



THE EVOLVING ROLE OF THE AUDIT COMMITTEE

Audit committees have assumed a much more important role in public companies over the last few years. They are primarily responsible for ensuring the financial position of the company is reflected accurately in its reports and for overseeing the necessary internal controls to achieve this result. They are also expected to monitor broader risk management strategies. Panellists on this roundtable discuss a range of issues facing audit committees in a challenging corporate environment. ►►

THE PANNELLISTS



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In your own words, can you describe the function of the audit committee and how it fits into the corporate governance framework?

Wardell: The function of the audit committee is to oversee and monitor the financial statements of the company and the parties whose responsibilities are reflected in those financial statements – namely, the finance group of the company as represented by the chief financial officer, internal audit and external auditors. The audit committee is also expected to review codes of ethics, whistleblower provisions and related party transactions. In the present governance structure, all this has provided the audit committee a very powerful, semi-autonomous role within the board. It is responsible to the board for the quality and accuracy of the financial statements as a result of its having properly exercised its monitoring and oversight function. It also has a first-line response to questions which may be raised about financial treatment. This may come up either directly to the audit committee, through internal audit or through whistleblowers. In those cases in which particular problems arise under the financial statements, the audit committee may be the committee in charge of special investigations of particular financial statement issues. These investigations can range from the informal to the highly formal – the latter resulting from a so-called 10A letter as issued by auditors pursuant to Section 10A of the Securities Exchange Act of 1934.

Cox: In the UK, the Combined Code (Code Provision C.3.2) outlines the role and scope of the audit committee in some detail. In essence, the function of the audit committee is to act as an independent internal watchdog over the company's financial conduct. This fits neatly into the corporate governance framework due to the emphasis on transparency, company accountability and shareholder value.

Midanek: The audit committee is charged with being sure that the company's results, resources and prospects are fairly and clearly represented to those parties – principally, but not only, shareholders – not able to see into the inner workings of the company themselves. The audit committee is in effect charged with being sure that the information provided can be used by arm's length parties to make reasonable investment decisions. It must therefore ensure that the process of collecting information and the framework in which it is presented are orderly, consistent and clear to all, and reflect the application of active business judgement of its members as to what and how much is presented to assure the greatest clarity.

Copnell: Investors rely on the board of directors to ensure that a company's accounts and reporting process is honest. In this respect, the audit committee, as the ultimate guardian of shareholders' interests, has a major role to play. The audit committee's role is to provide the board with additional assurance about the quality and reliability of the financial reporting process. It is an oversight role which typically would include oversight of the financial statements, the system of internal financial controls and the relationship with both internal and external auditors. It should be remembered that the committee is a committee of the board – it has no binding decision-making powers of its own, nor is it the duty of the committee to carry out tasks that properly belong to others, such as company management or auditors.

Harwood: I see the audit committee as key in holding the executive board to account for their stewardship of the company – although this must be balanced against the requirements in the UK for a unitary board. The quality of the non-execs is key to obtaining the requisite balance between the bona fide commercial goals of the company and the recognition of a duty for transparency – and integrity owed to shareholders. It

is useful to think of the committee as providing a safeguard, particularly for small investors who do not have access to ongoing information and analyst's briefings, and a series of checks and balances to ensure that the highest standards of governance and transparency are maintained. In the UK, the role of the audit committee in corporate governance is clearly set out in the Smith Report which is embodied in the Combined Code and therefore applies to listed companies. However, a robust audit committee is also highly desirable for non-listed companies where there is investment from external interests/capital markets (AIM listed companies, for example) and where the regulatory mantle is not as onerous but the risks may be at least as great. Confidence in capital markets is key to the retention of both small and large investor with reputational risk now playing an ever larger role in the success, or otherwise, of an entity.

What factors should be taken into consideration when deciding on the membership composition of an audit committee?

Midanek: The best committees include a mix of skills, including seasoned business judgement, a working knowledge of accounting principles, and knowledge of the financial markets and of the management practices in the company's industry. In addition to being comprised of independent directors, its members must be able to command the respect of management and the rest of the board, and be willing to take the lead as needed in asking difficult questions and navigating sensitive passages for the good of all. They must know their role and responsibility and discharge it actively, including engaging and managing the independent auditors and supervising the internal audit function.

Harwood: To be effective, an audit committee requires at least some non-executives who are financially literate. However, there is also great value in having members of the committee from diverse backgrounds who are not afraid to ask the obvious questions which others have perhaps taken for granted. The key attributes are therefore the willingness to challenge management and internal and external auditors, robustness in ensuring that matters considered by the audit committee are satisfactorily resolved and a willingness to commit the time to perform the role effectively. There is also a benefit in having audit committee members who sit on other boards, in that they can provide an increased level of insight. However, non-execs need to be careful not to spread their time too thinly. In most instances it will be difficult to perform a non-executive role effectively where non-execs sit on five or more boards. This presents a challenge, as there is something of a shortage of qualified people willing to perform non-executive roles. The key criteria are therefore integrity, experience and the ability to work as a cohesive team with no barriers to open discussion and debate.

