial Reporting:

"Are the Numbers Too Good To Be True?"


Audit Committees ("AC") have long been tasked to ensure that an organization reports accurate financial numbers which are crucial for stakeholders to make informed decisions. The credibility of the AC therefore hinges on how well it discharges this financial reporting oversight

role. Its main role is governed by regulatory requirements of the relevant authorities within the region and corporate governance codes.

The Listing Requirements of Bursa Malaysia Securities Berhad ("LR") state that listed issuers should ensure that its audit committee review and report to the board of directors, the quarterly results and year-end financial

statements, prior to approval by the board of directors.

The focus areas are mainly changes in policies, significant and unusual events, and compliance with accounting standards and legal requirements. The Malaysian Code on Corporate Governance ("MCCG") 2012 echoes this leverage by recommending that, "The Audit Committee should ensure financial statements comply with applicable financial reporting standards."



Therefore, it is important that Audit Committees are able to deftly detect red flags. The underpinning of an effective Audit Committee is its ability to ask the right questions and to always consider, "Aren't the numbers too good to be true?" A healthy dose of skepticism is imperative in the scrutiny of financial reports.

To do this, Audit Committees employ a holistic approach to overseeing the financial reporting process. Their responsibilities span from policies and

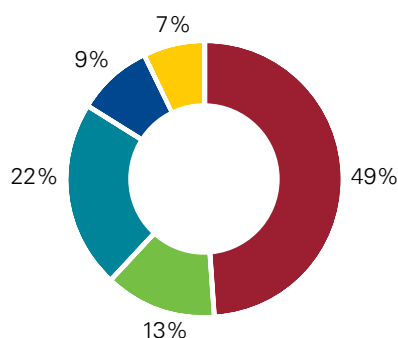
procedures to internal controls and risk management.

The depth of scrutiny and review will vary widely amongst companies and industries based on their nuances. In essence, there is no "one size fits all" but the overarching principles of conduct, that of fairness, integrity and accuracy should serve as beacon to guide Audit Committees.

Comprehensive information for Committee's Review

Q1

Do you receive comprehensive information, both financial and non-financial, from Management to assist you in reviewing the quarterly financial report?



- Yes, always
- Yes, but only sometimes
- Yes, but only when requested
- No, but Management is always invited to the meeting to provide information or explanation on an oral basis when required by the AC
- No, the AC only receives financial information as it is to review the financial report before recommending to the Board

The completeness and accuracy of information furnished to Audit Committees is pivotal to enable them to effectively discharge their financial reporting oversight role, especially in their review of quarterly financial reports for ultimate announcement to the regulators. It is heartening to note that almost half (**49%**) of the respondents mentioned that it is standard practice for them to be provided with comprehensive information, both financial and non-financial, by Management before Audit Committee meetings. However, there was still a fifth (**22%**) of the participants who believed that comprehensive information was only furnished by Management upon request.

Boards should be aware that both financial and non-financial information is invariably entwined, especially when non-financial data like production downtime, capacity utilization, customers' complaints, product recall, etc., have a bearing on the veracity of financial numbers reported.

One participant affirmed the importance of non-financial information and said that in most cases, his Audit Committee is provided with the financial report and questions, if any, are fielded by the CFO. In our interaction with Audit Committee members, one question invariably arises and that is, *"Is there any checklist to assist Audit Committee members concerning pertinent questions to ask Management when reviewing the financial numbers?"* The Corporate Governance Guide (Towards Boardroom Excellence) (Second Edition), which was issued by Bursa Malaysia Securities Berhad ("Bursa") in October 2013, contains two specific Exhibits that set out model questions directors may pose to Management to elicit pertinent

