



AUDIT COMMITTEE INSTITUTE

# Audit Committee Roundtable Highlights—2007

Building a Framework for Effective Audit Committee Oversight

MALAYSIA





# Foreword



We recognize that in today's business landscape, change is constant. Globalization, demands for faster technological upgrade, new political and economic orders and regulations are the forces behind the dynamics at play today. Consequently, it has become more challenging for every organization to remain competitive, and even more so important to be transparent.

This change did not go unnoticed at KPMG. In recognizing the growing importance of Audit Committees, KPMG set up the Audit Committee Institute (ACI) Malaysia to serve Audit Committee members, Board members, senior executives and other interested parties to adapt to their changing roles.

Last year, ACI Malaysia held five series of roundtable discussions where 90 Audit Committee members and directors attended to explore the Audit Committee framework and oversights. Their unbiased feedback provided us with the basis of this report.

The roundtable series provide a platform for Audit Committee members to exchange their views; and bring to light the challenges and the issues facing Audit Committee's such as risk management, Audit Committee agenda and new accounting standards. Along with their industry knowledge, they bring to the discussion their experience as Audit Committee members.

We thank all the organizations as well as individuals who kindly agreed to participate in this year long study. Through the findings of this study, we hope you will gain useful insights that would serve as a guide thereby allowing you opportunities for improvement and growth.

**David Lim**  
ACI Chairman  
KPMG in Malaysia



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## Introduction

The business and regulatory environment is becoming increasingly complex, and the pace of change and pressure on Directors remains relentless. The recent spate of financial shenanigans as reported by the media has provided impetus and rightly so for corporate governance reform, culminating in amendments to the Malaysian Companies Act, 1965 (the “Act”), the Malaysian Code on Corporate Governance (the “Code”) and the Listing Requirements (“LR”) of Bursa Malaysia Securities Berhad (“Bursa Securities”), just to name a few. Not many would have predicted the push for changes in investor protection and corporate governance reform would occur so quickly and with such vigour.



### **The ACI Roundtable: Enhancing Awareness**

KPMG's Audit Committee Roundtables are panel driven, interactive sessions designed to facilitate constructive dialogue among participants—typically including Audit Committee members, Board members, and other corporate leaders. The goal of our roundtables is to enhance participants' awareness of the issues discussed and identify actions to improve the effectiveness of Audit Committee.

### **Audit Committee Roundtable Format**

The Audit Committee Roundtable is structured to encourage participation and feedback between the audience and a panel. During each roundtable a moderator introduces topics, with the panel members providing much of the detailed discussion content. This approach results in an interactive format with the moderator, panel members, and audience collectively driving the direction of the discussion.

## **Audit Committee Institute**

The Audit Committee is at the frontline of this change. Charged from the beginning with specific responsibilities pertaining to corporate governance, the changes in technology, communication, values, regulation and stakeholder sentiments are placing even greater demands on the Audit Committee and other Directors, within an environment of ever increasing scrutiny.

The Audit Committee and its members face the formidable challenge of effectively overseeing the company's financial reporting process in an evolving and highly charged corporate governance environment.

To help instill awareness of the Audit Committee's new responsibilities, and to provide insights into, and strategies for, strengthening the Audit Committee's oversight of financial reporting, KPMG's Audit Committee Institute (ACI) conducted its first roundtable discussion: "Building a Framework for Effective Audit Committee Oversight".

Held at Hilton Kuala Lumpur and Carcosa Seri Negara, there were five interactive roundtable discussions to-date, providing a platform for dynamic exchange of ideas among 90 Audit Committee Chairman and members and other C-level executives.

## **Audit Committee Oversight: Key Challenges**

Given the challenging corporate governance environment, it is essential for Audit Committee to focus on a process that supports effective oversight, without unnecessary meddling in the management of the company. This requires an oversight framework that facilitates the coordination of activities and information needed to support the Audit Committee's understanding and monitoring of the company's financial reporting process.

Specifically, such a framework should enable the Audit Committee to:

- effectively prioritize financial reporting risks and issues;
- ensure that key issues are addressed in depth;
- establish a strong relationship with the company's independent auditors;
- identify and coordinate contributions of other key participants;
- facilitate an effective and efficient oversight process;
- ensure that the processes and organization are compliant with relevant rules and regulations; and
- keep its members abreast of regulatory changes and other emerging issues affecting the company and its subsidiaries.