Wardell: The factors which should be taken into consideration when appointing members to an audit committee are easily summed up in the term 'financial literacy', a standard imposed by the New York Stock Exchange. Financial literacy means what it appears to say – that is, the ability to read and understand financial statements and to be able to challenge either line items in the financial statements or the content and quality of footnote expressions. The footnotes in financial statements are particularly important because they reflect the further explanation and sometimes limitations that would not be apparent from the numbers themselves. (There is even an argument that the Enron financial statements were never wanting, since the description of the off balance sheet entities was in the footnotes. The problem, however, was that the description in the footnotes was so weak and inadequate that no one who was not familiar or reading closely would have realised there was information there about which more should have been asked.) ►►

Cox: In the UK, aspects of the Combined Code on corporate governance and the Smith Guidance (Guidance on Audit Committees, suggesting ways of applying the relevant parts of the Combined Code) must be taken into account. A range of suggestions are outlined in these documents, as follows. The chairman should not be a member of the audit committee. The audit committee should comprise at least three non-executive directors (or two in the case of smaller companies). At least one member of the audit committee should have relevant financial experience. The degree of financial literacy among the other members of the committee will vary according to the nature of the company, but experience of corporate financial matters will usually be necessary. Indeed, in order to carry out the responsibilities of the committee, members will need to be familiar with GAAP, performance indicators and ratios and deal with financial instruments. It is also recommended by both the Higgs review and the Institute of Chartered Secretaries and Administrators that no member of the audit committee should also be a member of both the remuneration and nomination committees. The board should undertake a formal and rigorous annual evaluation of the performance of the committee to ensure that the mix of characteristics, experience, and skills of all committee members continue to provide an appropriate balance. Appointments should be for a period of up to three years, extendable by no more than two additional three year periods, so long as members continue to be independent. It is also good practice for appointment periods to be staggered so that individual members of the committee do not retire at the same time.

Copnell: Nearly all the corporate governance codes and regulations address the membership of an audit committee. However, compliance with rules will not, of itself, create an effective audit committee. While the audit committee can provide additional, and more specialised, oversight of the financial reporting process, it can not be expected to provide meaningful protection for shareholders unless its members are independent of mind, diligent, knowledgeable and in possession of relevant and reliable information. Audit committee members must be in a position to challenge management and draw sufficient attention to dubious practices – even in apparently successful companies. Independence is above all concerned with the integrity of the individual in question, and it is not unreasonable to suggest that financial ties, whether personal, business, political or philanthropic, threaten the independence of audit committee members and therefore their motivation to actively challenge management. However, the merits of any particular case have to be judged on the facts, but in my view, rather than simply meeting some checklist of independence criteria, it is imperative that audit committee members are able in practice, not just in theory, to express views to the board that are different to those of the chief executive officer and be confident that, provided this is done in a considered way, they will not suffer.

Diligence is essential as the audit committee's role requires considerable commitment on behalf of its members. It is no longer acceptable that audit committees meet twice a year to rubber stamp the interim and annual financial statements. To be fully effective, audit committee members must be prepared to invest the time necessary to understand their businesses, the substance of complex transactions and ensure that the accounts fairly reflect their understanding. For a large public company, this may require between two and three days per month on audit committee business alone.

Clearly, audit committee members have to be knowledgeable. In an age of 'smoke and mirrors', where both financial transactions and accounting standards are becoming increasingly elaborate, it is no longer possible for audit committee members to operate effectively with only

a passing knowledge of finance. They must have expertise, or access to expertise, that goes beyond familiarity with financial statements. They must understand the principles that underpin the preparation of financial statements, why critical accounting policies are chosen, how they are applied, and satisfy themselves that the end result fairly reflects their understanding. However, financial acumen is not the only skill required. Sometimes the best questions can be asked by the least financially aware members – the why, how, show me, type questions. The important thing is to keep asking questions – even the potentially stupid questions – until the answers are understood.

Of course, even those audit committee members who are vigorously independent, diligent and knowledgeable will prove ineffective unless they have both access to, and an understanding of, all the relevant information. Audit committees are only as good as the information they receive and they must put a great deal of trust in their executive colleagues and auditors to tell them what they need to know. If they experience surprises – for example, material effects of a change in accounting policy come to light just before they are due to approve the financial statements – they need to start questioning their relationship with management and consider how they can ensure they get relevant and timely information. Of course, measuring how much trust to put in senior executives is still difficult – there is no easy answer to that question.

What principles should govern interaction between the board of directors, internal auditors and external auditors? How can each group maximise their contribution to the corporate governance process?

Harwood: A frank and open relationship is vital, as is ongoing dialogue and effective planning. The board should regularly reassess and reconsider the risk profile of the business and the way in which it responds to changes, which can often be driven by macroeconomic issues, regulatory developments and shifts in the competitive landscape. The work plan for the internal auditor should take account of the risk matrix and should be discussed with the external auditor and the audit committee. There are often opportunities for the external auditor to rely on the work of internal audit – but to be effective and efficient this requires ongoing dialogue. There should be a culture such that the scope of internal audit work reflects both the commercial and financial risks the entity faces and that, as an internal control in itself, internal audit can be relied upon where appropriate by the external audit function, hence promoting best use of resource. The audit committee should be involved in signing off the internal and external audit plan. Ideally, as the year progresses and as internal audit reviews are completed and interim external audit work undertaken, the results should be shared with the audit committee and all parties should reassess the scope of their work in the light of the early results. The audit committee should perform a regular appraisal of the effectiveness of internal and external audit and of the effectiveness of the executive board. Again, a professional relationship is required by the committee with both internal and external auditors such that the culture of openness is maintained. The reporting lines for internal audit should be strictly controlled to ensure necessary independence and objectivity from management.

Copnell: Establishing an effective relationship between the audit committee and the auditors is a key responsibility of both the chairman of the audit committee and the lead audit partner. The relationship must be mutual – it is not a one sided deal between a customer and a service provider. It requires effort on both sides. It cannot be like the rather ▶▶

one-sided relationship most people have with their dentist, where we wait to be told whether we have a clean bill of health or a problem. Audit committees should want informed assurance which confirms their own understanding of matters affecting the company, or enables them to build on their understanding so they can be better informed and better able to address the issues they face. An effective relationship is needed to achieve this, a relationship which sustains effective two-way communication.