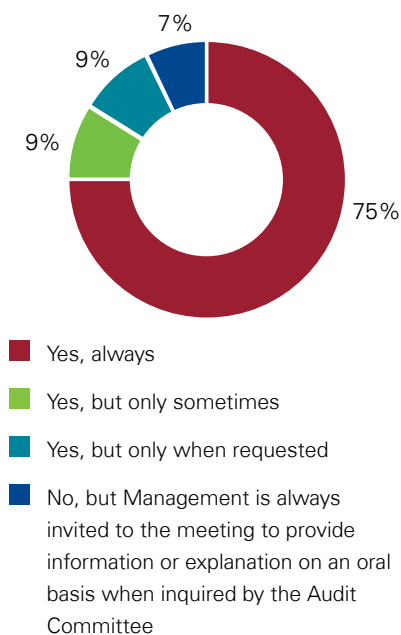
explanations and information which are useful to assist them in their review of financial reports.

The Listing Requirements ("LR") of Bursa stipulate that, *"a director of a listed issuer must ensure that he attends such training programs as may be prescribed by the Exchange from time to time"*. The LR further require listed issuers to disclose in their annual reports that, *"the board has undertaken an assessment of the training needs of each director and a brief description on the type of training that the directors have attended for the financial year"*. In respect of directors who have not undergone any training, explanations should also be disclosed. Whilst the LR currently insists on new directors to undergo the Mandatory Accredited Program, existing directors are given the latitude to decide on the types of training to attend. The Commentary to the MCGG 2012 states that, *"The Nominating Committee should facilitate board induction and training programs for directors"*. Such training programs are aimed to keep directors abreast with contemporary developments in regulatory requirements, their responsibilities as directors, as well as honing their skills in meeting the needs of the company.

Clarity of Financial & Non-Financial Information

Q2

Is the Audit Committee provided with summary of results of companies in the Group, with explanations provided by Management for significant variances noted for the reporting period?



A thumping **75%** of the participants responded in the affirmative – this certainly signals a heightened sense of transparency embraced by Management to assist Audit Committees in the discharge of their responsibility. Such information enables the Audit Committee to take note of companies in the Group that are thriving as well as those that are “bleeding”, where questions concerning the latter companies will likely be posed to Management on the root causes as well as remedial measures to “stop the rot”. It is essential for significant fluctuations in performance to be explained, especially when such fluctuations are attributed to changes in accounting standards, accounting estimates or unusually complex transactions or even a one-off deal. It is therefore crucial for Audit Committee members to be financially literate, as this is useful in understanding and validating the reasons and causes espoused by Management. Recent changes to the Financial Reporting Standards would likely have an impact on the numbers the company is reporting

and, as such, briefing by the external auditors at appropriate meetings, would certainly augment the Audit Committee’s understanding of the nuances such standards have on financial reporting.

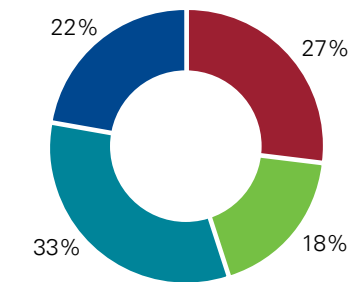




Validation by Internal Auditors (“IA”) and External Auditors (“EA”)

Q3

Does the Audit Committee utilize the independent IA or EA function to assess quarterly financial report to provide assurance on its accuracy, i.e. prepared in accordance with the Group’s accounting records and accounting policies?



- Yes, we use the internal audit function to validate the accuracy of the financial report
- Yes, we use the external auditor function to validate the accuracy of the financial report
- Yes, we use both the internal and external auditors to validate the financial report, with each auditor covering specific scopes which do not overlap
- No, we do not consider this question to be relevant

From the responses elicited, it appears that the Audit Committee is cognizant of the “help” that auditors can provide, and, accordingly, deploys its “**eyes and ears**” (as what auditors are now called) to assist the Committee in filtering any concerns that may cast aspersions on the veracity of the financial numbers. A whopping **78%** of respondents confirmed that either the IA or EA, and sometimes both, were roped in to perform limited review of the financial numbers and report to the Audit Committee. This is not unexpected due to the ever changing requirements of Financial Reporting Standards and the recently reported fiascos in financial reporting in Malaysia. There is still, however, about a fifth (**22%**) of those participants who have not deployed the IA or EA resources to assist them in this aspect – perhaps this could be due to such Audit Committee members having the experience and expertise and are already well apprised of developments in corporate reporting or perhaps, the nature of operations of their companies is not overly complex and the number of companies in the group is small, where reliance is placed on the CFOs or fellow

Executive Directors who are competent in financial reporting.