The 2007 Audit Committee Roundtables, Building a Framework for Effective Audit Committee Oversight, were conducted from January to December 2007 in Kuala Lumpur. More than 90 Audit Committee members and other C-level officers registered for this series.

The audience response system (ARS) used during the sessions provided real-time feedback from participants and facilitated interactive discussion of roundtable topics. Similar to the system that is used to poll audiences on popular television game shows, the ARS enabled participants to respond to survey questions via hand-held electronic devices. Polling results were displayed to the participants instantaneously.

Participants were asked a total of eight roundtable questions as follows:



- Q1. Do your Audit Committee's activities result in the appropriate level of knowledge and interaction implicit in the concept of "oversight" without taking on the role of Management?
- Q2. How does risk assessment/ reporting impact the overall Audit Committee process and agenda?
- Q3. Who has the ultimate authority to hire/fire the head of internal audit in your company?
- Q4. Do you believe that the independent auditor is more accountable to Management than to the Audit Committee?
- Q5. Do you believe that the Audit Committee should be responsible to prevent financial fraud or to uncover irregularities in financial reporting within the organization?
- Q6. Do you believe that the organization and operation of your company's Audit Committee allow for an efficient and effective planning and conduct of the Committee's activities to meet its responsibilities to the Board of Directors?
- Q7. How much time do you spend fulfilling your role as an Audit Committee member, including all related meetings and preparation time, on an annual basis?
- Q8. Do you believe your company's current approach to Audit Committee evaluation enhances the Audit Committee's effectiveness?

## The “Audit Committee” Defined



Firstly, it must be pointed out that unlike in the United States, there is no legal definition of an “Audit Committee” in Malaysia. In the United States, we can see that the roles and functions of the Audit Committee are more geared towards financial reporting. In the Malaysian context, the functions of the Audit Committee are somewhat broader. Details relating to the functions of the Audit Committee for a public listed company are set out in paragraph 15.13 of the LR of Bursa Securities.

In summary, the three fundamental responsibilities of the Audit Committee are:

- to assess the risk and control environment;
- to oversee financial reporting; and
- to evaluate audit processes.

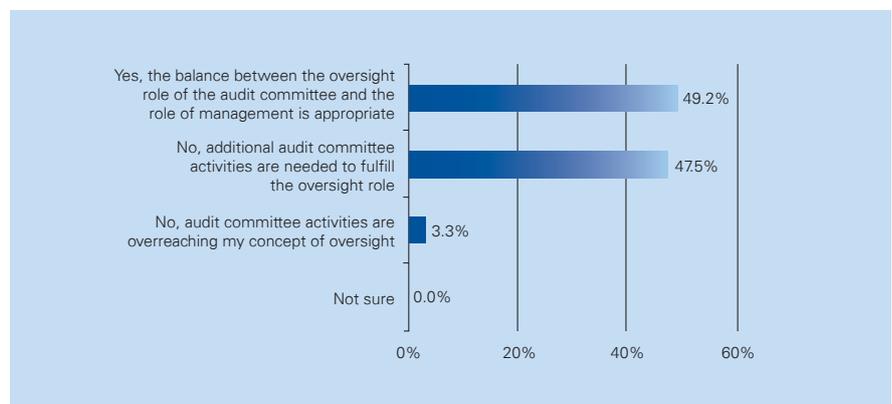


When it comes to addressing financial reporting risk, where does oversight end and management begin? As Audit Committee become more active and the expectations of a robust Audit Committee process increase, it can be difficult to ensure that the fine line between oversight and management of the financial reporting process is not crossed. Clearly, the Audit Committee should not assume the role of Management. Rather, Audit Committee members should provide their experience, insight, influence, and instincts to meet their oversight obligations from both regulatory and as well as overall business risk perspectives.

Key questions posed to participants at the roundtable discussions and their overall responses are summarized as follows:

**1. “Do your Audit Committee’s activities result in the appropriate level of knowledge and interaction implicit in the concept of “oversight” without taking on the role of Management?”**

**49%** of participants say that there is a balance between the oversight role of the Audit Committee and the role of Management.



