PRICEWATERHOUSECOOPERS

2nd edition

Audit Committees

Good practices for meeting market expectations

2nd edition

Audit Committees

Good practices for meeting market expectations

www.pwc.com/corporatereporting

PricewaterhouseCoopers (www.pwc.com) is the world's largest professional services organisation. Drawing on the knowledge and skills of more than 124,000 people in 142 countries, we build relationships by providing services based on quality and integrity.

Preface

Audit committees do not prepare financial reports. And audit committees do not conduct external audits. But they have an essential part to play in ensuring the integrity and transparency of corporate reporting. The market now expects that published information has been subject to objective, board-level review.

Thousands of pages of rules on corporate governance have now been issued. However, the regulations seldom provide helpful guidance on how the committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be communicated?

This booklet is designed to assist committee members in answering these questions. It includes our view of good practices, together with the latest requirements, from over 40 major countries.

We encourage you to consult with PricewaterhouseCoopers on any of the issues raised in this publication.

J. Frank Brown
Global Leader,
Assurance and
Business Advisory Services
July 2003

This booklet was researched and prepared by Graham Gilmour and Sukhumaporn Wong-Ariyaporn of PricewaterhouseCoopers' Global Corporate Reporting Group, with the assistance of partners and staff in our offices in more than 40 countries around the world.

Contents

Executive summary

Audit Committees – Good Practices for Meeting Market Expectations was first published in May 1999. This edition reflects the evolving role of the audit committee and latest good practices – for example the need for appropriate financial expertise, greater emphasis on training, and review of performance. An expanded section summarising the audit committee requirements in 41 major countries is provided. The appendices also include the latest influential pronouncements on audit committees from the UK and USA.

Why Audit Committees matter

(pages 6 to 9)

The audit committee is an essential part of the corporate reporting process. Its primary responsibility is to oversee on behalf of the board the integrity of the financial reporting controls and procedures implemented by management, to protect the interests of shareholders and other stakeholders. New regulatory pronouncements and requirements in many countries have served to re-emphasise the importance of objective oversight of financial reporting.

Organisation of the Audit Committee

(pages 10 to 24)

The audit committee should be well prepared to undertake its duties. A clear, well-written charter helps the committee and others to understand its role and responsibilities. All members of the committee should have appropriate qualities and skills, if they are to 'add value'. Ideally, all should be seen to be independent of management. They should also have appropriate financial expertise. Meetings should be held at relevant times throughout the year, supported by good agenda papers. New members should receive induction training and background information on the business.

Oversight responsibility for financial reporting

(pages 25 to 34)

The committee's key task is to ensure the integrity of published financial information. Thus, it needs to understand the whole financial reporting process. This starts with the procedures for managing financial risks and the internal financial controls (for example over recording of data) implemented by management. The committee should review each set of draft financial statements prior to publication – and discuss those statements with management and the auditors. (Some illustrative questions for reviewing financial statements are provided on page 31). In addition, the committee should consider legal, regulatory and ethical matters that have a potential financial impact.

Working with Auditors

(pages 35 to 43)

The audit committee should be the primary focus for the company's relationship with the external auditors. It should make recommendations to the board for the appointment of the auditors, agree the audit fees, review the scope of work, and hold private meetings with the auditors to discuss their findings. The committee should also review with the external auditors their independence. Where a company has an internal audit function, the committee should similarly review its capabilities, qualifications, resources, scope of work, and findings.

Communicating and reporting

(pages 44 to 46)

The committee needs to have a constructive working relationship with management, and should request presentations and information from management on specific issues. In most countries, the committee works under delegated authority from – and should report to – the main board of directors or supervisory board. Increasingly, good practice is for the committee to report on behalf of the board to the shareholders, either at the general meeting or in the annual report. A suggested list of contents for a written report is provided on page 46.

Maintaining and measuring effectiveness

(pages 47 to 54)

In a fast-changing environment, all audit committee members need to update their knowledge and awareness (particularly of financial accounting standards and wider reporting issues) on a regular basis. The committee should also evaluate regularly its performance against its responsibilities, as set out in its charter. This assessment can take place on an individual basis, and/or collectively for the committee as a whole. A suggested work programme and self-assessment guide is included on page 49 to help committees.

Overview of areas of focus

An overview of the audit committee's main areas of responsibility, and issues relevant to each area, is shown below. It may be used as a template for discussion, to highlight particular key areas for each committee to address.

Audit committees: areas of focus

Financial reporting
- Appropriateness of accounting policies
- Disclosure requirements
- Fairness and balance of MD&A/ operating review
- GAAP conversion

Risk management & internal control
- Understanding key risk areas
- Effectiveness of controls
- Fraud risk

External audit
- Appointment and remuneration
- Scope of work
- Independence requirements
- Significant audit findings/ recommendations
- Reviewing the performance of external auditors

Internal audit
- Charter, authority and resources
- Scope of work
- Internal audit effectiveness
- Responses to internal audit recommendations

Maintaining & measuring effectiveness
- Training needs
- Maintaining financial literacy
- Annual performance evaluation of audit committee

Communicating & reporting
- Relations with management
- Updates & recommendations to the full board
- Reports to board and shareholders

Regulatory, compliance & ethical matters
- Effectiveness of system for ensuring compliance with laws and regulations
- Code of conduct/ethics
- Whistleblowing

Why Audit Committees matter

Audit committees play a valuable role – through effective and informed oversight – in helping to ensure market confidence in high-quality financial reporting. We believe that every company listed on world equity markets should aim to have an audit committee or equivalent body with the type of good practice features described in this booklet.

Shareholders also have a responsibility to take an active interest in the governance arrangements of the companies they invest in. Where there is no audit committee or equivalent strong independent element on the board, investors should be asking questions of management.

Management
- Creating value
- Business processes
- Financial information and controls

Board of directors
- Setting policy
- Approve the financial statements
- Appointment of audit committee

Independent external auditor and audit committee
- Review integrity of the financial statements and annual report
- Assurance to board of directors and shareholders

Regulators, investors and other stakeholders
- Institutional and other shareholder involvement
- Balanced reporting by media and analysts
- Regulatory monitoring

The corporate reporting supply chain

The audit committee has become an essential part of what is sometimes referred to as the 'corporate reporting supply chain'. Each group in the chain has distinctive roles and responsibilities in relation to providing financial information to the market, as shown by the diagram above.

Management is responsible for the day-to-day operations and business processes that deliver value for shareholders. The board's role is to challenge the strategy and business decisions taken by executive management; and to ensure that appropriate policies and systems are in place to control the business. To be effective, there should be an independent element on the board – individuals able to exercise objective judgement and ask difficult questions of management.

The role of the independent external auditor is to give assurance to the shareholders on the fair presentation of the financial statements prepared by management and approved by the board.

The Audit Committee – a committee of the main board acting under delegated authority – provides key linkages between each of these groups. It can ease the pressure on a busy board because it is able to take more time to address financial reporting and internal control issues. And, by providing a primary focus for discussions with the internal and external auditors, it enables both sets of auditors to enhance their independence.

For the supply chain to work effectively, each group needs to live up to its responsibilities.

A common-sense set of skills

Some of the most important recent recommendations on audit committees are set out in the appendices to this booklet (they include those arising from the UK Smith Report, one of the most wide-ranging reviews exclusively focussed on the role of the audit committee). They re-emphasise the key attributes that audit committees should have if they are to perform their role effectively. Taken together, they provide a common-sense set of fundamentals that could apply to most companies' situations:

- Committee members who are independent and 'add value' to company decision-making
- Candid discussions with management and external auditors regarding the quality of financial reporting and compliance with standards
- Effective communication and information flow with management and the auditors
- A key role in monitoring the component parts of the audit process, and helping to ensure the auditors' independence.

Even more important, perhaps, are the recommendations aimed at enhancing the 'professionalism' of audit committees – equipping them to do their job:

- Committee members to have specific skills, particularly in financial matters
- Training of members, both on induction and throughout their terms of office
- Regular reviews of audit committee effectiveness.

The key to building increased confidence in financial reporting lies in high-quality people being involved in the review process. That means independently-minded directors on audit committees, and high-quality auditors able to draw on top-quality multidisciplinary expertise.

The principles highlighted above are developed in later sections of this booklet.

'The audit committee has a key role to play in the relationship between the executive managers and the external auditor…
We recommend the European Commission include provisions on the role and responsibilities of audit committees...'

High Level (Winter) Group of EU Company Law Experts, final report, November 2002

World markets

Until as recently as a decade ago, audit committees were found in only a handful of the largest capital markets. Now, as the chart on this page shows, they are a regular feature in a majority of the world's major economies. Audit committees are, or are soon to become, a mandatory requirement in 16 countries. A further 14 countries have either a 'comply or explain' requirement or the option, under either the law or a voluntary code, to establish an audit committee. (Details of the specific requirements in each country are contained in the Appendix on pages 55 to 62.)

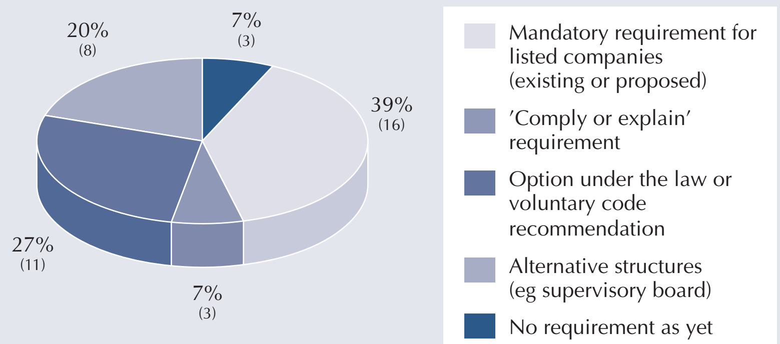
The trend is expected to continue. As leading companies adopt the recommendations contained in the latest influential pronouncements, those practices may be expected to spread to other territories and companies not yet covered by similar rules or codes of practice.