Nonetheless, it is pertinent to note that early detection of anomalous financial reporting, if any, is crucial. It cannot, and should not, be left until the fourth quarter of a company’s reporting for more scrutiny to be undertaken – any anomaly detected late may jeopardize the situation further, especially when the external auditors are unable to obtain sufficient and reliable audit evidence to enable them to form an opinion on the company’s financial statements for the year. For the last five years, there have been cases where listed issuers were required by regulators to carry out investigative audit on the back of “alarm bells” rung by the external auditors – and in most cases, the “anomalies” just did not happen in quarter 4 but had “occurred” in the previous few quarters. The question to ask then is, “*How is the Audit Committee able to identify such anomalies before the external auditors commence their work, especially on reporting for Q1, 2 and 3?*”

The PCAOB in the US recently released the Auditing Standard No.16 “Communications with Audit Committees” which focuses on fostering constructive dialogue between auditors and audit committees on pertinent audit and financial issues.

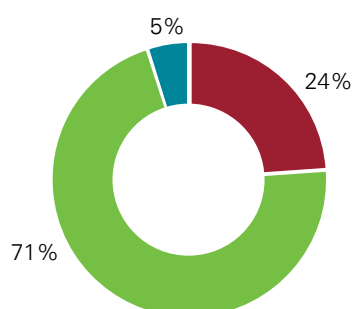
Some noteworthy communication points with the audit committee include:

- critical accounting policies and practices;
- critical accounting estimates;
- difficult or contentious matters for which the auditors consulted outside the engagement team;
- disagreements with management; and
- schedule of uncorrected misstatements related to accounts and disclosures that the auditor presented to management.

Policies on Non-Audit Services

Q4

The Audit Committee should establish policies governing the circumstances under which contracts for provision of non-audit services can be entered into and procedures that must be followed by EA. What is the status of this recommendation in your company?



- We have formalised policies and procedures in place
- We recognise the importance thereof and are in the midst of formalizing such policies and procedures
- We do not have such policies and procedures and do not intend to have them

This question is extracted verbatim from the MCCG 2012. Recommendation 5.2 of the MCCG 2012 states that, "The Audit Committee should have policies and procedures to assess the suitability and independence of external auditors". The Commentary, that provides guidance on the recommendation, states that, "The independence of external auditors can be impaired by the **provision of non-audit services to the company**".

The MCCG 2012 was only released in March 2012 and based on past observations on changes to the MCCG in 2007, listed issuers normally take about a year to fully understand and imbibe the implications and repercussions such changes have on them before taking measures to address the changes. As such, it is not surprising to note that only a quarter (**24%**) of the respondents mentioned that policies and procedures on non-audit services provided by the EA have been formalized. Whilst about three quarters (**71%**) of the participants are in the midst of addressing the matter, there is still a niggling **5%** who feels that such policies and procedures are not necessary. Why is that so?

It is vital to understand the rationale for such policies and procedures. The MCCG 2012 recognizes the independence and financial threat, where non-audit services rendered by the EA and/ or their network member firms/companies may impair, or seen to impair, their objectivity and professional independence when they also report on the truth and fairness of the same group's financial statements.

Is this new? Obviously not! A flashback to the early 2000s will bring to memory the infamous Enron debacle where the EA also provided non-audit services (for example, internal audit and consulting) to the group, the fees of which were significantly disproportionate as compared to the audit fees (see bottom box). The firm of auditors has been the sole EA for the group for the last 16 years before the group collapsed!