There is a need to gain mutual respect. From that respect comes trust. With trust and respect there can be an open relationship where each feels free to challenge the other without it being perceived to be threatening. From that comes a positive outcome. The auditor earns respect by consistently delivering the highest quality work, clear communication and valuable insights. The audit committee earns respect by taking its responsibilities seriously, demonstrating an appreciation of the issues the company faces, and the audit's perspective thereon, and a willingness to express an independent point of view as befits non-executive directors. This is not to suggest that the depth of the audit committee enquiry should be such that, in essence, it expresses its own independent opinion. However, it must be informed. It must take as a base its existing understanding of the business and the risks it faces. There must be an appreciation of the auditor's assessment of those risks, particularly those affecting financial statements and the way in which the auditor proposes to address those risks and reach a conclusion.

Midanek: It must be crystal clear to all that the independent auditors are selected by, and the scope of the audit determined by, the audit committee and thence recommended to the entire board. Internal audit functions often report directly to the audit committee. For the checks and balances built into the US governance system to work best, the independent auditors must clearly understand that while they have a strong working relationship with management on a day-to-day basis, their only reporting obligation is to the audit committee. Many audit committees today do not understand they have an active, not a passive, responsibility to select and charge the various audit teams and often other professionals as well.

Wardell: Under the new governance structure of public companies in the US, there is, in fact, very little direct interaction between boards of directors and either internal auditors or external auditors. Both internal and external audit are expected to report to the audit committee. Indeed,

the audit committee is mandated to have sole authority over the engagement of external auditors and the review of their work. Obviously, this occurs as a matter of formal governance structure of the board of directors having delegated that authority to the audit committee. Both internal and external auditors have a reporting role to the directors under circumstances in which a report would be appropriate. But, in virtually all cases, all these matters will have first come to the audit committee, which in turn will be reporting to the board, supported by internal or external audit, or both if they deem it necessary.

How can audit committees strive to improve relations between the company and a watchful public?

Wardell: There is virtually nothing audit committees can do in a direct way in dealing with the public. Audit committees do not deal directly with the public – that is left to the investor relations people and, typically, the chief executive officer and chief financial officer. The audit committee can, however, strive to improve relations by insisting upon better quality disclosure, amplified footnotes and improved processes for gathering and analysing financial data. These are all important parts of the audit committee's oversight function. It should not be forgotten that audit committee members are directors, not managers. Therefore, their role is to urge management and external service providers to execute their roles properly and to hold them accountable when they do not.

Copnell: Much of the audit committee's real work will be invisible to the 'watchful public'. The challenge provided by audit committee members goes on behind closed doors and this is entirely appropriate. It is the board as a whole that approve the financial statements and the audit committee is just one part of the process, albeit an important one. As a committee of the board, it works with management and auditors to ensure the accounts don't reflect an inappropriate degree of management bias and that everything that should be disclosed is disclosed. Transparency of financial reporting is key. In many ways, the audit committee acts as the corporate conscience – it is the guardian of shareholders' interests. However, the board must present a unified front, not only in theory, but in practice. Not only should audit committees work to ensure the transparency of financial reporting itself, but transparency of the audit committee's processes is also important. Making the committee's terms of reference available to the public is a start. But in terms of helping restore confidence in the capital markets, reporting how the committee discharges its duties is equally important. This is where a company can really show what the audit committee does – something that is very often misunderstood by the public at large.

Harwood: Much of what the audit committee does is out of direct sight of the public, but an effective audit committee can ensure that a company follows best practice in corporate governance and that it makes full and appropriate disclosure in its financial statements. Time can also be taken at shareholder meetings, which the audit committee chair should attend, to explain how the company's governance procedures operate. Increasingly audit committees are asking tougher questions of management – for example, regarding business ethics, changes in accounting policy and so on, and this is very much to be encouraged. It is encouraging to hear audit committees ask challenging questions – and disappointing when they do not. In a sense an audit committee is most effective in terms of governance where such matters are resolved privately between the board and the audit committee and do not become issues in the public arena. ▶▶

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Midanek: Companies need to establish clarity, completeness and consistency in their communications to the public. Audit committees need to be sure that the language of reporting, both financial and narrative, can be understood by someone who has no knowledge of the company, the industry or the financial markets.

Are there any guidelines an audit committee should follow when sourcing and appointing a chief audit executive?

Copnell: While heads of internal audit are primarily sourced by the executive function, preferably the chief executive, it is important that the audit committee has a full role in approving any appointment. For any head of internal audit, financial aptitude is important, though a specific internal audit qualification might be considered as valuable as a general accountancy qualification. However, a wide range of general business experience and softer skills and personal attributes are also important. The Institute of Internal Auditors has issued guidance which rightly asserts that audit committees should look for a person of integrity who is committed to the highest ethical and professional standards, a dynamic and inspirational person capable of leading the function and being an ambassador for it across the organisation, and a flexible pragmatist who understands the organisation and can develop an internal audit approach that reflects the needs of the organisation. These are attributes that one might expect to find in any senior management role, but they have particular poignancy for the head of internal audit. Personal integrity is absolutely essential in a role that demands objectivity and independence. The ability to inspire and lead is essential in a role that can demand negotiation, assertiveness and conflict resolution on a daily basis.