Government authorities, regulators and international bodies (for example, IOSCO and the OECD) have indicated that they view audit committees as a potentially powerful tool that can enhance the reliability and transparency of financial information. The most significant push towards audit committees may be yet to come.

The European Commission has indicated that it will adopt recommendations on the role of independent directors and audit committees. That will send a powerful signal to the markets that governance responsibilities are being taken seriously in the 25 member states of an enlarged European Union.

The purpose of the guidance in this booklet is not to suggest that the approach taken in any particular country should be followed elsewhere. Its more modest aim is simply to share good practice. There is no 'one size fits all' solution, since the role and detailed responsibilities of the audit committee will vary depending on the circumstances of each company.

Requirements for audit committees



(From 41 surveyed countries)

Mandatory requirement for listed companies (existing or proposed)	'Comply or explain' requirement	Option under the law or voluntary code recommendation	Alternative structures (eg supervisory board)	No requirement as yet
Argentina	Germany	Belgium	Austria	Luxembourg
Australia (1)	South Africa	Brazil	Chile	Norway
Canada	United Kingdom	Czech Republic	China	Taiwan
Hong Kong		France	Denmark	
India		Greece	Finland	
Indonesia		Italy	Hungary	
Ireland		Japan	Poland	
Korea		Netherlands (2)	Portugal	
Malaysia		Russia		
Mexico		Sweden		
New Zealand		Switzerland		
Singapore				
Spain				
Thailand				
Turkey				
USA				

1) Only for those top 500 listed companies in the Australian Stock Exchange.
2) New draft proposals envisage a 'comply or explain' requirement.

The future

PricewaterhouseCoopers' views on how corporate reporting may develop in the next decade are set out in our recent book *Building Public Trust – The Future of Corporate Reporting*.* The book proposes a model for corporate transparency based on three tiers of information:

- Financial information, based on globally-accepted accounting principles and standards
- Industry-specific information, based on agreed industry standards
- Company-specific information such as strategy, risk management practices, compensation policies, corporate governance, and performance measures.

The information published by companies in each of these areas will increasingly be analytical and qualitative, rather than simply quantitative.

When shareholders and stakeholders have this enhanced information set, they will be better able to properly value and assess the companies they invest in and do business with.

As companies' public reporting begins to reflect more of these elements, the audit committee is likely to assume an even more important role. Some audit committees already review the other information published by companies alongside their financial reports.

The range of skills and experience of audit committee members may need to evolve to enable them to understand how the business generates this wider set of data. Other committees, for example risk, environmental, compensation and governance committees, may be created to deal with specific areas. But the audit committee will still be responsible for ensuring that all the financial aspects are reported in a balanced and understandable way.

* *Building Public Trust – The Future of Corporate Reporting* by Samuel A. DiPiazza and Robert G. Eccles is published by John Wiley & Sons and is available through your nearest PricewaterhouseCoopers office.

Organisation of the Audit Committee

The legal or regulatory requirements for an audit committee vary between countries – in some they are mandatory for listed companies, in others voluntary. In addition, the responsibilities of each audit committee differ, depending on local business culture and the particular needs of the company.

Single and two-tier board structures

In many countries where audit committees are found, there is a single-tier board structure. In some of these countries (for example the USA), the board comprises mainly non-executive directors. In others, the board is composed of an almost equal number of executive and non-executive members. The audit committee is a committee of the main board, and its members are drawn from the non-executive directors on the board.

Two-tier board structures are adopted in some markets, either because the law requires it or on a voluntary basis. Our survey of countries on page 55 shows that these structures are most commonly found in Continental Europe, for example in Germany and the Netherlands.

These structures consist of a Management Board responsible for day-to-day operations, and a Supervisory Board mainly responsible for overseeing management and the strategy of the company. Members of the supervisory board are nominated by the shareholders in the general meeting. Under the co-determination laws of some countries, a proportion of the members must be representatives of the employees. Other members may represent key shareholders or providers of finance.

The law usually prescribes certain responsibilities for the supervisory board, including, in some cases, responsibility for financial reporting matters. In these countries, membership of the audit committee is logically drawn from the supervisory board. Depending on local laws and circumstances, the supervisory board could form a separate audit committee drawn from its members. Alternatively, the whole supervisory board could be designated as the audit committee.

Some other countries, such as Japan, have alternative structures such as a 'board of statutory auditors', that performs oversight responsibilities in relation to the directors.

The key requirement – regardless of structure – is that there should be appropriate independent director involvement in the review of the company's financial reports and the processes and controls underpinning those reports.

Irrespective of how the functions of the audit committee are organised, there are several steps that can be taken that will contribute to its effectiveness, including:

- Establishing a written charter/terms of reference
- Selecting appropriately qualified committee members
- Defining the roles and responsibilities of the chairman
- Considering the perceived independence of committee members
- Determining the term of office of committee members
- Appropriately scheduling meetings
- Providing high-quality meeting papers on a timely basis
- Ensuring that sufficient resources and professional advice are available to the committee
- Providing an orientation for new committee members.

Each of these aspects is discussed in the following pages.

‘Sony has chosen, according to the amended Japanese Commercial Code, to abolish its current Board of Statutory Auditors and established Nomination, Audit and Compensation Committees as of June 2003 at its shareholders’ meeting. These committees are composed of a majority of outside directors’

Sony Corporation, June 2003

Charter

Audit committees should have a written charter (or terms of reference) that provides a clear understanding of the committee's role, structure, processes, and membership requirements. A well-written, detailed charter will provide a framework for the committee's organisation and responsibilities that can be referred to by the board, committee members, management and external and internal auditors. The audit committee should, at least annually, review the charter and recommend or propose changes to the board for approval.

'The audit committee should be given the necessary power and resources to meet its charter. This will include rights of access to management and to auditors (external and internal) without management present and rights to seek explanations and additional information'

Australian ASX Corporate Governance Council, March 2003

Consideration should be given to making the charter available to shareholders, perhaps by inclusion in the annual report. In some countries, companies must disclose whether the audit committee has a written charter.

The committee's charter should define:

- Overall purpose and objectives
- Authority
- Organisation – membership, qualification, size, term of office
- Meetings of the committee – frequency, participants and documentation
- Roles and responsibilities
- Relationship with management, and external and internal auditors
- Reporting responsibilities
- Evaluation of the audit committee.

In developing a charter, it is important that the committee's activities are not unduly restricted. The committee's duties and responsibilities need to be flexible enough to allow it to operate effectively.

Establishing a detailed, well-written charter will be beneficial only if the audit committee uses it as an effective tool. For example, the charter should be:

- Used as a guide in establishing the committee's meeting agendas
- Reviewed annually in order to reflect any changes required by law and regulations and to ensure it responds to the changing needs of the company and the market
- Used to evaluate whether the committee satisfied its responsibilities during the year
- Adopted as a framework for reporting the committee's activities to the board.

Included on the following pages is an outline of an audit committee charter. It is presented for illustrative purposes and should be tailored according to the needs of the company.

Example audit committee charter

1. Overall purpose/objectives

The audit committee is appointed by the board of directors (or supervisory board) to assist the board in discharging its oversight responsibilities. The audit committee will oversee the financial reporting process to ensure the balance, transparency and integrity of published financial information. The audit committee will also review: the effectiveness of the company's internal financial control and risk management system; the effectiveness of the internal audit function; the independent audit process including recommending the appointment and assessing the performance of the external auditor; the company's process for monitoring compliance with laws and regulations affecting financial reporting and, if applicable, its code of business conduct.

In performing its duties, the committee will maintain effective working relationships with the board of directors, management, and the external and internal auditors. To perform his or her role effectively, each committee member will need to develop and maintain his or her skills and knowledge, including an understanding of the committee's responsibilities and of the company's business, operations and risks.

2. Authority

The board authorises the audit committee, within the scope of its responsibilities, to:

2.1 Perform activities within the scope of its charter.

2.2 Engage independent counsel and other advisers as it deems necessary to carry out its duties.

2.3 Ensure the attendance of company officers at meetings as appropriate.

2.4 Have unrestricted access to members of management, employees and relevant information.

2.5 Establish procedures for dealing with concerns of employees regarding accounting, internal control or auditing matters.

2.6 Establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters.

2.7 Be directly responsible for the appointment, compensation, retention and oversight of the work of the external auditor.

2.8 Approve all audit engagement fees and terms as well as reviewing policies for the provision of non-audit services by the external auditors [and, when required, the framework for pre-approval of such services].

3. Organisation

Membership

3.1 The board of directors [or shareholders' meeting] will nominate the audit committee members and the chairman of the audit committee [who is an independent director].

3.2 The audit committee will comprise at least [number] members and [the majority of] / [all] members shall be independent non-executive directors of the company.

3.3 A quorum of any meeting will be [number] members/ [proportion] of members.

3.4 Each member should have skills and experience appropriate to the company's business.

3.5 Each member shall be financially literate; at least one member must have accounting or related financial expertise.

3.6 Members will be appointed for a [number] year term of office.

3.7 The secretary of the audit committee will be the company secretary, or such other person as nominated by the board.

Meetings

3.8 Only committee members are entitled to attend meetings. The audit committee may invite such other persons (eg the CEO, CFO, head of internal audit and external audit engagement partner) to its meetings, as it deems necessary.