The By-Laws (on Professional Ethics, Conduct and Practice) of the Malaysian Institute of Accountants prohibit the provision of certain non-assurance services to assurance clients (i.e. financial statement audit clients), which are public interest entities, including listed issuers, by the EA and/or its network firms. One of the non-audit services that is totally prohibited is the rendering of internal audit by the EA and/or its network firm to the listed audit client, as there are practically no safeguards that are able to reduce the independence threat to an acceptable level. In Malaysia, where the internal audit function is mandatory for listed issuers, there is a risk that a network member firm of the EA may be appointed to conduct internal audit on an outsourced basis, especially when the name of the network member firm cannot be readily identified with that of the EA. To avoid this, the Audit Committee, in its quest to develop policies and procedures on the provision of non-audit services by the EA, would do well by requiring the identified service provider to furnish to the Audit Committee, in writing, its relationship, if any, with the incumbent EA. Negative relationship should also be affirmed.

Enron's case

In 2000, the now-defunct accounting firm Arthur Anderson was paid a total sum of \$52 million, split into:

- \$25 million for audit services
- \$27 million for non-audit services

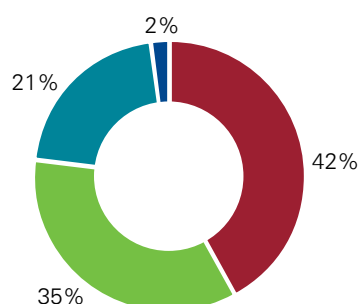
Source: <http://www.pbs.org/newshour/bb/business/enron/player6.html>



Standardised Internal Audit Function

Q5

The IA should carry out its function according to standards set by recognized professional bodies. What is the stand currently taken by your Audit Committee?



- We have an internal audit charter or equivalent that states the Head of Internal Audit must, as a minimum, deploy standards set by recognized professional bodies on internal auditing
- We recognize the importance of the MCGG 2012 Recommendation and are in the midst of formalizing standards to be observed by the Head of Internal Audit
- We rely on the experience of the Head of Internal Audit and do not have any particular preference on the standards accepted by him/her
- We have yet to establish an internal audit function

Whilst the Corporate Governance Blueprint issued by the Securities Commission in July 2011 paid no heed to the internal audit function, even though internal audit has been mandated by the Listing Requirements in 2008, the MCCG 2012 included a recommendation pertaining to standards that should be deployed by the internal audit function. The internal audit function can be in-house (i.e. the internal audit personnel are employees of the company), out-sourced (i.e. undertaken by an independent professional firm based on an engagement contract) or co-sourced (i.e. the listed issuer has an in-house IA function but engages an independent professional firm to augment the in-house IA resources, for example expertise may not reside in-house and, hence, external subject matter experts are engaged to assist). There are currently no specific bodies tasked to regulate the internal audit profession, i.e. their qualifications as well as the way IA should be conducted. As such, IA are not required to adopt specified internal auditing standards unlike the EA who are regulated by the Companies Act, 1965 (company auditor must have a valid audit license to sign audit report and if the client is a listed issuer, the audit firm and partners involved must be registered with the Audit Oversight Board) and the Malaysian Institute of Accountants, where the firm needs to be a member firm and the partners members of the Institute and that they must deploy the International Standards on Auditing in carrying out a financial statement audit.

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes".
(Source: International Professional Practices Framework [IPPF] of the Institute of Internal Auditors)

In Malaysia, there are currently two bodies that have issued internal auditing standards or guidelines, i.e. the Institute of Internal Auditors (Malaysia) and the Malaysian Institute of Accountants. It is gratifying to note that **42%** of the respondents indicated that their internal audit charter or equivalent states that their heads of internal audit are required to adhere to standards set by recognized professional bodies on internal auditing. An encouraging **35%** mentioned that they are aware of the importance of deploying internal auditing standards as mentioned in the MCCG 2012 and are working towards formalizing this requirement for their IA function. A significant portion of the participants (**i.e. 21%**) had no particular preference on the standards adopted by their IA heads but instead rely on the experience of the IA function to carry out internal audit activities. Perhaps, this is one area that advocates of corporate governance as well as professional bodies may need to continuously engage with the regulators, i.e. Bursa Malaysia, to consider regulating the profession to streamline standards deployed and, in so doing, infuse a higher level of proficiency in the internal audit profession to meet the needs of listed issuers.