Harwood: Essentially, as with any other executive appointment, the chief audit executive should have the right blend of qualifications and experience for the position. The audit committee should satisfy themselves that the candidate is familiar with the industry, is technically up to date, and has the skills to add value to the internal audit function. As the candidate will be appointed by and report to the audit committee but also have at least an administrative reporting line to executive management it is essential that the candidate has the interpersonal skills to be able to balance effectively these potentially conflicting interests.

In what ways can the audit committee drive change throughout the company to positively impact the financial reporting process?

Midanek: The audit committee has an important role in shaping both the language and the culture of the company. By fostering open communication and an environment that treats mistakes as learning opportunities, the audit committee can contribute quite substantially to corporate health by making it very difficult to ignore or allow systematic wrong doing. Importantly, the audit committee also has the ability to question complex financial transactions and their role in furthering overall corporate goals. Financial technology has become so complex that in order to achieve this goal the committee must be comfortable with its ability to engage its own professionals should the need arise. Within the audit committee, more detailed analysis of such transactions may usefully occur before they are presented to the entire board. Finally, audit committees should set out very clear statements in its charters governing the decision-making process.

Wardell: An audit committee meets at least quarterly with the financial management of the company, particularly the chief financial officer, and with internal audit and external audit. To be satisfied the financial

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statements accurately reflect the financial operations of the company, the audit committee can demand extensive explanations, challenge assumptions, review the underpinnings of the financial statements and in general address the operations of the company as they are reflected in the financial statements. Since Sarbanes-Oxley, public companies have been obliged also to certify as to disclosure controls as well as internal controls over financial reporting in their quarterly reports. The audit committee is charged with reviewing these quarterly reports, and it can demand an explanation of what, if anything, was revealed as a result of the disclosure controls process and the review of internal controls by management. Disclosure controls are supposed to surface those material matters which have not yet been disclosed to the public which might nevertheless be ripe for disclosure. Internal controls, of course, are designed to make sure that the checks and balances needed in the financial reporting apparatus of the company are in place so that the financial statements are accurate and timely. It is nevertheless important that an audit committee and its members remember that the committee is a creature of the board and its members are directors, not management.

Harwood: The financial reporting process is ultimately the responsibility of the board but the audit committee can be very influential in setting the tone at the top as regards corporate governance and adherence to best practice in financial reporting. Involvement of the audit committee on a timely basis throughout the whole financial reporting cycle is key. They should be actively involved in reviewing and challenging, where necessary, the actions of management in relation to the financial statements. In particular, the audit committee should be involved in reviewing all critical accounting policies and any changes made to them, they should also consider carefully any areas that are matters of judgement and consider any unusual transactions. Key to all this is ensuring that there is sufficient time reserved to the audit committee throughout the year and sufficient information for them to be able to make informed decisions. Too often, audit committee meetings are squeezed into the agenda before main board meetings with insufficient time allowed for the committee to give the matters reserved to it appropriate consideration. It is up to audit committee members to ensure that they do have both the time and the information to perform their role effectively.

Copnell: There are many ways an audit committee can act to positively impact the financial reporting process, but the following fundamentals provide a foundation for each audit committee to develop and adopt its own best practices. First, recognise that the dynamics of each company, ►►

board, and audit committee are unique – one size does not fit all. The organisation and operational approach followed by any audit committee should take into account the unique aspects of the company’s organisational and governance structures. In addition, the responsibilities delegated to an audit committee must be explicit and responsive to the needs and culture of the company and the board as a whole. The audit committee should avoid both overload and the temptation to immerse itself in too much detail – otherwise the committee may lose sight of its key objectives or perform its duties superficially. Once delegated, the ongoing support of the board for the activities of the audit committee, including appropriate management interaction, is critical. The board must ensure the audit committee comprises the ‘right’ individuals to provide independent and objective oversight. It is imperative that all audit committee members are able, both in theory and in practice, to express views to the board that are different to those of the CEO and be confident that, provided this is done in a considered way, they will not suffer. Culture is also critical. The audit committee must continually assert that, and assess whether, the ‘tone at the top’ embodies insistence on integrity and accuracy in financial reporting. The company must have the right tone at the top and the audit committee, as a check and balance on management, is the guardian of the company’s financial reporting integrity. The highest standards of objectivity, integrity and judgement can’t be the exception – they must be the rule. The audit committee must demand and continually reinforce the accountability of the external auditor to both the board and audit committee as representatives of shareholders. The external auditor’s accountability to the board and the audit committee, as representatives of the shareholders, must be more than words in the audit committee’s terms of reference. The audit committee, external auditor, and senior management must all acknowledge this reporting relationship and ‘allegiance’ by their actions and deeds. Finally, audit committees must implement a process that supports their oversight role. With a well defined process based on an understanding of the specific roles of management, the internal auditor and the external auditor, the audit committee will have established the framework within which to exercise effective oversight – listen, ask, assess, and challenge.

How should audit committees go about implementing complaint procedures and adhering to whistleblower rules?

Cox: Interestingly, the Combined Code stresses the need for the au-

dit committee to review arrangements by which company staff may raise concerns in confidence about possible improprieties in financial reporting and other matters, but not necessarily to operate the whistleblowing policy at the company. The audit committee’s objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action (Combined Code Provision C.3.4). The Institute of Chartered Accountants in England and Wales has produced useful guidance for audit committees on how to review the complaints procedure and adhere to whistleblowing rules. However, in order to comply with the law on whistleblowing, any such policy must provide a clear, confidential and effective avenue for employees to raise genuine whistleblowing concerns to a senior officer of the company, including: a breach of legal obligation; a criminal offence; a miscarriage of justice; endangerment to health and safety; environmental damage; or the deliberate concealment of any of the above. A failure to implement such a policy and prescribe relevant persons to whom concerns can be addressed will make it easier for employees to blow the whistle on such matters lawfully outside of the company.