3.9 The external and internal auditors should be invited to make presentations to the audit committee as appropriate.

3.10 Meetings shall be held not less than [number] times a year and should correspond with the company's financial reporting cycle.

3.11 Special meetings may be convened as required. The secretary will convene a meeting on receipt of a request by the external or internal auditors.

3.12 The secretary shall circulate the agenda and supporting documentation to the audit committee members a reasonable period in advance of each meeting.

3.13 The secretary of the committee shall circulate the minutes of meetings to members of the board, members of the committee, (and the head of internal audit and the external auditor where appropriate).

3.14 As a minimum, the chairman of the committee [or another member of the committee] shall attend the board meeting at which the financial statements are approved.

3.15 Members of the audit committee should attend every meeting of the committee.

3.16 The committee should meet with in-house legal counsel on a regular basis. A meeting with outside legal counsel should be held if it is deemed necessary.

3.17 The audit committee will meet with the external auditors [at least once a year] without management present.

4. Roles and responsibilities

The audit committee will:

Internal control

4.1 Evaluate whether management is setting the appropriate 'control culture' by communicating the importance of internal control and management of risk.

4.2 Understand the internal controls systems implemented by management for the approval of transactions and the recording and processing of financial data.

4.3 Understand the controls and processes implemented by management to ensure that the financial statements derive from the underlying financial systems, comply with relevant standards and requirements, and are subject to appropriate management review.

4.4 Evaluate the overall effectiveness of the internal control and risk management frameworks and consider whether recommendations made by the internal and external auditors have been implemented by management.

4.5 Consider how management is held to account for the security of computer systems and applications, and the contingency plans for processing financial information in the event of a systems breakdown or to protect against computer fraud or misuse.

Financial reporting

4.6 Gain an understanding of the current areas of greatest financial risk and how these are being managed.

4.7 Review significant accounting and reporting issues, including recent professional and regulatory pronouncements, and understand their impact on financial reports.

4.8 Oversee the periodic financial reporting process implemented by management and review the interim financial statements, annual financial statements and preliminary announcements prior to their release.

4.9 Review management's process for ensuring that information contained in analyst briefings and press announcements is consistent with published financial information, balanced and transparent (particulary regarding GAAP vs non-GAAP data).

4.10 Meet with management and the external auditors to review the financial statements, the key accounting policies and judgements, and the results of the audit.

4.11 Ensure that significant adjustments, unadjusted differences, disagreements with management and critical accounting policies and practice are discussed with the external auditor.

4.12 Review the other sections of the annual report before its release and consider whether the information is understandable and consistent with members' knowledge about the company and its operations and lacks bias.

Compliance with laws and regulations

4.13 Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any fraudulent acts or non-compliance.

4.14 Obtain regular updates from management and company's legal counsel regarding compliance matters that may have a material impact on the company's financial statements or compliance policies.

4.15 Be satisfied that all regulatory compliance matters, related to the business of the company, have been considered in the preparation of the financial statements.

4.16 Review the findings of any examinations by regulatory agencies.

Working with auditors

External audit

4.17 Review the professional qualification of the auditors (including background and experience of partner and auditing personnel).

4.18 Consider the independence of the external auditor and any potential conflicts of interest.

4.19 Review on an annual basis the performance of the external auditors and make recommendations to the board for the appointment, reappointment or termination of the appointment of the external auditors.

4.20 Review the external auditors' proposed audit scope and approach for the current year in the light of the company's present circumstances and changes in regulatory and other requirements.

4.21 Discuss with the external auditor any audit problems encountered in the normal course of audit work, including any restriction on audit scope or access to information.

4.22 Ensure that significant findings and recommendations made by the external auditors and management's proposed response are received, discussed and appropriately acted on.

4.23 Discuss with the external auditor the appropriateness of the accounting policies applied in the company's financial reports and whether they are considered as aggressive, balanced or conservative.

4.24 Meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed privately. Ensure the auditors have access to the chairman of the audit committee when required.

4.25 Review policies for the provision of non-audit services by the external auditor [and where applicable the framework for pre-approval of audit and non-audit services].

4.26 Ensure the company has appropriate policies regarding the hiring of audit firm personnel for senior positions after they have left the audit firm.

Internal audit

4.27 Review the activities, resources and organisational structure of the internal audit function and ensure no unjustified restrictions or limitations are made.

4.28 Participate in the appointment, promotion or dismissal of the internal audit head and discuss with the external auditor the standard of work of internal audit staff.

4.29 Review the effectiveness of the internal audit function and ensure that it has appropriate standing within the company.

4.30 Meet separately with the director of internal audit to discuss any matters that the committee or internal auditors believe should be discussed privately.

4.31 Ensure that significant findings and recommendations made by the internal auditors and management's proposed response are received, discussed and appropriately acted on.

4.32 Review the proposed internal audit plan for the coming year and ensure that it addresses key areas of risk and that there is appropriate co-ordination with the external auditor.

Reporting responsibilities

4.33 Regularly update the board about committee activities and make appropriate recommendations.

4.34 Ensure the board is aware of matters that may significantly impact on the financial condition or affairs of the business.

4.35 Prepare any reports required by law or listing rules or requested by the board, for example a report on the audit committee's activities and duties to be included in the section on corporate governance in the annual report.

Evaluating performance

4.36 Evaluate the committee's own performance, both of individual members and collectively, on a regular basis.

4.37 Assess the achievement of the duties specified in the charter and report the findings to the board.

Review of the committee charter

4.38 Review the audit committee charter annually and discuss any required changes with the board.

4.39 Ensure that the charter is approved or reapproved by the board.

Membership

The appointment of suitably qualified members to the audit committee is a critical factor for a committee's performance.

The board or a nominations committee is usually responsible for appointing the audit committee members. The board (or nominations committee) should select only those members who possess the necessary qualifications and experience.

Qualifications

Each member should be capable of making a valuable contribution to the committee. A diverse outlook among members is desirable, since a uniform point of view could lead to over-emphasis in one direction. Qualifications that each committee member should possess include:

- An attitude of mind independent from the company's management
- Integrity
- Capacity to dedicate sufficient time and energy
- Understanding of the business, its products, and its services
- Knowledge of the company's risks and controls
- Ability to read or understand basic financial statements, ask pertinent questions about them and interpret and evaluate the answers
- Ability to give direct and honest opinions
- Inquisitiveness and independent judgement
- Ability to offer different perspectives and constructive suggestions.

Newly appointed committee members may not initially possess all of these characteristics. They should be allowed a sufficient period – say 6 to 12 months – to acquire the necessary level of familiarity with the company's operations.

‘I have in mind a person with the intelligence, experience and understanding to know the right questions to ask of management or the auditors and the forcefulness and tenacity to ask a direct question and insist on a straight answer. Ideally, all audit committee members should have these qualities’

US SEC Commissioner, February 2003

Independent directors

The audit committee is responsible for overseeing the financial reporting process and, in doing so, it may need to challenge the judgement of management or take positions that may be contrary to those of management. Because of this oversight role, independence from management is an essential quality for audit committee members.

A committee composed wholly of independent directors is optimal. In some countries, all members are required to be independent non-executive directors. Independent directors are better equipped to express their opinions in a free and unrestricted manner, unconstrained by any financial ties or position in the company.

The concept of independence is not easy to define, though many major investors and representative bodies have developed frameworks or guidance for their own purposes. It is necessary that the board has a strong understanding of how 'independence' is defined and how it is perceived by the market. It is also important that the board's approach to independence is communicated to shareholders.

To be considered 'independent', each member must satisfy all applicable laws and regulations relating to audit committee independence. For example, an independent director must be a person other than an officer or employee of the company or its affiliates, or any other individual having a relationship that would interfere with the exercise of independent judgement.

Relationships that may be perceived to impair an audit committee member's independence include the following:

- Current or prior employment at the company or any of its affiliates (the period in which the prior employment occurred can vary considerably – it is quite common, however, for investors to concentrate on the last three years)
- Cross-relationships or significant links with other directors in other companies
- Receipt of consulting, advisory or other compensation from the company (or its affiliates), except for director's fees consistent with the committee duties undertaken
- Participating in the company share option or performance-related pay scheme
- Obtaining financial assistance from the company in terms of loans or advance payments other than on ordinary terms

'Potential conflicts exist if audit committee members formerly were part of the company management team. Former working relationships may place undue pressure on the audit committee to avoid asking hard questions'

OECD – Second South Eastern Europe
Corporate Governance Roundtable, May 2002

- Being a member of the immediate family of the management team
- Being a director or major shareholder of a significant customer or supplier
- Being a representative of a substantial shareholder or provider of finance.

The company may decide to appoint a director who has one or more of the above relationships in some jurisdictions if the board considers that membership is in the best interests of the company and its shareholders as a whole. In the interests of transparency, the nature of such a relationship and the reasons for appointment should be disclosed to the shareholders.

Financial expertise

It is good practice that each member of the audit committee should be financially literate – having the ability to read and understand primary financial statements, including a company's balance sheet, income statement and cash flow statement.

In order to conduct its responsibilities, committee members will need to give attention to matters such as:

- GAAP and non-GAAP amounts, key performance indicators and ratios
- Complex and sensitive or judgemental areas, such as financial instruments, accounting for pensions and share options, business combinations and valuation of intangible assets
- In the case of companies with multiple listings, the implications of preparing financial statements under several reporting frameworks
- Moving from one reporting framework to another (for example from national GAAP to International Financial Reporting Standards).

Emerging practice (and a requirement in recent US and UK pronouncements) is that at least one member should be a financial expert who has accounting or related financial expertise. This could have arisen through past employment in finance or accounting, a professional qualification in accounting, or any other comparable experience, for example as a senior officer with financial oversight responsibilities or as an auditor of a listed company.