The current environment, increased expectations and regulations impacting Audit Committee have resulted in many Audit Committee members spending significantly more time fulfilling their role and asking Management more questions. These new roles, responsibilities, and activities are also causing Audit Committee members, to feel more “empowered,” which may cause friction with Management. This may be particularly so now that the LR and the Code have been amended requiring Audit Committee to comprise wholly members who are non-executive directors, the majority of whom are independent. The revised Code also stipulates that all the Audit Committee members should be financially literate – this is expected to result in more pertinent questions raised pertaining to financial risk as well as financial reporting.

#### Participants’ Views ON OVERSIGHT

- “I wonder who actually appoints the internal auditor who is supposed to assist the Audit Committee discharge its oversight role?”
- “There is a need for the role of Audit Committee to be clarified, particularly for organizations with numerous subsidiaries and associates, both local and foreign”; and
- “So many items on the agenda and so limited time – how to discharge oversight role?”

Approximately 48% of roundtable participants felt that additional Audit Committee activities were needed to fulfill the oversight role over Management, whilst 49% believed that their Audit Committees’ activities resulted in an appropriate level of oversight without encroaching on Management activities. The remaining respondents (3%) claimed that the Audit Committee activities were overreaching their concept of oversight.

The concept of “eyes on, hands of” approach was broached several times by participants. One commented that for an oversight to be effective, the Audit Committee should not only adopt the “eyes on, hands off” approach, but pepper it with pertinent questions to elicit more information to assist the Committee in discharging its duties. Going further may be construed as trying to interfere with Management or usurping Management’s role. Audit Committee needs to be aware of current development in the organization - that is the main reason why the revised Code stipulates that the Audit Committee Chairman should continuously engage with Senior Management, and the internal and external auditors to be kept informed of matters affecting the company. Invariably, Audit Committee members will need to ask more pertinent questions in their quest to understand the company’s operations, particularly on matters relating to financial reporting and business risks faced by the company. In so doing, there is propensity for them to be labeled as “micro-managing”.

## Basic Principles versus “Best Practices”



ACI encourages Audit Committees' to consider five basic principles that can help provide the foundation for an independent, objective, and effective oversight process:

1. Recognize that the dynamics of each company, Board, and Audit Committee are unique - “one size does not fit all”;
2. The Board must ensure the Audit Committee comprises the “right” individuals to provide independent and objective oversight;
3. The Board and Audit Committee must continually assert that, and assess whether, the “tone at the top” embodies insistence on integrity and accuracy in financial reporting;
4. The Audit Committee must demand and continually reinforce the “direct responsibility” of the external auditor to the Board and Audit Committee as representatives of shareholders;
5. Audit Committee must implement a process that supports their understanding and monitoring of the:
  - specific role of the Audit Committee in relation to the specific roles of the other participants in the financial reporting process;
  - critical financial reporting risks;
  - effectiveness of financial reporting controls;
  - independence, accountability, and effectiveness of the external and internal auditor; and
  - transparency of financial reporting.

**5** principles for an independent objective and effective oversight

The recent changes to the LR mandating the internal audit function and its direct reporting to the Audit Committee could not have come at a better time to assist the Audit Committee in its oversight role. The head of internal audit, based on changes to the Code, is now required to review/appraise the risk management process in addition to providing assurance to the Audit Committee on the adequacy and integrity of the internal control system established by Management to regulate the activities and operations of the company.

## Financial Reporting Risk Assessment



Audit Committee should ensure that the most important financial reporting issues facing their companies, guide their process and activities. Financial reporting risks, therefore, should be the primary driver of the Audit Committee's agenda. As noted previously, a well-defined framework should allow the Audit Committee to receive the right information, at the right time, from the right individual, and in the right context to support effective oversight of, and response to, risk.

Audit Committee should re-evaluate their approach, capabilities, and overall understanding of the company's risk by asking themselves key questions.

### Key questions to understand the company's risk

Such questions might include:

- Do we know what our financial reporting risks are?
- How do Management and the Board define significant risk?
- Do we understand the interrelationships of our risks?
- Do we know who our risk owners are? And do they have systems in place for measuring and monitoring risk?
- What are the perspectives of the individual(s) and department(s) overseeing risk?
- How do our incentive systems affect risk management?
- Does an understanding of the risks we face permeate our organization and culture?
- Does each individual understand his or her role and responsibility for managing risk?
- Is risk a priority consideration whenever business processes are improved?