Harwood: While in most cases the traditional reporting lines will provide a satisfactory mechanism to prevent malpractice, and effective whistleblowing policies can provide a useful safety valve and an additional line of defence to protect the reputations of the company and its senior management. To be effective, however, a culture must be established that allows staff to raise their concerns without fear of retribution. The audit committee should ensure that the tone at the top recognises the importance of an open culture where whistleblowing is seen as providing a valuable contribution to the risk management framework. It should be the role of executive management to put suitable whistleblowing procedures in place – but the audit committee should establish, by enquiry, that procedures are established and regularly reviewed and when matters come to its attention to indicate that procedures may not be working effectively it should ensure that appropriate remedial action is taken. The committee itself would not usually be part of the complaints procedure although audit committees may wish to allow whistleblowers to contact the audit committee chair as a means of demonstrating commitment to the process.

Copnell: Audit committee members are not involved in the day-to-day management of the company and therefore will not be close enough on an ongoing basis to the detail on matters related to fraud and unethical activities. The audit committee can, however, usefully focus attention on the need for proper policies and procedures to help prevent fraud and unethical activities. The audit committee’s objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

When reviewing the arrangements in place, the committee should question not just the appropriateness of the policies adopted by management, but also their effectiveness and whether they are user friendly and adopted by all relevant business units. Again, the audit committee role is one of oversight. If employees believe reasonably that malpractice exists in the work place, they should, in the first instance, report it to their line manager or, if they are reluctant to do so, another executive such as the company secretary or HR director. Only where such channels have been exhausted, or if an employee feels the matter is so serious that it cannot be discussed with such people, should the audit committee become actively involved in the grievance procedure.

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Midanek: If the audit committee has established clear protocols first for ►►

recognising and learning from mistakes so they are not hard to confess while still minor, and has specified a clear and well understood reporting protocol that is impartial and independent when an individual feels cause for concern, the culture of transparency goes a long way toward instilling employee, management and investor confidence and reducing the likely scale of undetected fraud.

What risk management strategies should audit committees undertake to minimise the company's exposure to internal and external threats?

Wardell: Risk management strategy should be the responsibility of the entire board or a special risk committee and not the responsibility of the audit committee. The audit committee, however, will be pulled into the risk management discussion because of the reporting requirements of public companies. Under these requirements, a company must identify the risk factors that impact its business and, with respect to certain risks, must provide a discussion of the nature of the risk and how the company addresses and manages the risk. So, the audit committee has an opportunity to understand and push solid risk management strategy upon management because of the committee's responsibility to assure adequate and accurate disclosure in the public company reports.

Midanek: Herein lies the heart of the matter: as companies move forward by taking and managing various kinds of risk, the art lies in having the blend of judgement and insight required to assess and manage the risks the company takes. Recent regulations are intended, among other things, to ensure that company managements and boards recognise and evaluate the risks they are taking, which is useful in clarifying the role of the committee. There is serious danger, however, in creating an environment that seeks not to identify but to eliminate risk, by relying too much on checklists and third party opinions to protect the board from feared liability. The formation of open ended questions by the audit committee in examining and evaluating various aspects of risk is critical.

Copnell: There is still some confusion surrounding the role of the audit committee in relation to risk management. The board as a whole is ultimately responsible for risk management; and the identification, evaluation and monitoring of risks facing the business lies firmly with the executives. The process of managing risks, however, can be a matter for the audit committee. As part of its assessment, the audit committee should consider requesting from management an overview of the risks, policies, procedures, and controls. However, the committee should strive to ensure the information it receives is manageable – it should not be so voluminous as to deter a proper understanding of the key risks. It is more important that the audit committee gains meaningful insight into the key sources of risk and how such risks are managed, and responds with pertinent challenge than be presented with a substantial, albeit complete, register of all the risks facing the business.

Harwood: The audit committee should ensure that procedures are in place to identify and manage risk within the company. This assessment should include enterprise risk and reputational risk, financial risk and non-financial risk. At a minimum, the audit committee should be involved in the regular review of the company's risk register and should satisfy itself that procedures are in place to manage risk in a changing environment. It is not the audit committees role to undertake risk management strategies – rather to apply oversight and review to ensure that appropriate strategies are in place. One of the issues facing audit committees and management is the role of internal audit. Increasingly,

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MARK HARWOOD

internal audit has been asked to perform a compliance role rather than providing assurance on business risk. Internal audit is a scarce resource and often cannot perform both functions. The audit committee can help set the agenda for the internal audit team and to ensure that there is sufficient resource with the right skills to cover off both these angles. Ultimately it is a question of priorities.

Is it vital for audit committees to engage external advisers when tracking evolving regulatory requirements in today's shifting corporate governance landscape?

Copnell: It is not vital that audit committees engage external advisers, though there are times when it might be advantageous. If the only recourse open to audit committees was to engage external advisers, trust in the boardroom would soon be under threat. While audit committees fulfil an oversight role, they are also board members. Trust, albeit with a degree of professional scepticism, is an essential boardroom component. Turning constantly to external advisers could easily create a fissure in the boardroom which might threaten the unitary board concept. One of the unintended consequences of creating non-executive board committees such as the audit committee, might be a shift towards a two-tier board – and no one wants that. What is important in today's shifting regulatory landscape is professional development. This can come not only from within the organisation – executives, internal auditors and company secretariat all have a role to play – but also from the external auditors and third party providers such as the professional representative bodies and the Audit Committee Institute. Of course, there may be occasions when external advisers need to be engaged, but it should be the aim of committee members to be up to speed with the issues affecting the company. There should be a process in place to engage professional advisers when they are needed and the audit committee's terms of reference should make provision for the appointment of advisers at where required at the company's expense.