The chairman's role

The position of committee chairman is pivotal – he or she must be the focal point for the committee's relations with the board, the chief financial officer and the internal and external auditors. The chairman is responsible for the smooth running of meetings, ensuring that the views of each member are heard and that sufficient time is devoted to each issue for discussion. The chairman should plan the agenda for each meeting in conjunction with the committee secretary.

In selecting a committee chairman, the board should choose someone with strong and effective leadership qualities and the ability to promote effective working relationships (among committee members and with others such as management and external and internal auditors).

The roles of chairman and financial expert might in some cases be combined in one individual. However, for most committees, a better balance of skills will be achieved by having these roles performed by different individuals. In these circumstances, the chairman must be properly briefed on the technical aspects to enable him to report to the board and shareholders.

The board should periodically review the mix of characteristics, experience, and skills of all committee members to ensure that it continues to provide an appropriate balance.

Commitment

To fulfil their responsibilities, committee members need to dedicate a significant amount of time and energy to committee activities. This will include familiarisation with the company's business and industry and preparation for, and attendance at, meetings.

Members should strive to attend every meeting of the committee.

The number of other directorships held by committee members may affect the amount of time they are able to devote to audit committee activities. When evaluating potential candidates for the committee, boards will therefore want to consider the number of other directorships and committee responsibilities held by candidates.

Size of committee

An audit committee should be large enough to represent a balance of views and experience, yet small enough to operate efficiently.

It is now a requirement in markets such as the USA and UK that the committee should consist of no fewer than three members who should all be independent non-executive directors.

Earlier research by PricewaterhouseCoopers found that in major European companies, 70% of committees had between three and four members.

It is generally thought that committees composed of three to six members represent the optimum size. However, the size of each committee should be appropriate for the company's circumstances and will depend on the extent of the committee's responsibilities.

Term of office

The number of years that members serve on a committee varies. A common term is three years, with possible reappointment for a second term, but longer terms are also possible. It is rare for committee members to rotate on an annual basis, which is why a programme that regularly evaluates the committee members' performance is useful. (See page 48.)

When determining the length of time committee members may serve, the board should weigh two opposing considerations; continuity and freshness. Rapid turnover can be detrimental to the committee's effectiveness, since members need time to familiarise themselves with the company's business and financial reporting structure and understand technical issues. On the other hand, new members bring a fresh perspective to the committee. To balance these considerations, the board may wish to establish staggered terms for committee members.

Meetings

Frequency

An audit committee should hold regular meetings and should plan carefully the timetable, agendas and participants.

The number of meetings the committee holds is influenced by its objectives and scope of activities, and the size and nature of the business. Regular meetings provide the opportunity to review and discuss financial information on a timely basis. It is helpful to schedule meetings (particularly those at which the financial statements are reviewed) well in advance of the corresponding board meeting, to allow time for dealing with issues raised by the committee. Generally, meetings correspond with major phases of the financial reporting, external audit, and internal audit cycles. The chairman of the committee should decide the frequency and timing of its meetings.

Research into practice at European companies shows that audit committees meet, on average, three to four times a year. However, the key is that the number and length of meetings are appropriate to ensure that the committee meets its objectives.

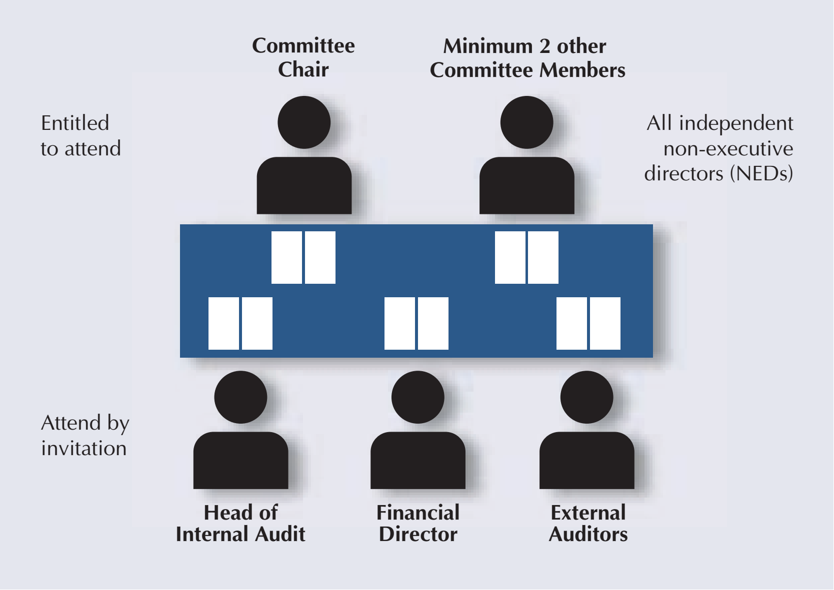
Participants

Members of the audit committee should attend all meetings of the committee. In addition to members of the committee, other participants are often present, by invitation, at meetings. Such participants may include:

- The director or head of the company's internal audit function
- The lead partner from the external auditors
- Senior management, including the chief financial officer (CFO) or financial director.

Additional attendees should be limited to those who are familiar with, or responsible for, the topics on the agenda. If necessary, the audit committee should invite the in-house lawyer or outside legal counsel to attend a meeting.

Where appropriate, the audit committee should arrange separate meetings with management, and the external and internal auditors. Topics for discussion with management might include the evaluation of the external auditor, accounting and internal audit personnel. Discussions with the auditors might include the cooperation that the external and internal auditors receive from the company's staff and management.



Agenda and meeting papers

In our experience, the reaction of members to the arrival of audit committee papers is typically 'Too much!' or 'Too late!' To maximise effectiveness, a detailed written agenda with clear supporting papers highlighting matters for decision should be prepared for meetings. They should be distributed to committee members a reasonable period in advance to allow proper consideration.

Appropriate notice should be at least three or four working days to allow for adequate study of the papers.

In the case of the annual financial report, it may be appropriate to schedule two meetings – one two weeks or so before the report is due to be released to ensure adequate time to address fully the significant issues, and another just prior to the release to review the final numbers.

'The committee should meet a sufficient time before the results announcement to enable issues to be discussed with management and the auditors and resolved'

CEO of African company,
February 2003

Resources

Audit committees must have access to the resources and information necessary for them to fulfil their duties. This will mean continuing administrative and secretarial support. Occasionally other resources may be required (for example, when conducting special investigations), such as access to legal advisers and other outside specialists. It should be made clear to all directors and staff that they must fully cooperate with the audit committee and supply all information as required.

Minutes

Minutes of meetings should be prepared and sent to members of the committee, the board of directors (and the external and internal auditors where appropriate) on a timely basis. These, in addition to direct reports to the board from the chairman of the audit committee, help keep the board fully informed about the committee's activities.

Best practice is that the number of meetings held and the number of members who attended the meetings should be disclosed in the annual report.

New members – getting started

Companies make use of executive selection agencies to screen directors for new positions. In the same way, prospective audit committee members will want to conduct their own 'due diligence' before they accept the role, particularly if they are new to the board.

Questions prospective new board and audit committee members might ask themselves about the company before taking on the role include:

- Can investors understand the company's governance structure?
- Who are the company's principal advisers?
- How does the business make its money?
- Is the company clearly open, honest and transparent in its dealings with stakeholders?

Further questions that might be asked in relation to the audit committee role include:

- Is the committee seen as important internally as well as externally?
- How wide is the audit committee's remit (too narrow or too broad)?
- Who is the committee chairman, and how does he or she control the meetings?
- Do the other members add value by virtue of skills or experience, and how will I complement these skills and experience?

Once their appointment is confirmed, committee members should be provided with sufficient background information. Although they will normally also be directors of the board, the amount and nature of information and knowledge that will be required to fulfil their audit committee role will be different from that necessary for their board functions.

The induction process should cover the role of the audit committee, expected time commitment by members, overview of the business and an introduction to the company's finance staff.

New members should ensure they have an appropriate understanding of the company, its products and services, areas of risk, and its internal control and financial reporting systems. They also need to understand the requirements and objectives of the audit committee and so should review the charter, minutes of prior meetings and any recent reports made by the committee to the board.

On the following page is a list of items that new members may consider when familiarising themselves with the company. Page 47 considers the committee's continuing need to keep up to date – 'Maintaining and measuring effectiveness'.

Orientation information for new committee members

New members will need background information on many areas, including:

The company

- Products and services
- Foreign and domestic operations
- Key areas of risk and how they are being managed
- Financial and operational controls, and planned modifications
- Types of budget and management reports produced
- Key accounting policies and the reasons for their use
- Key areas of concern about the financial position and the reported value of individual assets and liabilities
- Statutory reporting and exchange listing requirements to which the company is subject
- Litigation and contingencies facing the company
- Annual and interim earnings trends
- The company's code of conduct or business behaviour.

Management

- Background and qualifications of senior executives and financial management
- An organisation chart setting out reporting lines and responsibilities
- The basis on which senior management is remunerated.

The committee

- The audit committee's charter – its role in overseeing company policies, financial reporting, and other special areas
- Nature and timing of reports prepared by management for the committee
- Company staff available to support the audit committee
- External advisers available to support the audit committee.

Internal auditors

- The responsibilities of the internal audit function
- The number of internal auditors and their qualifications and experience
- The committee's relationship with the internal audit department
- The types of reports the audit committee receives from the internal audit department
- The current year's internal audit plan.

External auditors

- A copy of the current year's external audit engagement letter
- The scope of the external audit, including the current year audit plan
- The committee's relationship with the external auditors
- The types and timing of reports issued by the external auditors
- Company policy with respect to engaging the auditors to provide audit and non-audit services.

