



Chairing an effective Audit Committee

Sibusiso Luthuli

Chairman: Telkom Group Audit and Risk Committee



For today's discussion

- Setting the stage: current regulatory environment
- Selected leading practices
 - Responsibilities: Financial statements, risk management & internal control, compliance & ethics
 - Relationships: Management & internal audit, external auditors
 - Other keys to effectiveness: Composition, training, meetings, charter & evaluation



Setting the stage – current Regulatory environment

- Global economic crisis – increased focus on risk management and whether companies properly reported the state of their economic health to investors
- International focus on anticorruption; greater cross-border cooperation between judicial and regulatory authorities, as well as significant rules, e.g.
 - US: Foreign Corrupt Practices Act; new SEC whistleblower rules approved May 2011, King III, Companies Act
 - UK: Bribery Act, effective July 1, 2011
- Complexity of and ongoing changes to accounting standards - e.g., IFRS major projects for revenue recognition, leasing, financial instruments, etc.



Setting the stage – current Regulatory environment

- International developments on role of auditors
 - European Commission Green Paper , with focus on auditor independence; possible approaches to develop smaller accounting firms
 - US: PCAOB working on cross-border inspection rights/cooperation; examining auditor's report; expanding auditor communications with audit committees; considering mandatory auditor rotation
- High level of emerging regulation –with greater expectations of audit committees
- Greater focus (by regulators and investors) on the role of compensation incentives in risk-taking



Setting the stage – current Regulatory environment

- Balance between governance and commercial reasonability needs to be struck,
- Greater liability exposure for AC members



What we are hearing from audit committee members

- Recent survey done on AC effectiveness (PWC and IIA, 6 September 2011)
- Concern over extent of role in risk management oversight
- Information technology concerns
 - Oversight of major new projects
 - Security - cyber attacks and move toward cloud computing
 - Social media – strategic opportunities and risks
- Concern over intensity of enforcement agenda – across all agencies and geographies
 - Role of audit committee in investigations
 - When company should self-report issues to regulators



Financial reporting

- Committee needs to
 - Read and discuss financial statements with management and external auditors
 - Assess quality, not just reliability, of earnings
 - Apply appropriate level of skepticism, ask probing questions, and engage in frank discussions with management and auditors
 - Be comfortable with treatment of unusual/complex issues
 - Consider the formation of a disclosure committee
- Effectiveness of oversight based on
 - Applying robust knowledge of company to reviewing financial reports
 - Understanding how materiality is evaluated, quantitatively and *qualitatively*
 - Understanding significant accounting policies as well as estimates and other areas where management applies judgment



Financial reporting

- Ensure appropriate focus on interim financial statements prior to filing with regulators
- Discuss
 - Significant judgments and issues in period-end closing
 - Consistency of interim statements with annual statements
 - Overall quality of earnings and adequacy of proposed disclosures
 - Results of external auditor's review
- Other keys
 - Recognise financial reporting areas most susceptible to fraud
 - Revenue recognition
 - Expense classification
 - Accounting for business combinations
 - Maintain healthy skepticism when considering the risk of fraud—it is never zero



Risk management and internal control

- Understand and maintain skepticism for key areas of greatest fraud risk for the company, including those from
 - Pressure being exerted from CEO
 - Preparation for major transactions, including mergers or public offerings
 - Compensation plans – particularly what level of financial results will lead to bonuses
- Clearly define audit committee's risk responsibility relative to the entire board – so even if audit committee is overseeing the risk assessment process, other board committees or the full board participate in oversight of key risks
- Committees can fully embrace this role by
 - Understanding how risk management process is tailored to company's specific needs
 - Probing whether process is ongoing - not just at a point in time
 - Ensuring responsible individual has appropriate stature, expertise, and time
 - Audit Committee vs. Risk Committee



Compliance and company culture

- Take needed steps to ensure tone at the top is adequate
 - Results of any employee surveys about ethical conduct
 - Results of any 360 degree assessments of CFO /Finance Director by his or her staff
- Understand whether compliance programs are effective at promoting proper conduct and behavior through the company, especially in light of
 - Current enforcement activity
 - Expectations for what constitutes an effective compliance regime



Oversight of management and internal audit

Relationship with management

- Recognise responsibility to evaluate management
 - conduct a formal annual performance review of senior finance management, processes and systems
 - Assess strength and performance of key finance managers at and between committee meetings
 - Consider confidential feedback of internal and external auditors
 - Understand bench strength of management team and consider succession planning



Oversight of management and internal audit

Relationship with Internal Audit

- “*Eyes and ears*” of the audit committee
- To be effective, internal audit must have appropriate stature within the company
- Accomplished by
 - Having Chief Audit Executive report directly to committee
 - Ensuring internal audit’s continual access to committee
 - Playing key role in selection, evaluation, compensation, succession of Chief Audit Executive



Oversight of management and internal audit

Relationship with Internal Audit

- Ensuring adequate budget and resources
- Confidence in internal audit:

“If someone in the company is trying to bully the Chief Audit Executive, my money is on the Chief Audit Executive”

- Insist on effective internal audit reporting at the right level of detail (i.e., executive summaries, most significant findings, cumulative listing of reports, and status of past key recommendations)
- Make the audit committee’s support for internal audit visible to management
 - Private sessions with internal audit as part of most audit committee meetings
 - Through periodic contact with internal audit director between meetings