Harwood: While it isn't vital to engage external advisers to keep track of evolving regulatory requirements, it is important that members of audit committees keep technically up to date. Ideally audit committee members should negotiate a certain number of paid training days each year to assist them in building and maintaining their knowledge. Additionally, the company's existing advisers – in particular the auditors – should be making audit committee members aware of technical developments as part of their regular reporting to the committee – ►►

although this should not be relied on as the sole source of information. Numerous publications, websites and training courses are geared at providing technical input to non-execs. But the most valuable resource, often in the shortest supply, is time.

Cox: The audit committee can only be effective if it has the relevant expertise and information passed to it in a timely fashion. Funds should also be made available to the audit committee to enable it to take independent legal, accounting or other advice when the audit committee reasonably believes it necessary to do so. This is supported by the Smith Guidance, in paragraph 2.15. Also, it is regarded as good practice for the audit committee to have a period alone with the external and internal auditors without the presence of the executive directors, at least once a year, to discuss matters relating to its functions and any issues arising from the audit, as noted in paragraph 2.10 of the Smith Guidance.

Wardell: External advisers are useful to audit committees for tracking regulatory changes. Especially in the last three years, these changes have been substantial and have come in rapid-fire succession. Therefore, external advisers whose function is to stay abreast of these changes – both in accounting requirements and legal requirements – are valuable resources to audit committees. These advisers will see more examples of the impact of the changes than members of management and staff of the company are likely to.

Midanek: It is vital that audit committees are aware of shifting regulatory requirements among other things. More vital though than having outside advisers is their understanding that in the free exercise of their judgement they may retain advisers as they see fit. To make this as easy and routine as possible, it helps to make these powers an explicit part of the audit committee's charter.

What has been the role of the audit committee in managing the adjustment to the 404 process and the changes it requires?

Wardell: The audit committee's role is one of monitoring and oversight, but to do this job properly requires a great deal of information. Perhaps no task set before US audit committees has been as challenging to this role as the implementation of Section 404 of Sarbanes-Oxley. At an extremely generic level, audit committees have been able to maintain a sense of the calendar and of the serious issues that have been brought to their attention. Nevertheless, it has been very difficult for companies

to establish schedules and proper control documentation and testing and, therefore, even more difficult for audit committees to understand the state of the controls, the review of controls, the development of additional controls, the assessment process and weaknesses as well as remedies for weaknesses and deficiencies when they were identified. It is, frankly, unlikely that many audit committees emerged from this process with a clear understanding of the state of their company's internal controls and the extent of any weaknesses, deficiencies and remedial programs. Going forward, it should get easier. The audit committee can focus on the continuing assessment of controls and the reports they receive both from the finance group of the company, and internal audit and the external auditors. With respect to remediation as well as the development of new controls or modification of present ones, the task should then become one of filling in the blanks in the audit committee's understanding. The audit committee's role as Section 404 was installed was principally to stay on course and be apprised of shortcomings, both in terms of controls and schedules. That left little time to fully understand the control systems that were in place or were being put in place.

Copnell: With the initial compliance deadlines and efforts behind most US companies, and new priorities and pressures confronting them, audit committees may have less time to devote to section 404 issues as they head toward financial reporting deadlines for 2005 and subsequent years. Nevertheless, Sarbanes-Oxley section 404 remains both a strategic priority and a compliance risk for businesses, and audit committees must ensure it is high on their agenda. A key role for the audit committee is to help ensure that senior management leverage the company's initial section 404 investment into a sustainable, business-as-usual process that also achieves significant benefits to the business. Through close oversight of the section 404 compliance process, audit committees can help verify that management establishes an efficient, effective and sustainable compliance approach – one that addresses the regulatory and business needs of the company as well as the expectations of its shareholders. The audit committee can play an important role in helping to set expectations with management and in overseeing the transformation of the Sarbanes-Oxley section 404 compliance project of year one into a sustainable compliance process. Three areas of possible audit committee focus and attention stand out. First, the audit committee should understand the ongoing Sarbanes-Oxley 404 compliance benefits, risks, and costs, and discuss them with senior management regularly. Second, the committee should ensure that senior management has established clear, agreed-upon priorities for building a sustainable section 404 compliance process. Finally, the committee should ask senior management the right questions to help understand and evaluate the ongoing state of the organisation's section 404 compliance process.

Harwood: Audit committees within UK-based foreign registrants have breathed a sigh of relief that they are not in the front line facing Sarbox compliance. Accordingly they are learning from the US experience – in particular looking at the resourcing and planning of the work, exploring how elements of the work will integrate with existing procedures carried out under Turnbull and ensuring that work is focused on key risk areas. Additionally, many companies are taking advantage of the deferral of the compliance date for foreign registrants by planning dry runs of Sarbanes-Oxley evaluation and testing and re-evaluating internal controls to remove duplication and improve documentation. Of course, in the UK, audit committees have also had to assess and monitor readiness for compliance with International Financial Reporting Standards and a considerable amount of audit committee time has been taken up by assessing the impact of the change in accounting standards on the financial statements. ▶▶

It is regarded as good practice for the audit committee to have a period alone with the external and internal auditors without the presence of the executive directors, at least once a year, to discuss matters relating to its functions and any issues arising from the audit.