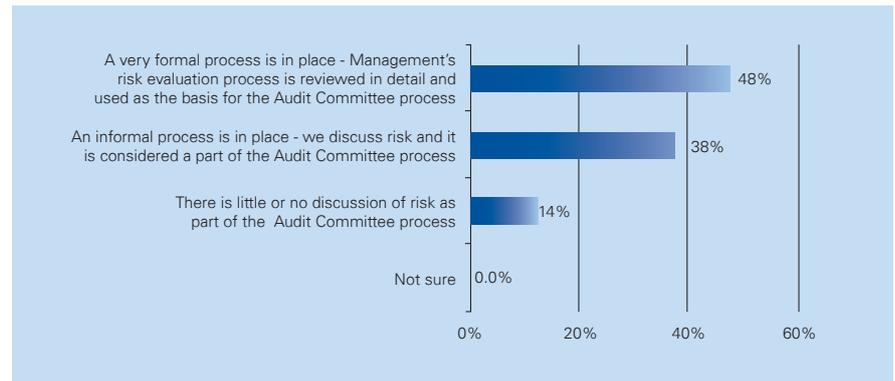
Audit Committees' are taking different approaches to identifying and assessing risk. Ultimately, however, success will hinge on the ability to define the scope and timing of Audit Committee activities based on the company's most significant areas of financial reporting risk.

**52%** of participants say that there is room for improvement when it comes to risk assessment

#### Participants' Views ON CHALLENGES WITH RISK MANAGEMENT

- “Independent Directors are not involved in operations and may find it difficult to ensure risks are completely identified, especially when they are not aware of what is happening in the company and industry”;
- “Mapping the results from internal audit against the risks faced by the company to determine if the risk ratings have been appropriately prioritized”;
- and
- “The time normally slated for Audit Committee meeting is not adequate, what more for the agenda to cover risk management issues.”

## 2. How does risk assessment/ reporting impact the overall Audit Committee process and agenda?



Majority of the participants responded that they already have some sort of risk management/assessment processes in place (either formal or otherwise) within their Audit Committee. This seems unusual as the risk management agenda is not specifically mentioned in the LR nor provided for in the Code as part of the duties of the Audit Committee. Risk management would normally come under the purview of the Board, as prescribed by the Code. Nevertheless, this augurs well and supports the notion that corporations in Malaysia take cognizance of risk management. To underscore the importance of risk management within the Audit Committee agenda, the head of internal audit who reports directly to the Audit Committee is now required under the revised Code to review/appraise the risk management process of the company.

Whilst 52% of respondents indicated room for improvement when it comes to risk assessment and reporting being part of the Audit Committee process, 48% of participants concurred that a formal evaluation of risk was in place and included as an Audit Committee agenda.

As part of its oversight responsibilities, the Audit Committee must play an active role in evaluating the risk management framework. As with any process, regular evaluation is necessary as the framework matures or changes over time.

To obtain reasonable assurance, Audit Committee members need to have a very clear understanding of the control environment and framework, to effectively challenge and test the control environment established by Management.

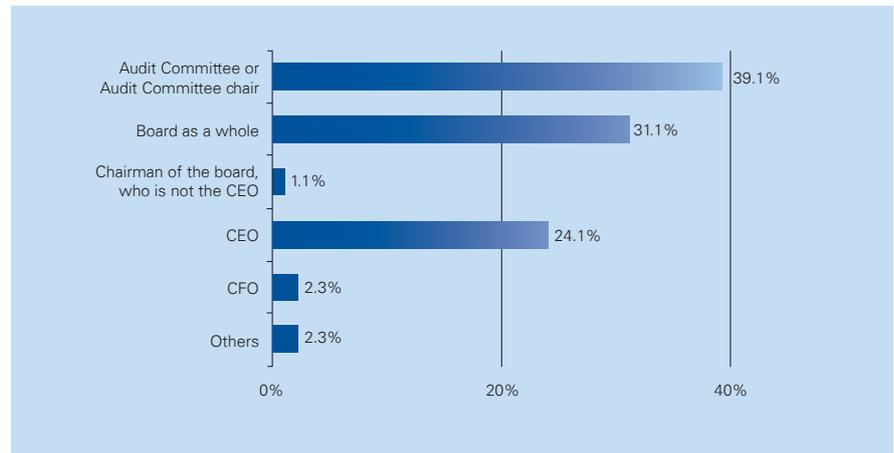
The Audit Committee should also be briefed on how Management is embedding a culture that is committed to ethical and lawful behaviour. While such a culture does not of itself guarantee that an organization will achieve its goals or operate efficiently and effectively, but on the reverse the lack of such a culture will provide greater opportunities for errors or improprieties to occur.