Relationships with External Auditors

Reporting Relationship

- Report directly to committee
- Now, direct audit committee role in
 - Selecting or reappointing external auditors
 - Evaluating auditors' performance
 - Ensuring auditors' independence, through preapproving all audit and permitted non-audit services
- Candid and ongoing communications are vital, and timely and robust dialogue on complex issues is essential
- Audit committee separate legal persona vis a vis the board in accordance with new companies act



Relationships with External Auditors

Using other auditors

- Ensure the rationale is appropriate if there are plans to use a firm other than the principal auditors
- Consider the lead partner's willingness to consult internally on issues and leverage other firm resources as needed
- Understand whether principal auditors are planning to assume responsibility for work of the other auditor
- Understand any situations when company seeks second opinions from other accounting firms
- An absolute obligation exists to ensure that the "right person" is leading the audit
- Engage in selecting new audit partner (during mandatory partner rotation) or new audit firm (if current firm not meeting your needs)
- Evaluate audit fees through peer company comparisons and understand reasons for overruns



Resources and special investigations

Resources and advisors

- Committees need adequate resources to support them in fulfilling their responsibilities, including formal resources in special situations, e.g.
 - Management lacks capability to address major issue adequately or IFRS is not clearly defined
 - There is a disagreement between management and the auditors, and committee members lack needed expertise
- Committees should have the authority to hire independent counsel or other advisors, with the company providing funding



Resources and special investigations

Special investigations

- Recognize need for greater involvement in selected situations
- If errors are found in previously-issued financial statements
 - Decide with management on materiality of error and need for restatement; ensure auditors' concurrence
 - Ensure full scope of errors are identified during the investigation
- If allegations of fraud or illegal acts surface
 - Determine if they require further investigation and consider whether audit committee should lead
 - Ensure investigation conducted appropriately: right participants, process, communications, documentation



Committee fundamentals

- **Ensure that committee agendas and briefing materials focus on the right topics, have the right level of detail and are received at least a week before meetings**
- **Hold private sessions, typically at every face-to-face meeting, and ensure they are scheduled as part of the agenda**
- **Communicate regularly to the board by providing a report on issues and decisions discussed at the meeting, minutes are usually provided to the board**
 - Minutes should provide insight on the topics discussed and not be bare bones
- **Committee evaluations**
 - Compare the committee's performance against charter and leading practices focusing on true improvement opportunities versus compliance
- **Committee training**
 - Consider whether members receive appropriate ongoing training, given the velocity of changes to financial reporting and governance standards
 - Provide robust orientation program for new members



Committee composition

Selecting new members

- Ideally independent nominating committee or independent directors select audit committee members
- Increasingly difficult to recruit new members—liability concerns, time commitment, heightened independence requirements



Committee composition

Members Attributes

- Key is good understanding of the business—including company's products, services, and industry
- Willingness to dedicate substantial time and energy
- Other relevant attributes
 - Extremely high level of integrity
 - Healthy skepticism and courage to challenge
 - Inquisitiveness and independent judgment
- Due diligence exercise by new directors



Committee composition

Members Attributes

- Financial knowledge
 - Good understanding of financial reporting
 - Concern that “financial experts” may be subject to additional liability and “non-expert” members may over-rely on them
 - 64% of companies identified the audit committee chair as the financial expert



Committee composition

Training

- Training vital to support committee effectiveness
- Set specific educational and training objectives
- Possible training
 - Specially scheduled sessions
 - Part of regular meetings
 - External directors “colleges” or conferences
 - Review of director orientation programmes
 - CPE initiatives by professional bodies



Meetings

Frequency and duration

- Audit committees meet at least 4 times a year in person and 3 or 4 times via phone
- Frequency driven largely by
 - Requirements for involvement with quarterly regulatory filings
 - Need to address responsibilities stemming from stock exchange rules
- Most in-person meetings last 2–4 hours
- Meet privately with internal and external auditors as and when required
- Guard against too many observers



Meetings

Agenda and materials

- Use scheduling calendar to drive agendas
- Committee chair involvement crucial
- Distribute detailed written agenda, along with briefing materials, well before meeting
 - Strike balance between communicating needed information and avoiding extraneous detail



Charter and evaluations

Charter

- Ensure board approves written charter and any changes
- Assess annually and ensure all responsibilities discharged
- Disclose on company's website



Charter and evaluations

Evaluations

- Evaluate committee performance regularly by comparing activities against
 - Charter
 - Leading practice
- Assess committee dynamics, not only on *what* the committee does, but also on *how effectively* it functions
- Should be robust—not simply a “check the box” exercise
- Obtain feedback from board, management, internal audit, general counsel, and external auditors



Charter and evaluations

Evaluations

- Ensure confidentiality of responses, and discuss documentation with general counsel
- Review results and action plans with full board, and discuss additional actions
- Consider assessing performance of individual members
 - Allows committee to identify which members are effective and which need to improve
 - Helps determine whether committee has appropriate skill sets and in identifying need for additional training



Conclusion

- Fundamentals remain unchanged,
- Increased regulatory scrutiny,
- Increased liability exposure,
- Keep your CAE at your side
- Balance between commercial and governance value add is key,



Thank you