Oversight responsibility for financial reporting

The audit committee normally undertakes, on behalf of the board, responsibility for ensuring the integrity of the company's financial reports by having oversight of internal control, the financial reporting process and compliance with regulatory matters.

The specific responsibilities of each committee will vary depending on the particular circumstances of the company. However, in general, the audit committee will review the:

- Adequacy and effectiveness of risk management systems and the company's internal controls as they affect financial reporting
- Adequacy and effectiveness of the system for the preparation of financial data reported to the market, including the annual financial statements and review of operations, and interim reports
- Process for monitoring compliance with relevant laws and regulations, and any legal matters that could have a significant impact on the company's financial reports
- Process for monitoring compliance with any internal code of conduct, including procedures for dealing with concerns of employees and complaints received by the company regarding accounting and auditing matters.

These functions are described in more detail below.

Risk and controls

Risk management

Risks are uncertain future events – both positive and negative – that could affect future cash flows, profitability, shareholders' return and the company's reputation. It is the responsibility of the board to determine the risk appetite of the company and set policy in relation to this. Management's responsibility is to assess what risks the company may be exposed to and to develop procedures for managing risk in line with board policy. The audit committee's role is to review the risk profile and ensure that risk management strategies, particularly as they affect financial reporting, are in place.

Risks may arise from both external and internal factors, such as: competition and complexity of the market; economic conditions; regulatory changes; weaknesses in the company's business model; and deficiencies in internal control. The audit committee should:

- Discuss with the board its attitude to risk and the policies established to ensure management operates within these parameters
- Understand the company's framework for risk assessment and management and the assignment of responsibilities
- Review the company's major financial risk exposures and steps taken to monitor and control those risks.

In some business sectors, particularly regulated industries (for example banking, financial services, pharmaceuticals and transport) it is increasingly common for companies to establish separate risk committees. The audit committee should understand the role and activities of the risk committee and, through the board, should ensure that it has regular contact with the risk committee.

For risks that are accepted, management will establish a control system. A well-designed and implemented internal control system provides the right environment for the efficient running of an entity's operations, and will reduce the risk of financial information being materially misstated.

Internal control

The board of directors sets policy and oversees management who have primary responsibility to design and implement systems of internal control. Management's responsibilities include:

- Establishing and maintaining an adequate internal control structure and procedure for financial reporting
- Evaluating the effectiveness of internal control, at least on an annual basis
- Identifying promptly material weaknesses in internal control and taking corrective steps
- Notifying the external auditor and audit committee of significant internal control deficiencies, and any instances of fraud.

The audit committee should gain an understanding of the system of controls over financial reporting implemented by management. This includes controls over the integrity of the financial accounting systems and records, and controls to ensure fair presentation and disclosure of financial information in accordance with standards. Where the company has a treasury function, the committee should also understand the treasury controls operated by management.

The committee should obtain this understanding through reports from and discussions with management, internal audit, and the external auditors. The audit committee should also understand the extent to which the external and internal auditors review controls.

The audit committee's involvement is important and can help to reinforce a strong 'control culture' in the business. Where internal controls are weak, the audit committee should require the board to make improvements.

Where management outsources a key part of the information and controls system, for example to a shared service centre, the committee will want to ensure that an appropriate service agreement is in place and that performance is being monitored. The agreement should specify the services to be performed (for example processing of sales and purchasing, and maintaining financial accounting records,) and rights of access to and procedures for reviewing the performance of the provider.

In some cases, the audit committee or management may request an independent accountant or auditor to prepare a special report on aspects of the internal control and risk management systems. If so, the audit committee will need to specify the nature of the engagement and should review with the independent accountant the basis for the report.

'Audit committees should, for example, satisfy themselves that there is a proper system and allocation of responsibilities for the day-to-day monitoring of financial controls but they should not seek to do the monitoring themselves'

UK Smith Report –
Audit Committees Combined Code Guidance,
January 2003

Fraud risk

Fraud risk should be a major business concern. The audit committee should gather information from management of the company, external and internal auditors to enable it to:

- Understand and be aware of fraud risk
- Ensure that the risk of fraud has been communicated by management
- Review management's steps to implement adequate controls to mitigate the risk of fraud.

Fraud can take the form of management fraud, employee fraud or external fraud. Management fraud involves intentional misrepresentation of financial information or improper use of the company's resources by senior management. Where there is deliberate collusion by management, it is unlikely that normal audit procedures will uncover fraud and error.

Fraudulent financial reporting is a particular type of management fraud that can significantly affect the integrity of financial statements and damage the company's reputation. In its review of periodic financial information, the audit committee should be alert to indications that fraud may be present.

Audit committee responsibilities...

- **Evaluate whether senior management has set an appropriate 'control culture' by establishing procedures for the assessment and management of risk**
- **Understand the systems of controls implemented by management for the approval of transactions, recording of data and compliance of financial statements with relevant requirements**
- **Enquire whether internal control recommendations made by the external and internal auditors have been implemented by management**
- **In reviewing the financial statements and other financial information, be alert to possible indications of fraud.**

Financial reporting

The preparation of the financial statements is a primary responsibility of the company's management. The audit committee plays a key role in reviewing the financial information before it is published. As explained on page 19, it is important in order to fulfil this role that the committee's members have a good understanding of financial accounting. The committee will need to consider:

- Critical accounting policies, judgements and estimates applied in the financial statements
- Alternative accounting policies applied by peer-group companies
- Quality of earnings and the implications of exceptional and/or non-recurring income and expenses
- The impact of business risks and sensitivities on the company's financial statements
- Implications of expected changes in accounting policies
- The impact of the company's financing structure on current and future profitability
- The way in which such matters are dealt with in the company's financial reports.

The accounting framework

The audit committee should be familiar with the accounting framework used by the company for its financial reporting. In most cases this will be national GAAP – generally accepted accounting principles – the body of accounting standards and interpretations approved for use in a particular country. Where companies raise capital on foreign markets, they may have to report in accordance with more than one GAAP, or provide a reconciliation from one GAAP to another.

In the interests of improved comparability, many countries are adopting International Financial Reporting Standards (IFRS). A recent study by the large accounting firms revealed that over 90% of the world's major economies are planning to adopt or converge with IFRS. Listed companies in the European Union member states, for example, are required to adopt IFRS in 2005.

Where appropriate, the audit committee needs to be familiar with the company's transition process from national GAAP to IFRS. The audit committee members should:

- Understand the wider effects on the company's reported results of moving from national GAAP to IFRS
- Understand the transition or conversion plan implemented by management
- Receive reports from, and perhaps attend meetings of, the company's transition steering group
- Consider how management is preparing in advance for the more complex areas, such as financial instruments, goodwill and deferred taxation.

As indicated in the section on membership, knowledge and experience of the relevant accounting standards is a great advantage. Committee members, particularly those designated as 'financial expert', should be up-to-date with changes in regulations and standards.

Reviewing the annual financial statements

The audit committee will review the annual financial report and assess whether it is complete and consistent with the information known to committee members. It should have enough time to conduct its review of the financial statements and the supporting commentary by management. The final draft of the financial statements should be received by the committee at least two or three days in advance.

The audit committee should meet with management and the external auditors to review the annual report and financial statements and the results of the audit.

The type of review will vary, depending on the complexity of the company and its industry. It will, however, cover the selection and application of accounting principles and estimates, the presentation of disclosures, going concern disclosures (if applicable), and any other matter significant to the company's financial reporting process.

Significant fluctuations in results from year to year as well as variations between actual results and the budget or forecast need to be explained and understood. The committee should pay particular attention to complex or unusual transactions and to judgemental areas, particularly those areas where different assumptions could have a significant effect on the financial statements. Examples of such areas include restructuring charges, acquisitions, special-purpose entities, off-balance sheet transactions, derivatives, valuation and impairment of assets, warranty obligations, environmental liabilities or litigation provisions.

Pages 31 and 32 provide a list of questions that may be asked of management and the external auditors prior to the release of the annual financial statements.

Audit committee responsibilities...

- **Review significant accounting and reporting issues, including recent professional and regulatory pronouncements, and understand their impact on the financial statements**
- **Review schedules of adjusted and non-adjusted items and obtain explanation from the external auditor and management as to why errors remain unadjusted**
- **Read the directors' or management letter of representation to the auditors on the financial statements and consider issues addressed in the letter**
- **Review the financial statements and determine whether they are complete, reflect appropriate accounting policies, contain adequate disclosure and are consistent with the information known to committee members**
- **Review other sections of the annual report, particularly management commentary, and consider whether the information is adequate and consistent with members' knowledge about the company and its operations**
- **Review the results of the external audit.**

Interim financial statements and other published financial information

All financial information published by companies is closely scrutinised by the investment community, and the price of a company's stock is significantly affected by investors' reaction to results announcements.

It is important, therefore, that the audit committee includes both preliminary announcements and interim (including quarterly) statements within its remit.

Regulators in some territories (such as the European Union) are proposing to introduce requirements for quarterly reporting and for reports to be filed more quickly. Although this may increase the burden of work for the audit committee, there are significant benefits in the committee reviewing interim information and preliminary announcements, including:

- Enhancement of the committee's ability to identify and direct attention toward significant issues on a timely basis
- The establishment of a regular, almost continuous, flow of information from management to the committee. Committee members' understanding of the company's business will be improved
- The opportunity for the external auditors to engage in discussions with the committee, particularly on matters of accounting policy treatment, at an early stage.

These benefits, of audit committee involvement in reviewing other financial information, might be built on further by obtaining the committee's input on the material used for analyst and institutional investor presentations.