JAMES COX

How can audit committees continually revise their processes and improve their monitoring functions?

Midanek: Audit committees must stay awake and ask questions actively. They need to avoid the trap of thinking that if something important happens, somebody from management will let them know. They should also set an agenda that puts healthy, open discussion of successes and failures front and centre.

Harwood: Audit committees and boards can become complacent but should strive not to. There is a temptation to consider year after year the same major risks without challenging whether the environment and risk have actually changed. Recently, however, the regulatory environment has been such that even the most complacent audit committee should have performed a reassessment of their role and the processes by which they perform it. Bringing new blood onto the audit committee can help by bringing new ideas and different experiences. In the UK, the Smith Report guidance is for audit committee members to serve for up to three years, extendable by no more than two additional three-year periods. Feedback should be sought from external auditors on the operation of the audit committee and best practice suggestions canvassed. Consideration should also be given, periodically, to benchmarking performance against other similar companies.

Copnell: Evaluation of the effectiveness of the audit committee is something that should take place at regular intervals. The Combined Code recommends a formal and rigorous appraisal on an annual basis. Of course, there are many ways to appraise the effectiveness of an audit committee – everything on the spectrum from simple checklists to the use of specialist consultancies. Whatever mechanism is used, it is important that the evaluation process is used to make the committee more successful, rather than simply fulfil a box ticking exercise. Among the things to consider is ensuring the committee understands what it is supposed to do. Are terms of reference in place and are they being followed? It is important that the committee's terms of reference don't sit on a shelf gathering dust, but are used to drive the committee's agenda and work programme. Processes are also important. Does the committee dispatch business effectively both in and between meetings? Does the chairman organise and conduct meetings well, and is the debate robust and coherent? Timeliness can be judged against the plan for the committee's work, but other qualitative aspects of the committee's work need to be judged against the standards of best practice and experience elsewhere – for example, there should be no 'no go' areas for internal audit. Equally important is the committee's influence on decision making and its credibility within the organisation. The committee needs to be very careful about credibility. Silence might be taken as a vote of confidence and lead to complacency.

Wardell: Audit committees continually need to review their processes and revise the ones that need to be modified. Going forward, audit committees will need to continue to review the control systems and to insist upon an update at least once a year. Audit committees may well need an orientation session once a year, both to the control system as well as to other significant accounting principles and the underlying assumptions and estimates that go into them. These will be reflected in the financial reports that the company makes to the investing public and, by constantly reviewing these and insisting upon updates from management and the auditors as to changes, the audit committee can continue to be on top of the financial reporting process. The audit committee

should insist upon receiving a review from the auditors of any aggressive assumptions, and any alternative accounting policies that would be available. In this way, it can stay abreast of the requirements. The same is true for whistleblower procedures or related party transaction reporting. These processes can be more easily updated because the reported incidents themselves will point up changes or weaknesses that appear and the audit committee can respond accordingly.

Do you think corporate governance reform has placed too much responsibility on the shoulders of the audit committee?

Cox: Due to the broad spectrum of tasks which can be assigned to an audit committee there is a danger that committee members may become overburdened. Indeed, some commentators are of the view that audit committees are taking on more of the responsibilities undertaken by the supervisory board in continental European countries and that the committee's role has increased by the requirement that a section of the annual report should describe the committee's work in performing its responsibilities (Code Provision C.3.3). These concerns however can be addressed by a combination of factors including directors' training on appointment, clear terms of reference, the timely exchange of information, provision to the committee of all key reporting and auditing issues and access to external advisers as necessary. A growing area of advisory services to quoted companies is training board directors on their roles and responsibilities as directors, their duties as committee members and risk management generally.

Midanek: In the short run it may appear that the burden is disproportionate to the responsibility of other directors as boards adjust to the newly explicit regulatory requirements. One of the weaknesses of corporate governance effectiveness has been director ignorance of their responsibilities and their difficulty establishing independence from management-guided information. The most effective boards and audit committees have long practiced many of the processes now mandated by regulation.

Wardell: Because so many issues find their way first to the audit committee and because the audit committee has a specific role in reviewing and understanding the financial statements and the matters that are reflected in the financial statements, the audit committee has become very powerful and has assumed a great deal of responsibility under the governance structure imposed by the revisions in the securities laws either directly through the federal securities laws or indirectly through the stock exchange listing requirements. It is hard to say that this is too much responsibility since these responsibilities need to be allocated within the board on some basis. It is true, however, that the audit committee has so much authority and so much responsibility that it runs the risk of being and becoming a rump board – a place where issues get resolved but are not then discussed at the board level when they should be.

Copnell: Although it is unclear whether too much responsibility has been placed on the shoulders of the audit committee, one certain fact is that the role of the audit committee is generally misunderstood by the public at large, as well as elements of the media and some regulators. Just as an 'effective' police force will never entirely eradicate crime, an 'effective' audit committee is not a guarantee against missed earning projections, financial statement revisions or even fraud. Sometimes things go wrong. A good audit committee will reduce the likelihood of errors and maybe their impact, but it is not failsafe – nor should one expect it to be. Reformers have been very quick to increase regulation ►►

in this area – sometimes without giving proper consideration to the real issues driving good and bad corporate governance. At times it seems that we are in a vicious circle. Corporate collapse leads to governance regulation then more corporate disasters lead to more regulation. Where is the time to reflect on whether the right governance models are being followed or whether the increased levels of regulation add any tangible benefits?