Although the internal audit function has been mandated for listed issuers (Paragraph 15.26(b) of Bursa's Listing Requirements) since 2008, it is interesting to note that **2%** of the participants indicated that they had yet to establish an internal audit function. If this is true, the company(ies) concerned may receive a reprimand from the regulators for breaching the Listing Requirements!

Conclusion Remarks

Malaysia was not spared the debacle of Enron – we had our fair share of debacles, especially one about six years back, which culminated in two independent directors being fined RM300,000 and imposed custodial sentence of one year each. Since then, there have been more reported cases of financial irregularities as well as breaches of the Listing Requirements on financial reporting and disclosure. These events have invariably sent shudders down the spine of directors of listed issuers, in particular, the Audit Committee which comprises exclusively non-executive directors, with a majority independent – all of whom are not involved in the day-to-day running of the company's operations and hence may not be aware of the finer happenings in the organization. What then can the Audit Committee do? Oh, yes, plenty.... at the least, the Audit Committee can, and should, do, inter-alia, the following:

- establish clear terms of reference in writing for the Audit Committee to function (as a minimum, the terms should mirror those stipulated by Bursa), with endorsement by the Board;
- ensure the internal audit function is adequately staffed with qualified personnel and that they deploy internal auditing standards recognized by professional bodies - this includes having the quality of the internal audit function assessed by an independent competent party at least once every five years (*promulgated by the IPPF*);
- formalize policies and procedures in writing to assess the suitability and independence of the EA;
- engage with Management to ensure the organization has in place formal policies and procedures regulating the financial reporting processes, including how the Audit Committee members are notified on any changes in accounting policies and financial reporting standards that affect the organization;
- consider the use of IA and/or EA resources to assist the Audit Committee in reviewing (although most likely on a limited basis) the veracity of financial reports to flag any areas of concerns or anomaly; and
- engage with the EA on a continual basis, not only when the audit is already completed – remember, the Audit Committee has the right to meet the EA or IA or both any time in the absence of Directors, Management or any employees, as deemed necessary (*Paragraph 15.17(f) of Bursa's Listing Requirements*).

A contemporary tool the Audit Committee should consider deploying is the Corporate Governance Guide (Towards Boardroom Excellence) (Second Edition), a recent publication of Bursa which sets out the following exhibits that directors (in particular, Audit Committee members) can use in engaging with management:

- Exhibit 1 Whistle-Blowing Policy;
- Exhibit 3 Financial reporting questions to be posed to Senior Management;
- Exhibit 4 Controls and Regulation – Questionnaire to be posed to Senior Management;
- Exhibit 7 Matters to be tabled to the Audit Committee on related party transactions;
- Exhibit 13 Internal audit function evaluation checklist;
- Exhibit 14 External auditor perform and independence checklist; and
- Exhibit 15 Private session with the external auditors.

The Audit Committee is certainly here to stay, mainly to function as an effective vanguard as well as gatekeeper, on behalf of the board, pertaining to the financial reporting process. Of course, its duties and responsibilities are many and sometime onerous in view of the ever changing financial reporting standards and regulatory requirements. Some soul searching questions the Audit Committee should ask are:

- Do I have what it takes to be an Audit Committee member?
- Do I understand my roles and responsibilities as an Audit Committee member?
- Do I have the relevant resources to assist me in the discharge of my responsibilities?