Where financial information of a routine nature is produced on a regular basis, for example returns to regulators and debt circulars, the committee should establish protocols with management for its review and release. The committee needs to be satisfied there is an appropriate process for its preparation, but need not itself review every document that is filed or published.

Ultimately, as a result of the increased oversight by the audit committee, the whole financial reporting process will be strengthened and investors' interests will be further protected.

Audit committee responsibilities...

- **Ascertain how management develops and summarises interim and preliminary results information, and the extent of external and internal audit involvement in the review of such information**
- **Agree with management appropriate procedures for the preparation and review of other types of financial information, for example summary financial statements, regulatory returns and debt circulars.**

Illustrative questions for reviewing financial statements

A. Financial reporting process

- What are the current areas of greatest financial risk, and how are these being managed?
- Are the accounting systems (including controls over disclosure, and controls over financial reporting processes) adequate and appropriate?
- What significant recommendations have been made to management (by external and / or internal auditors) for improvements to the reporting process? How has management responded? Are there any significant areas that still require attention?
- What are the procedures for making profit and cash flow projections?
- What evidence has management considered to satisfy itself that the company is a going concern (that it will continue to operate for the foreseeable future)?

B. Accounting policies

- Do significant accounting policies continue to be appropriate? Are the assumptions underlying them still valid?
- Did any accounting policies change this year? If so, for what reasons, and what were the effects of the changes?
- What effects would any new or proposed change in generally accepted accounting principles or in other regulations have on the financial statements?
- Do the financial statements contain a clear and unambiguous reference to the accounting framework (national GAAP or IFRS) adopted?
- Where a new framework is adopted for the first time, have appropriate policies and disclosure been followed?
- Were there any disagreements between management and the auditors on accounting policies or principles? Were they satisfactorily resolved?
- How do the company's policies compare with industry norms?
- Is the revenue recognition policy appropriate?
- Are any policies regarding capitalisation of expenditure in accordance with generally accepted accounting principles?
- What are the overall impressions of the conservativeness or aggressiveness of the accounting policies adopted and the underlying estimates?

C. Financial statements

Overall

- Are there significant fluctuations between account balances in the financial statements between current and prior periods? What caused them?
- What significant accruals or adjusting entries were made as part of the year-end accounting process?
- Were there any prior-period adjustments? What were the circumstances?
- Were any significant transactions completed during the year that are not evident from the financial statements? How were they accounted for? Did any of these transactions involve related parties?
- Were any significant issues raised by management, company's legal counsel, or outside legal counsel concerning litigation, contingencies, claims or assessments? How are such matters reflected in the financial statements?
- Is the company in danger of not complying with the provisions of loan agreements and covenants?

Measurement and recognition

- How did management satisfy itself about the value of long-term investments?
- Has the company invested in any unusual types of financial instruments?
- Has the value of marketable securities or other financial instruments changed significantly since year-end?
- What other implications might falling equity values have (eg pension fund deficits)?
- How does the average age of accounts receivable at year-end compare with the preceding year?
- Is the collectibility of any large receivable amount (for example in a loan portfolio) in question?

- Is there any indication that tangible or intangible assets may be impaired?
- Are revenues properly accounted for? What about volume sales incentives and discounts?
- What steps were taken to determine obsolete or excess inventory? Were there any significant write-downs?
- Are there government or regulatory programmes, for example concerning the environment, that could adversely affect the value at which items are recorded or that could require provision?
- What are the open tax years? Are there any significant items that are or may be in dispute?
- Were there any commitments or contingent liabilities indicating possible impairment of the value of an asset or the incurrence of a liability that were not provided for in the financial statements?

Disclosures

- Are there appropriate disclosures regarding going concern issues?
- Is there adequate disclosure of financial risks?
- Are all material off-balance sheet transactions, arrangements and obligations (including contingent obligations) appropriately accounted for and disclosed?
- Are other relationships of the company with unconsolidated entities or other persons appropriately disclosed?
- Are there any significant or unusual amounts due from officers or employees?
- Are there any other significant related party transactions that require disclosure?
- Do the disclosures meet the requirements of each jurisdiction in which the financial statements may be filed?

D. Transparency

- Is the management commentary consistent with the financial statements? Is it balanced, comprehensive and understandable?
- What significant changes have taken place during the year in the markets that the company operates in? Is this reflected in the management commentary?
- Is the funding and liquidity position of the company adequately explained?
- Overall, does the annual report (the financial statements, operating review and other parts of the annual report taken together) give a transparent view of the company's performance?
- Are references to non-GAAP amounts or measures appropriate and fully explained?
- From a review of the financial statements, is there any indication of possible deficiencies in internal control or fraud and error?
- Are there any situations developing that do not require accounting recognition or disclosure this year, but may next year if conditions do not improve?

E. Questions to ask the auditors about the financial statements

- Did the actual scope of the audit differ from pre-audit plans? Did management restrict or limit the scope of the audit in any way?
- Did management cooperate during the course of the audit and were you provided with all the information and explanations you required without hesitation?
- Was there any difficulty in obtaining written representations from the board of directors or executive management?
- Were any significant adjustments to the financial statements made as a result of the audit?
- Are there any unrecorded adjustments resulting from the audit? What is the quantum effect of these adjustments?
- What are the most significant judgemental areas in the accounts?
- Would you consider the accounting policies prudent or aggressive?
- Has management resisted any significant areas of disclosure?
- If you had prepared these financial statements yourself, what would you have done differently and why?

Regulatory, compliance and ethical matters

Regulatory, tax and legal issues

The audit committee should also have oversight of the company's process for monitoring compliance with laws and regulations that have a financial impact. The committee will normally receive briefings from management, such as the compliance officer, company's legal counsel or tax manager, to gain an understanding of the procedures designed for ensuring compliance and for assessing the potential impact on the company and the financial statements. The committee should also review reports on the company's compliance with financial laws and regulations.

The audit committee should periodically meet with the company's in-house legal counsel (and if appropriate, external legal advisers) to consider any matters that may have a material impact on the company and the financial statements.

Business ethics

There is increasing recognition that the reputation of a business is a critical factor in the determination of its value. Given the increased attention that the media, the public and the investment community pay to ethical issues, many more company boards are now devoting considerable resources to ethical programmes.

One sign of the increased importance attached to business ethics is the adoption by many companies of formal codes of conduct, which set out the board's guidelines for acceptable business practices. Codes of ethics should be designed to promote:

- Honest and ethical conduct, including the handling of actual or apparent conflicts of interest
- Full, fair, and understandable disclosure in reports and public communications
- Compliance with applicable governmental rules and regulations
- Prompt internal reporting of violations to an appropriate person
- Accountability for adherence to the code.

Some companies are publishing their codes, so that stakeholders such as customers, suppliers and local communities can see the standards by which the company judges itself.

Well-defined ethical standards and written guidelines for acceptable business behaviour help establish a climate that encourages reliable financial reporting and a sense of fiduciary responsibility among employees. The audit committee is not normally responsible for determining ethical standards. That responsibility should belong to the board as a whole. However, the board and management may consult the audit committee in designing a code or setting the guidelines for business behaviour.

The audit committee will be interested in the extent to which ethical standards are embedded in the company's internal control and internal reporting procedures. It should also consider whether management has a programme for monitoring compliance with the code and for enforcing instances of non-compliance.

Whistleblowing

The audit committee may be expected to establish, or review steps taken by management to establish, whistleblowing procedures on financial matters. Managers and employees who become aware of instances of possible financial malpractice within the company should have a safe channel through which to report their concerns. The audit committee should ensure that any concerns are properly investigated and necessary follow-up action taken.

The establishment of complaints handling procedures should also be extended to financial reporting issues raised by regulatory agencies, investors and members of the public. The audit committee needs to be satisfied that these are properly dealt with.

Audit committee responsibilities...

- **Review the systems implemented by management for monitoring compliance with financial laws and regulations**
- **Obtain regular updates from management regarding compliance and the results of management's investigation and follow-up of any instances of non-compliance. Review the findings of any examinations by regulatory agencies**
- **Assess whether all legal and regulatory compliance matters have been considered in the preparation of the financial statements**
- **Review the programme for monitoring compliance with any code of ethics, and periodically obtain updates from management regarding compliance**
- **Ensure the company has appropriate mechanisms for dealing with financial accounting and reporting issues raised by employees, investors, members of the public and others.**

Working with Auditors

External and internal auditors have knowledge and experience that can help the committee to perform its activities. To fulfil its responsibilities, the audit committee needs to communicate with both groups of auditors.

External auditors

The objective of an external audit of financial statements is to determine whether, in the auditors' opinion, the statements present fairly in all material respects, or show a true and fair view of, the company's financial position, results of operations, and cash flows in conformity with national or international generally accepted accounting principles.

The audit committee's primary interest is reliable financial reporting, so communication with the external auditors on a regular basis is important. Discussions with the external auditors should cover the following four key areas:

- **Service approach** (the auditors' qualifications, including independence, to perform the work and the approach to the audit)
- **Risk and controls** (the key risks identified by the auditors in relation to the financial statements and the company's controls, and the resulting audit plan and response to the risks)
- **Financial reporting** (accounting policies, disclosures, and observations on the overall quality of financial reporting)
- **Governance matters** (matters noted by the auditors in the course of their work that they consider should be brought to the audit committee's attention).

The audit committee should have discussions with the external auditors at appropriate times during the year, not simply at the time of the completion of the annual audit. Ideally, the committee will meet at least three or four times during the year, to coincide with the external reporting and audit cycles.