## Oversight of Internal Audit



Audit Committees' today are increasingly relying on internal audit as one of their primary resources. As a result, it is important that the right relationship is established to help ensure that internal audit will report controversial issues to the Audit Committee, particularly those that directly or indirectly involve Senior Management. Providing the Audit Committee with the authority to approve the appointment and termination of the company's head of internal audit encourages such a relationship.

### 3. Who has the ultimate authority to hire/fire the head of internal audit in your company?



**70%** say the authority to hire/fire the head of internal audit rests with the Audit Committee or the Board

Nearly 70% of participants mentioned that the authority to hire/fire the head of internal audit of their companies rests with the Audit Committee/the Audit Committee Chair or the Board whilst the remaining 30% indicated such authority was wielded by others. Now that the internal audit function has been mandated by Bursa Securities, it will be interesting to see how this trend evolves, i.e. whether Audit Committee really have the clout to hire/fire internal auditors or Executive Management continues to call the shots.

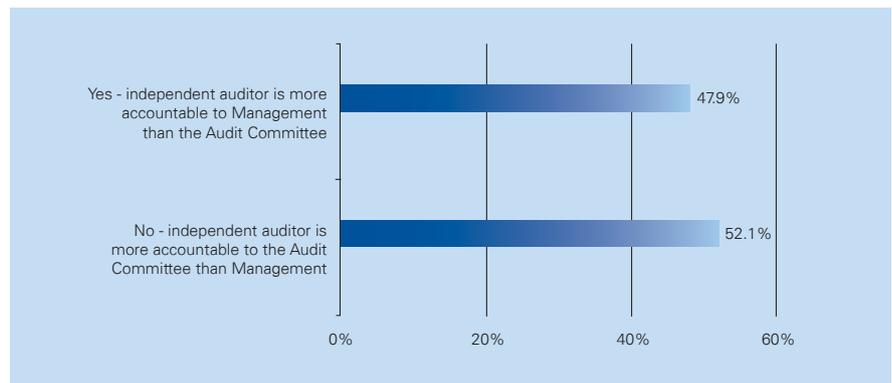
## Oversight of External Audit



The purpose of an external audit of the financial statements is for the auditor to express an opinion on whether the financial statements, taken as a whole, comply with applicable approved accounting standards and the law, and present a true and fair view of the financial position, performance and cash flows of the organization.

Under the Listing Requirements of Bursa Securities, the Audit Committee has a responsibility for making a recommendation to the Board on the nomination, reappointment and resignation of the external auditor.

### 4. Do you believe that the independent auditor is more accountable to Management than to the Audit Committee?



Here, the results are somewhat split - 48% of the participants indicated that independent auditor is more accountable to Management than the Audit Committee whilst 52% stated otherwise.

**48%** agree that an independent auditor is more accountable to Management.

In short, it is now clear that independent auditors work with Management but for the Audit Committee. Indeed, Audit Committees' today should expect to be treated as the independent auditor's "client."

There was more than one view from the roundtable discussions saying that the external auditor should be accountable to the shareholders of the company. The performance of external audit should be regularly reviewed by the Audit Committee. Some of the performance criteria that may be used by Audit Committee include:

- the overall comprehensiveness of the external audit plan;
- the timeliness and quality of communications promised under the plan; and
- the competency of external audit staff and adequacy of resources to achieve the scope as outlined in the plan.

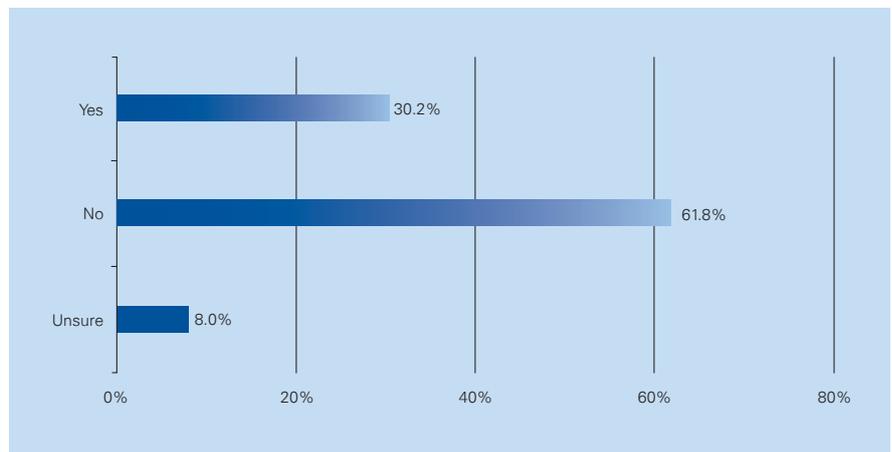
In addition, the Audit Committee should obtain feedback from Management on the conduct of the external audit.