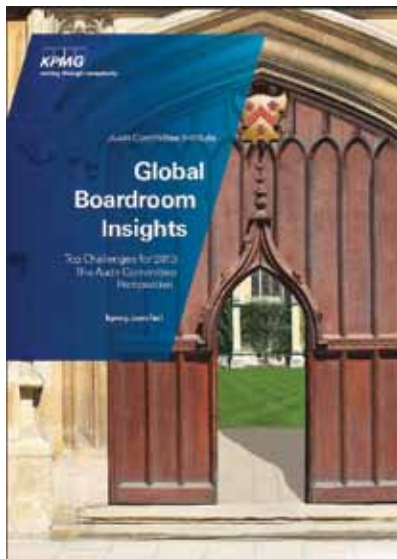
Ten years ago, listed issuers may not have adequate resources to assist the Audit Committee in its role – now the resources are aplenty. The key question for Audit Committee to answer is, ***“Are we really deploying the resources at our disposal”?***

ACI Thought Leadership



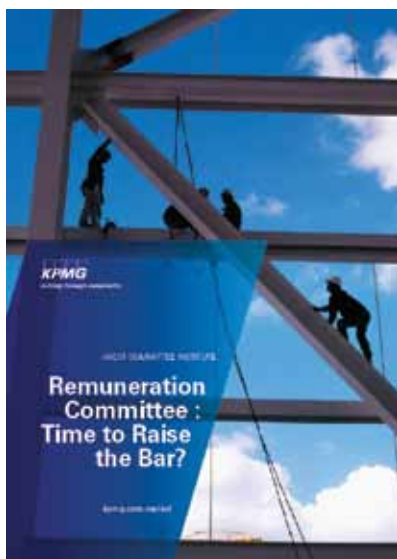
Every issue of the **Audit Committee Insights** newsletter has exclusive KPMG analysis.

Shareholders' Questions 2010
Developed by our professionals, the newsletters leverage the thought leadership behind KPMG's Audit Committee Institute (ACI). The newsletters provide access to ACI updates and unique insights that can help you understand the changing nature and emerging trends of the audit environment.



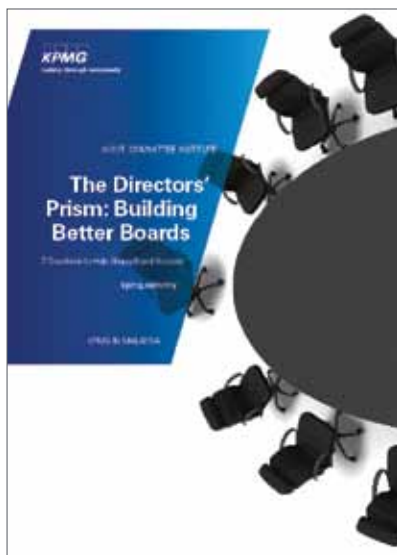
Global Boardroom Insights 2013

Audit committee chairs from global organisations in Brazil, Germany, the U.S. and UK offer perspectives on a range of issues, including lessons learned from the past several years; keys to maintaining strong audit committee/auditor communications; how the speed of technology change and an increasingly complex risk environment are impacting the audit committee and board agenda; and more.



Remuneration Committee : Time to Raise the Bar?

is centred on the changing remuneration landscape of some developed economies, and provides much needed literature on this very current topic.



The Director's Prism : Building Better Boards

This publications identifies a listing of 7 probing questions, compiled with a view to helping shape success for boards and directors.



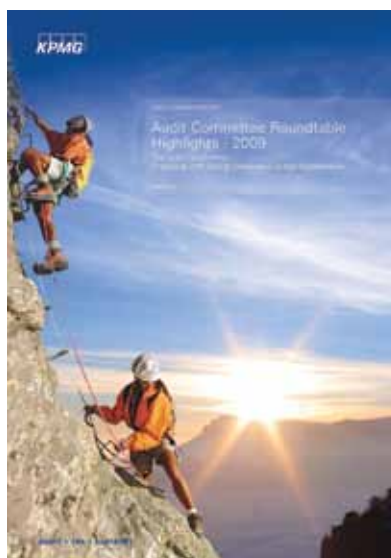
Shareholders' Questions 2010

Today's globalised environment has produced a new breed of shareholders, more technically savvy and more aware of their rights than their predecessors, the result of which directors can expect a challenging array of questions to be raised during the upcoming AGMs.