The committee and the external auditors should communicate at the following stages of the audit:

- Pre-engagement – to approve the scope of the audit service, discuss the auditors' independence, and agree the audit engagement letter
- Planning – so that the committee can understand the planned audit approach
- During the audit – for example at the half-year, so the committee is kept informed of significant matters relevant to the audit
- Resolution and completion – to discuss the auditors' findings.

In some countries, generally accepted auditing standards include specific requirements for communication between the external auditor and the audit committee. The International Auditing and Assurance Standards Board (IAASB) has also developed guidance on this – International Standard on Auditing (ISA) 260, *Communications of Audit Matters with Those Charged with Governance*. The standard indicates matters that, ordinarily, the external auditor should report or discuss with the audit committee. These are included on page 41, 'What you should expect from your auditors.' Relevant matters should be communicated to the committee on a timely basis.

Getting started – pre-engagement

- Review last year's external auditors' performance – audit team, services and fees
- Discuss audit proposal – service approach/strategy, terms and fees
- Review auditors' independence and experience of audit team
- Consider engagement letter
- Make proposal to board for appointment

Understanding the audit plan

- Discuss and agree audit plan for current year
- Understand from the auditors what to expect – services, timing and reporting requirements
- Consider how key risk areas will be addressed during the audit

Staying informed during the audit

- Be aware of difficulties encountered in performing audit – restrictions on access to information/management
- Be informed of deficiencies in internal control/ fraud/illegal acts
- Be updated on matters impacting on the auditors' independence

Resolution and completion (post year-end)

- Review the audited financial statements
- Discuss key audit findings – significant accounting policies/audit judgements/ financial reporting quality
- Discuss any disagreements with management
- Meet separately with external auditors
- Appraise external auditors' performance

The diagram above shows how the committee's experience of how the external audit was conducted helps to inform its decisions about the audit relationship for the following year.

The committee should meet privately with the external auditors at least once each year to ensure free and open communications. The audit committee may also utilise the knowledge and experience of the external auditors by meeting with them to receive regular updates on developments affecting financial reporting.

Service approach

Reviewing the auditors' performance

Whether assessing the company's current auditors prior to reappointment, or evaluating new ones, the committee should consider:

- The firm's professional capabilities, resources, and personnel assigned to the audit
- Audit approach
- The audit team's knowledge of the company's industry
- Geographic coverage of the audit.

There are many advantages to continuing with a firm that is providing good service. However, if a new firm is being considered, the audit committee should consider the appointment after consultation with management and make a recommendation to the board. It is the board that normally recommends the appointment to the shareholders.

The committee should also be involved in any decision to dismiss the external auditors. In such cases, the committee should assure itself that the dismissal is on substantial grounds and not, for example, merely because the external auditors took positions on accounting issues that were contrary to management's preferences.

If the audit committee has concerns about the quality of service, it should discuss them with the partner in charge of the external audit. Open and candid discussions among all parties can lead to a constructive resolution of matters giving rise to concern.

The audit committee should annually review the fees charged for the audit, alongside the reappointment of the external auditors. The committee considers whether the fee is fair compensation for a comprehensive and competent audit. This review might also include the fees in respect of other services provided by the external auditor.

Some countries require disclosure of fees paid to the external auditors in respect of different categories of work. The US SEC, for example, requires disclosure of fees paid for audit, audit-related, tax and other services provided by the auditor.

Independence of the external auditors

To perform their work effectively, external auditors must act with objectivity. The audit profession recognises this and requires its members to observe ethical rules that are designed to safeguard the auditors' independence. The International Federation of Accountants (IFAC) has issued a Code of Ethics that sets out potential threats to independence, and safeguards to mitigate those threats.

While the audit committee focuses primarily on the effectiveness of the audit, it should also consider the effect on the auditors' objectivity of any relationships or other services the auditors have with, or provide to, the company or its management. The committee will need to determine to its own satisfaction that the auditors' independence has not been compromised.

The rules in some countries require the audit committee to review and make recommendations on company policy with respect to engaging the auditor to perform other services. For SEC registrants, there is also a requirement that audit committees must pre-approve all services – both audit and non-audit – performed by the external auditors.

In establishing such policies, the committee needs to balance several factors. It should contribute to the perceived robustness of the audit by discussing independence issues with the external auditors, and help the auditors to ensure that their independence is not compromised. (The committee should take note of the broad range of safeguards that the audit firm uses to protect its independence, such as the regular rotation of the engagement partner, use of review partners, and internal quality inspection programmes.) At the same time, it has a responsibility to act in the best interests of the company and ensure that value is delivered for shareholders in terms of the services supplied.

The company may engage the auditing firm for a variety of special services if those services do not pose an unacceptable threat to independence or breach specific independence restrictions. Using people that know the company and its culture, and who can apply and leverage this knowledge in providing other services, has great advantages. And the increased knowledge the auditors gain from performing these services can in turn contribute to the quality of the audit.

If the audit committee is happy, the company should be free to engage the firm it considers best equipped to perform a particular task, based on the skills and knowledge required, and the committee's perception of the abilities of the people it sees across the table.

Risk and controls

Analysis of key risks

Good practice is for the audit committee to meet the auditors and discuss the company's business risks with them. The meeting should focus on those key risks that, in the auditors' judgement, give rise to a greater risk of material misstatement of the financial statements. This discussion is helpful because it allows the committee to confirm its understanding of:

- The risks requiring its attention
- Management's response to address and mitigate those risks
- The external auditors' approach to the risks.

Scope of audit work

Based on an understanding of the company and the risks related to the financial statements, the external auditors prepare a detailed audit plan. The audit committee's review of the proposed audit plan and approach enables it to obtain an understanding of what it can expect from the external audit. Questions the audit committee might ask the external auditors about the plan include:

- What are the objectives of your audit?
- What are the company's financial reporting requirements and what is your expected timetable for meeting them?
- Which risk areas do you plan to emphasise in your audit? Why?
- To what extent will you assess the company's system of internal controls?
- How will any recent actions by the company, such as mergers and acquisitions, restructurings, changes of business strategy, and changes in financing arrangements, affect your audit?
- Do you plan to rely to any extent on the work of the internal auditors?
- Which company locations will you visit this year? How do you determine which locations to visit and when?
- Which subsidiaries will you audit? What steps do you take for those not audited?
- If other auditing firms are involved, how will you satisfy yourself that their work is acceptable and that they are independent? Do you intend to refer to them in your report?

The committee should ask the external auditors to inform it of any major unresolved problems encountered during the audit, or of any restrictions senior management impose on the scope of the audit.

Financial reporting

Normally, the audit committee, management, and the external auditors meet to review the financial statements and the results of the audit. (A suggested list of questions the committee might ask about the financial statements is included on pages 31 and 32.)

In some countries, external auditors discuss with the audit committee their judgements about the quality, not just the acceptability, of the company's financial accounting principles. The discussion could include such issues as the transparency of the company's financial disclosures, and the degree of aggressiveness or conservatism of the company's accounting policies and underlying estimates.

The intention is to encourage open and frank dialogue between the committee and external auditors. This should be considered good practice and a basis for all such discussions.

'Alongside the financial statements submitted for review, the audit committee should be provided with a report from the statutory auditors setting out key points, not only of results, but also of the accounting options that were selected'

Bouton Report (France), September 2002

Governance matters

There should be a continuous dialogue between the audit committee and the external auditors. The committee evaluates and comments on the overall effectiveness of the external audit process. At the same time, the committee should seek views from the auditors on the company's systems of governance and controls.

Arising from the financial statement audit, the external auditors often develop suggestions for improvements to the business' operations and internal controls. The committee should ask management to report on any significant suggestions received and on plans to respond to them. The audit committee should also question whether recommendations made in the prior year were implemented.

The auditors may also have views about the company's governance structure and processes. Good practice is for the committee to invite the external auditors to comment on:

- The manner in which the committee has operated and responded to significant issues
- The composition and range of committee and board member experience
- Company and board responsiveness to recommendations and requests
- The effectiveness of governance processes from the auditors' perspective.

Audit committee responsibilities...

- **Review the qualification, performance and compensation of the auditors and make recommendations to the board for the appointment of the external auditors**
- **Consider the independence of the external auditors**
- **Review the proposed audit plan and scope of work**
- **Consider the findings from the financial statements audit and ensure management responds to the findings**
- **Seek auditors' views on the effectiveness of the company's governance process.**

What you should expect from your auditors

The auditors will normally prepare reports for the audit committee in relation to the annual audit of financial statements. These may be delivered at different times of the year, as the work progresses. The reports may take different forms – a written report covering all relevant matters; a series of papers to be discussed in a meeting; a presentation; or an oral report. The content of the reports will vary, depending on circumstances. The following list of matters on which the auditors would ordinarily report is taken from International Standard on Auditing (ISA) 260, *Communications of Audit Matters with Those Charged with Governance.*

- The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements
- The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements
- The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements
- Audit adjustments, whether or not recorded by the entity, that have, or could have, a significant effect on the entity's financial statements
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern
- Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditors' report. These communications include consideration of whether the matter has, or has not, been resolved, and the significance of the matter
- Expected modifications to the auditors' report
- Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management
- Any other matters agreed on in the terms of the audit engagement.

The auditors may also report formally to the committee on a number of other matters, for example where required to do so by local law or regulation.

Internal auditors

A PricewaterhouseCoopers survey of large European companies found that 88% had an internal audit function and, in most of these cases, audit committees reviewed and approved the scope of work and activities of the internal auditors.

The internal audit function assists the audit committee in meeting its responsibilities, particularly in the areas of internal control, fraud and internal investigations. To be effective, an internal audit department needs to have the support of both management and the board. It should always have an open line of communication with, and unrestricted access to, the audit committee.