## What Constitutes “Effective Oversight”?



The discussions centred on the suggestion that the Audit Committee is responsible for preventing financial fraud and, in particular, whether it is realistic to expect Audit Committee to prevent financial fraud. This issue goes directly to the heart of the oversight challenge: What are the expectations of Audit Committee effectiveness, and what can Audit Committee do to help ensure that they are meeting those expectations?

### 5. Do you believe that the Audit Committee should be responsible to prevent financial fraud or to uncover irregularities in financial reporting within the organization?



More than 60% of respondents believe that Audit Committee should not be responsible to prevent financial fraud in financial reporting within the organization. However, during discussions, a significant number of participants agreed that the Audit Committee, at a minimum, should be looking at whether there are processes in place to deter or detect fraud or irregularities.

**62%** do not believe that the Audit Committee should be responsible for the prevention of financial fraud.

#### Participants’ Views ON EFFECTIVE OVERSIGHT

- “Audit Committee can be there to ensure there are controls or processes in place to prevent fraud or irregularities. Anything beyond that is not the Committee’s responsibility”;
- “In order to prevent fraud, a company must establish a system of internal control to look after risk management and it is the responsibility of the Audit Committee to review such systems. If the Audit Committee does not do that, it has failed in its job”;
- “The set-up of a channel for whistleblowers to report improprieties is important”.

## Audit Committee Organization and Operation

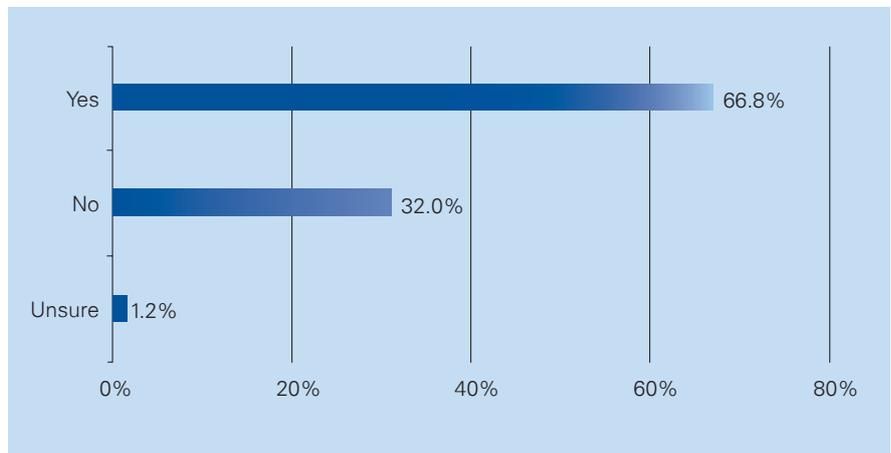


The importance of the organizational and operational aspects of the Audit Committee cannot be overstated. Structure and process are as important to the Audit Committee’s success as they are to the success of any effective business enterprise. As a result, the Audit Committee should—like a business enterprise—plan and conduct its activities to efficiently and effectively meet its responsibilities to the Board of Directors.

This requires, among other things:

- considering carefully the qualifications of its members;
- developing a clear and realistic Audit Committee charter;
- selecting an independent auditor that has the right approach and skills to serve the Audit Committee and shareholders; and
- ensuring effective “whistleblower” procedures.

### 6. Do you believe that the organization and operation of your company’s Audit Committee allow for an efficient and effective planning and conduct of the Committee’s activities to meet its responsibilities to the Board of Directors?



**67%** believe that their Audit Committee has in place an appropriate structure and process that supports its work.

67% of respondents believe that their Audit Committee has in place an appropriate structure and process that supports its work.