2009 Non-Executive Directors: Profile, Practices & Pay

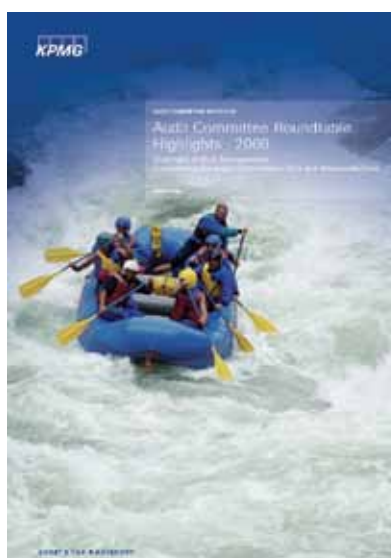
This ground-breaking publication aims to provide boards of PLCs with an understanding of a non-executive director's profile, role and remuneration in Malaysia. Published in 2009, it is the precursor to this current study.



Audit Committee Roundtable Highlights – 2009

The Audit Committee – Grappling with Rising Challenges in the Marketplace

This survey highlights the results of 154 participants over 6 interactive Roundtable discussions held during the last two quarters of 2009. It shows the participants' concerns, perspectives and preparedness on risk management in the midst of an economic downturn.



Audit Committee Roundtable Highlights – 2008

Oversight of Risk Management - Considering the Audit Committee's Role and Responsibilities

To help Audit Committee members, directors and senior management gain a better understanding in the oversight of the risk management process, ACI Malaysia hosted a series of roundtable discussions in 2008. This report is a compilation of the feedback provided by Audit Committee members and directors at the roundtable discussion series.



Audit Committee Roundtable Highlights – 2007

Building a Framework for Effective Audit Committee Oversight

In 2007, ACI Malaysia held a series of five roundtable discussions where 90 audit committee members and directors attended to explore the audit committee framework and oversights. This is the first report by ACI Malaysia which is a compilation of the feedback provided by the participants at the roundtable discussion series.

Contact us

Should you have any feedback on this report, or wish to obtain a complimentary copy, please drop us a note at info@kpmg.com.my

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To learn more about Audit Committee Institute Malaysia or to access our resources, please visit our website (www.kpmg.com.my/aci) or contact us by e-mail (info@kpmg.com.my).

About ACI Malaysia

In recognising the importance of audit committees, the Audit Committee Institute Malaysia (ACI) was created to assist audit committee members adapt to their changing role.

Sponsored by KPMG in Malaysia, the Institute's primary mission is to communicate with audit committee members to enhance their awareness of, commitment to, and ability to implement effective audit committee processes.

ACI Malaysia engages in a variety of initiatives to assist audit committee members by providing a range of resources through its website, publications and roundtables, all designed to facilitate the exchange of views and insights on audit committee best practices and processes, and other topics of interest.

The Institute has developed a range of tools to assist audit committee members in meeting their oversight role. These tools include:

- **Audit Committee Guide** – a comprehensive reference for audit committee members. It captures KPMG's insights into what makes a best practice audit committee and provides practical tools to help improve audit committee processes.
- **Regular updates** – ACI Malaysia will publish regular newsletters to provide audit committee members with timely updates on significant reporting and regulatory changes, and emerging issues.
- **Website** (www.kpmg.com.my/aci) – Designed to provide audit committee members, board members, senior executives and other interested parties with timely access to a wide range of useful resources. ACI Malaysia's website provides you access to updates on current and emerging issues related to governance, risk management, internal and external auditing, accounting, financial reporting and a library of reference materials.
- **ACI Roundtables** – ACI Malaysia facilitates interactive roundtable forums which provide a platform for the exchange of views and insights on contemporary topics of interest to board members, audit committees members and senior executives.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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