Putting this in an audit committee context, the US Blue Ribbon reforms in 1999 provided a blueprint for the independence and expertise of audit committee members. Following Enron and WorldCom, Sarbanes-Oxley tightened the rules. Will another significant US corporate collapse usher in even more stringent requirements? It seems like a peculiar path to follow when most people would agree that behavioural issues are the most fundamental component of good governance. Adherence to procedural matters is not nearly as important and can easily lead the unwary into complacency. Europe has faced the same issues too. The recently introduced Statutory Audit Directive effectively mandates audit committees for listed companies in the EU. In effect it adds a tier of regulation over and above existing practice – practice which by and large was working well. If existing practice was demonstrably flawed, then the imposition of a regulatory approach might be beneficial. However, the new rules set a lower hurdle than many of the voluntary codes already in place – for example, audit committees need only have one independent member. For those countries unused to modern governance practices, what good is there in setting such a low hurdle? Rather than harmonise governance, one could argue that this does little more than encourage two-tier standards – the precise opposite to what was intended.

Harwood: There is no doubt that recent developments in corporate governance have thrust the role of the audit committee to centre stage – but quite rightly so. In the past, some audit committees have been ineffective with a propensity to fall back on ticking compliance boxes rather than providing real challenge and support to the board in ensuring that the integrity of the financial statements, internal control and risk management systems are maintained. However, standards of governance are continually increasing and their role as custodians of shareholders interests is paramount in the minds of many audit committee members. Non-executives are also very focused on the reputational risks attached to corporate failure. However, no audit committee or internal control system can be completely fail safe. Increased regulation, changing legislation and an altered risk landscape all increase the burden for audit committees. Companies must recognise that to perform their role effectively, audit committee members need to be appropriately rewarded, including being paid to attend training and update courses, and must be provided with sufficient information and time to perform their role effectively.

In general, do you believe corporate governance regulations are damaging the appetite of private companies to pursue a public offering and prompting listed companies to move off the capital markets? Should reforms be scaled back?

Copnell: There is some anecdotal evidence to suggest that the lure of the quoted marketplace is less attractive than it once was. Also, companies that do pursue a public offering are mindful of the regulatory environment in choosing where to list. The number of foreign registrants listing on the NYSE has reputedly fallen in the past few years while in the UK there has been a renaissance in the popularity of AIM. Unfortunately, it is difficult to scale back reforms once they have been

implemented. Nevertheless, what is needed is a period of reflection before introducing any further corporate governance reforms. Business needs to be given time to work with what we have. Regulatory processes such as Sarbanes-Oxley Section 404 need to be embedded within organisations to such an extent that they become good for business rather than just a compliance issue. When it comes to voluntary ‘comply or explain’ codes such as the UK’s Combined Code, directors should explain their governance procedures in an open and transparent way and not be ‘bullied’ into Code compliance when it is not in the best interests of the company. Likewise, investors must ensure they interpret governance disclosures in an enlightened and objective manner. At the end of the day, it all comes down to being open and transparent about what governance procedures have been adopted, and why.

Wardell: There is much talk about private companies resisting going public, but little evidence that suggests the talk is being translated into action. What does appear is that companies are considering more whether they are ready to undertake the cost of full-scale compliance. This may be having the effect of delaying rather than eliminating public offerings – almost a return to the old thinking that a company needed to be ‘seasoned’ before coming on to the public financial markets. It is also true that outright sale of a company to private buyers is more frequently discussed alongside a public offering as a possible liquidity strategy. This is the result, at least in part, of the substantial amount of private equity being managed currently and by the fact that many of these private funds are willing to pay significant premiums in purchasing companies so that there is less disparity between the pricing for purchase of a public company and that for purchase of a good private company. Though there is some media discussion about public companies going private, there is no particularly hard evidence that a significant number of companies are doing so. The reforms are now installed. Scaling back seems unlikely. And many of the reforms were no more than codification of existing best practices. The most significant possible retreat is in the area of internal controls for smaller companies. This brings with it the risk that the investing public may wind up needing to understand that there are two standards of financial statement reliability, which could prove to be unsettling in the markets.

Harwood: The UK markets have not, of course, been subject to the burdens of Sarbanes-Oxley. While it is true that there is currently something of a trend for the acquisition of public companies by private equity and their subsequent delisting, corporate governance regulations are not really a factor. Generally, there is widespread recognition of the importance of sound corporate governance. Many UK companies not governed by the Combined Code and Turnbull (AIM-listed companies, for example), and as such are not strictly required to have audit committees, still choose to do so.

Midanek: Reforms have been well intentioned in the wake of scandal. They have also been costly to implement in the first couple of years. To the extent they have focused renewed attention on the role of the board and on the definition of director responsibilities, they are beneficial. To the extent they create the impression that ‘the problem’ has been solved, they are not helpful. The effectiveness of the US system of governance depends of the vigorous application of seasoned, independent judgement. The complacency that can come from following the rules is to be assiduously avoided. The regulations should be seen as a prod to directors, to make them active rather than passive participants responsible for the long-term health of the corporations they serve. ■



The KPMG sponsored Audit Committee Institute (ACI) was formed in 2002 to help audit committee members adapt to their changing role and enhance their awareness, commitment, and ability to implement effective audit committee processes. Through programs like the ACI's biannual Roundtables, technical update seminars, monthly breakfast programme and topical publications such as the Audit Committee Quarterly, we continue to offer the kind of objective, usable information needed in a rapidly evolving corporate governance environment.

We believe that it is a job that was important in 2002, and is even more important today.

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