When asked whether the internal audit function could be outsourced, some of the comments provided by participants are as follows:

- “Outsourcing is more organized as compared to in-house internal audit”;
- “Audit Committee must understand and “feel” the business and key issues of the organization before considering outsourcing”; and
- “The size of the organization plays an important part on whether outsourcing is needed or not.”

## Influences on Audit Committee Effectiveness



Every Audit Committee is unique—and each will have its own strengths and weaknesses. The effectiveness of most Audit Committee, however, generally hinges on the ability to recognize and manage certain core elements that greatly influence the Committee’s effectiveness, including:

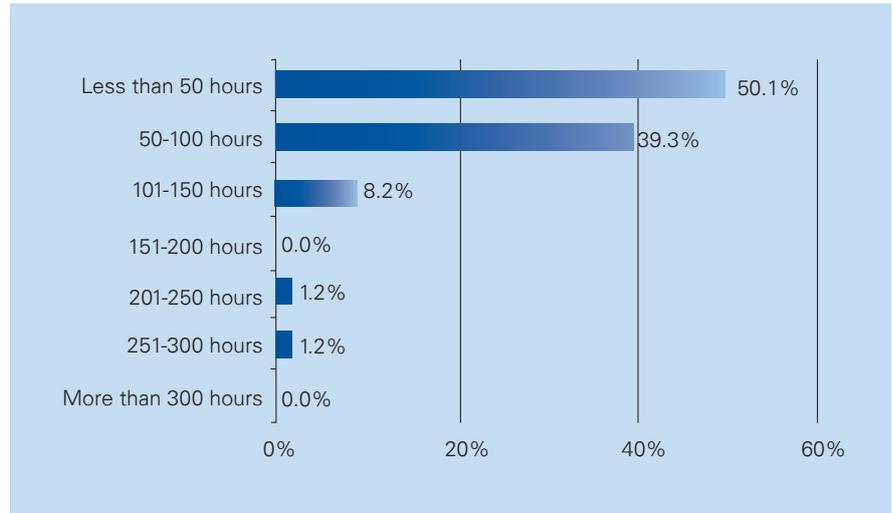
### Core elements that influence the Committees effectiveness

- Committee leadership and composition;
- Committee members’ independence from Management (actual or perceived);
- time allocated to oversight responsibilities;
- timeliness and quality of information provided to the Committee;
- quality of communications and dialogue;
- Audit Committee resources;
- whistleblower policies and processes;
- Audit Committee education; and
- Audit Committee charter, agenda, and other organizational documents.

This dynamic mix of people, policies, processes, and perceptions will affect Audit Committee in different ways; what “works” for one Audit Committee may not work for another. These elements, however, are fundamental to influencing key relationships and accountabilities, the quality and independence of audits (both internal and external), transparency of financial reporting, tone at the top, and Board culture.

7. How much time do you spend fulfilling your role as an Audit Committee member, including all related meetings and preparation time, on an annual basis?

**50%** of participants say they spend less than 50 hours annually on their role as an Audit Committee member



In addition to their other Board responsibilities, 50% of participants said they spent less than 50 hours in their Audit Committee role annually. Nearly 40% spent between 50 and 100 hours. While these figures may reflect typical allocations of time devoted to Audit Committee duties, there is no "right answer": Audit Committee members should devote time according to their Committees' needs and responsibilities. With the amendments to the Code on 1 October 2007 which require the Audit Committee Chairman to continuously engage with Senior Management and the internal and external auditors in order to be kept informed of matters affecting the company, it is envisaged the time spent will increase. Audit Committee evaluation plays an important role in determining the

## Trends in Audit Committee Evaluation



Committee's effectiveness and in identifying areas for improvement.

The LR stipulates that the Board must review the term of office and performance of the Audit Committee and each of its members at least once every 3 years to determine whether the Audit Committee and its members have carried out their duties in accordance with its terms of reference. The Code also requires the Board to implement a process, to be carried out by a Nominating Committee annually, for assessing the effectiveness of the Audit Committee.

### Self-Evaluation Practices

Self-evaluation is rapidly emerging as a leading practice in determining, demonstrating, and improving the Audit Committee's effectiveness in key areas, including its organization, agenda setting, and oversight of the financial reporting and audit processes.



Self-evaluation can take different forms—from informal discussions to a formal and detailed "checklist rating" approach. Audit Committee using the latter approach should consider the following steps as a rough framework for the process:

1. Discuss the self-evaluation process that will be adopted, decide who will coordinate the process, and create the evaluation form and compile the results;
2. Determine who will participate in providing initial input to the Audit Committee (e.g. Audit Committee members, Board members, CEO, CFO, internal auditor);
3. Provide copies of the evaluation form to all participants and have them returned to the coordinator for compilation; and
4. Use the evaluation input—both individual responses and average ratings—as the basis for a conversation concerning the Audit Committee's effectiveness and areas for improvement.

### Framework for self-evaluation

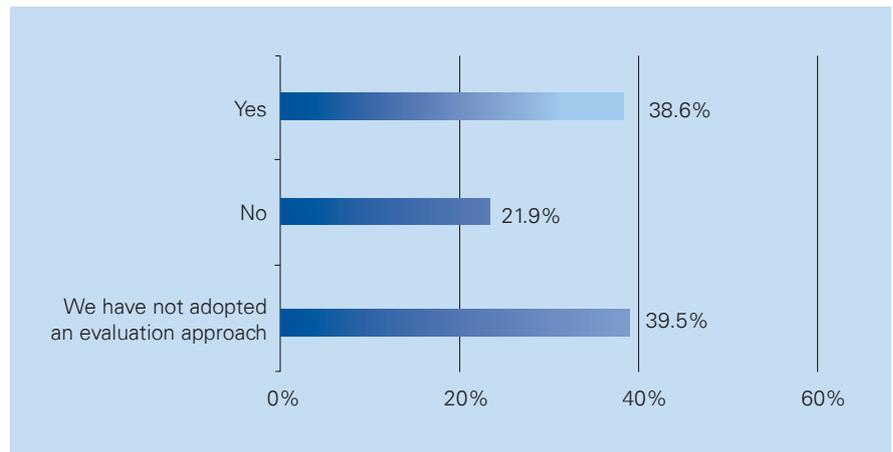
Whatever format is used, a well thought-out evaluation process will enable a company and its shareholders to benefit from the collective insights and experience of all members of the Audit Committee.

## Documentation

While self-evaluation should be conducted in an open and constructive manner, many Audit Committees' consult with external parties to determine how the self-evaluation process should be documented and the type of information that should be retained in the Audit Committee's files. Some Audit Committees' choose not to retain detailed self-evaluation files but instead retain a history of the self-evaluation process and related conclusions.

### 8. Do you believe your company's current approach to Audit Committee evaluation enhances the Audit Committee's effectiveness?

**39%** of participants said that their companies have not adopted an Audit Committee evaluation approach.



39% of participants said that their companies have not adopted an Audit Committee evaluation approach. Of the 61% respondents who said their companies had adopted an approach, 22% did not believe such an approach enhanced the Audit Committee's effectiveness.



## KPMG Comments

Clearly, the Audit Committee's oversight role is a vital element of the financial reporting process. As a result, the role of Audit Committee members is more time consuming and challenging than ever: they must be independent of Management, financially literate, experienced, ethical, inquisitive, and intuitive. Even with all these qualities, Audit Committee members can only be as effective as the framework within which the Audit Committee operates. The concept of "eyes on, hands off" in providing an effective oversight without encroaching into or usurping Management's role in the running of the company's operations is invariably pivotal towards expediting such a framework.

To provide greater oversight value, such a framework must support the Audit Committee's efforts to:

- focus its agenda and activities on the company's key financial reporting risks;
- set expectations with Management, internal auditors, and external auditors regarding their responsibility and accountability;
- prevent a "compliance mentality" from becoming the driving force behind the Audit Committee process – there is a need to look beyond compliance;
- establish and continuously monitor for the correct "tone at the top"; and
- ensure it receives the right information, from the right party, at the right time, and in the right context.

Audit Committee and its members will need to stay abreast of new developments, regulatory requirements, and emerging trends—and adapt quickly as circumstances require. By establishing a sound, comprehensive framework, Audit Committees' can strive to achieve the level and quality of oversight necessary to secure the public's trust in their company's financial reporting and, ultimately, in the capital markets.

## Contact Us

To learn more about Audit Committee Institute Malaysia or to access our resources, please visit our web site ([www.kpmg.com.my/aci](http://www.kpmg.com.my/aci)) or contact us by e-mail ([aci@kpmg.com.my](mailto:aci@kpmg.com.my)).

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