If a company does not have an internal audit function or department, the audit committee should consider, in conjunction with the board or senior management, whether such a department would benefit the company.

The director of internal audit may attend audit committee meetings by invitation and should meet privately with the committee at least once each year.

Activities and organisational structure

The audit committee needs a clear understanding of the internal audit activities, functions and organisational structure. To gain this understanding, information should be gathered from various sources, including:

- The department's charter, organisation chart, and internal audit plan (which should include an assessment of the organisation's risk profile)
- Reports on internal audit activities for the period, which include lists of projects completed, projects in progress and internal audit findings
- A description of the process for ensuring that management takes appropriate corrective action on suggestions made in internal audit reports
- Information on the department's current resources
- Plans for recruiting and training personnel.

Abilities and resources of the internal audit function

The audit committee should focus attention on the abilities of the internal audit staff and the adequacy of the resourcing of the department. The committee can enhance the quality of the internal audit department by determining whether the internal auditors:

- Have maintained their objectivity
- Are adequately trained – the company should provide a supportive atmosphere where internal auditors can receive continuing professional education
- Keep up with current issues and technology – for example, where a company has significant computerised operations or is heavily dependent on electronic commerce, internal auditors should have the skills required to understand the internal control implications

‘The chief auditing officer should be reporting directly to a private audit committee to ensure transparency of the company's management’

Anand Panyarachun, former Thai Prime Minister, November 2002

- Have appropriate qualifications, both in terms of professional training and practical experience. The company should encourage internal auditors to become members of professional associations, and to seek professional certification where appropriate

- Are appropriately funded within the organisation.

The committee should consider the adequacy of the size and skill-set of the internal audit department in the light of the business environment in which the company operates. Important attributes could include computer and systems experience, treasury experience, and foreign language skills, if appropriate.

The audit committee should also take responsibility for reviewing or concurring with the appointment, replacement, or dismissal of the director of internal audit.

Audit committee responsibilities...

- **Review the activities, resources and organisational structure of the internal audit function**
- **Consider the findings and recommendations of the internal auditors, and whether management responds to the findings**
- **Review the effectiveness of the internal audit function.**

Internal audit effectiveness

The audit committee should evaluate whether the company is fully utilising internal audit skills and providing necessary support. Some questions to ask include:

- Is the internal audit mandate appropriate? Has it kept pace with the company's activities and information and control systems?

- Does internal audit have adequate resources, both in terms of skills and funding?

- Would the function be better resourced and delivered if it was outsourced to an external supplier?

- How is the internal audit programme determined?

- Does internal audit investigate areas significant to the key operational and financial risks faced by the business?

- Does the company act on recommendations from internal audit and monitor the changes made?

- Do the internal auditors have an effective working relationship with the external auditors, and with company personnel involved in risk management processes?

Outsourcing is becoming a popular option for many companies. It provides access to a wider range of skills, which small, traditional internal audit departments may lack, and can provide a solution to the difficulties faced by companies of all sizes in retaining, for example, specialist IT and treasury auditors. Another advantage for some companies is that it can enhance the independence of internal audit from operational management.

A more radical approach to evaluation is to commission a benchmarking exercise. This involves an independent review of the internal audit department's activities, which is used as the basis for benchmarking its activities against comparative internal audit departments. Such reviews can improve the effectiveness of the internal audit department by identifying actions necessary to ensure that future needs are met.

Communicating and reporting

Effective oversight of the financial reporting process requires the committee to have significant interaction with management, ask difficult questions, and obtain reasonable answers.

The committee also has a duty to report on its activities to the main board.

Working with management

To be able to contribute constructively to the business, committee members must have a good understanding of the company's operations. Regular and meaningful dialogue with management will contribute toward maintaining this understanding. Matters on which the audit committee might obtain regular briefings from management include:

- Management's assessment of the business risks the company is facing and its planned response to those risks
- Current issues affecting the company's industry (for example regulatory issues or information about the competitive environment)
- The effect new tax laws or other regulations may have on the company
- The legal environment, including the status of any pending lawsuits or administrative proceedings, and the status of product and environmental liability and warranty reserves
- Treasury activities, including cash management, hedging, foreign currency transactions, and use of new or unusual financial instruments
- The company's foreign operations, including locations, and local controls over financial reporting
- Employee compensation policies, procedures for reviewing officers' expenses and benefits, and controls over agreements with temporary and contract staff
- Insurance cover for directors and senior officers.

Improved decision-making

Our experience from talking to companies about their audit committees is that most consider the committee does help to enhance the quality of financial and management information supplied to the board. This should, in turn, lead to improved decision-making in the company.

For some, particularly smaller, listed companies, there is a concern that the audit committee adds to the demands placed on management resources, and therefore costs. Indeed a few worry that audit committees could add an unnecessary tier to the management structure, or create unwanted and additional bureaucracy.

We believe there should be flexibility about how requirements for the composition of audit committees are applied in small companies. It may be acceptable to have non-executives on committees who are not completely independent, provided this is made transparent to shareholders. But we do not consider that smaller listed companies should be excused from the requirement to have a committee. New fast-growing companies are often in greater need of the experience and advice that an audit committee can offer than are much larger, more mature businesses. Younger companies tend to have less sophisticated risk management systems, less robust internal controls, and more aggressive accounting policies.

It is generally accepted that the commercial advantages of a well set-up audit committee outweigh any cost or management resource considerations.

Reporting responsibilities

Audit committees – operating under delegated authority – have a duty to report their activities to the main board. In some countries, committees also have a formal obligation to report to the shareholders.

The board of directors

The formality, detail, and frequency of audit committee reports to the board vary. For example, the board may ask the audit committee to undertake and report to it on a wider review of internal control. The reports should, however, contain an overall summary of committee activities for the period and a series of recommendations. A report in written form is preferable.

The audit committee should use its charter as a guide when preparing a report. If the audit committee intends to make any suggestions requiring substantive action by the board, it should ensure that board members have adequate time to consider the proposals and take appropriate action.

Shareholders

An increasing number of countries require the audit committee to report on behalf of the board to shareholders, for example by having the chairman of the committee report at the annual general meeting, or by including a written summary of activities in the annual report. In the USA, a letter from the audit committee must be included in the annual report or proxy statement. The European Union has proposed that listed companies include a corporate governance statement in their annual reports to shareholders.

Good practice is to include in the annual report information on the committee's organisation and membership, its charter and responsibilities, and its principal activities during the year. A suggested list of contents is provided on the next page. This information may be included as part of a wider section in the annual report dealing with the company's governance arrangements.

Opening channels of communication to shareholders underlines the growing belief that audit committees should play a more active role in encouraging greater transparency in financial information reported to the market.

‘Greater transparency about the workings of the audit committee will give greater confidence to shareholders and other users of accounts’

UK Institute of Chartered Accountants deputy president, April 2002

Outline report on activities of the audit committee in the company's annual report to shareholders

Set out below is an illustrative list of suggested contents.

Organisation and role of the audit committee

1. **Composition of the audit committee**
   – Members and secretary – names and appointment (short biographical details may be included)
   – Confirmation that the members of the committee met the definition of independence as required (by the SEC or other national regulation)
   – Appointment process
   – Relevant qualifications, expertise and experience of each member.

2. **Role of the audit committee**
   – Main responsibilities of the audit committee
   – The audit committee's charter (a copy may be included), and any changes made to it.

3. **Resources**
   – Any dedicated resources available to the committee, internal or bought-in.

4. **Remuneration of audit committee members**
   – Remuneration policies in relation to the members of the committee (or cross-refer to the directors' remuneration report, if any).

Principal activities of the committee during the year

5. **Meetings**
   – Number of meetings, and attendance
   – Agenda covered by the meetings.

6. **Financial reports**
   – Description of activities carried out to monitor the integrity of the financial reports
   – Confirmation that the committee reviewed and discussed with management and the external auditor the financial statements and supporting management commentary
   – Confirmation that the committee discussed with the external auditor any other matters required to be discussed by relevant law or regulation
   – The committee's recommendation to the board of directors on whether the board should approve the audited financial statements.

7. **Risk management and internal control**
   – Description of the committee's review of the company's systems of risk management and internal control, as they affect financial reporting.

8. **External auditors**
   – Procedures adopted to review the independence of the external auditors, including any policies on the provision of audit and non-audit services
   – Confirmation that the committee received from the external auditors a written disclosure of the auditor's independence, if applicable, and discussed with the auditors their independence from the company and management
   – Description of the committee's oversight of the external audit process, and confirmation that the external auditors' performance was reviewed
   – The committee's recommendation to the board on the appointment of the auditors and, if applicable, the process adopted to select new auditors.

9. **Internal audit function**
   – Any reviews carried out of the plans and work of the department. If there is no internal audit function, an explanation of the committee's consideration of whether such a function is needed
   – Description of the committee's oversight of the internal audit function and whether any review of its performance was performed.

Maintaining and measuring effectiveness

Maintaining the quality of the audit committee's deliberations, and effective oversight of financial matters, requires the committee to direct continuous attention to:

- Understanding business issues
- Communicating regularly with management and the auditors
- The ongoing training needs of committee members
- Evaluating its own performance.

The requirements to obtain a good understanding of business issues, and to communicate and work with management and auditors, were dealt with in earlier sections of this booklet. This section focuses on the areas of training and assessing performance.

Training needs

Audit committee members should maintain their knowledge and skills on a regular basis. Additional training should be given on joining the committee. Subjects for continuing training that may be appropriate include:

- Financial and risk management
- Treasury operations and controls
- Accounting and corporate reporting developments
- Regulatory requirements applicable to the company, including company law
- Developments in wider business sector trends, public policy and corporate governance.

Unless such matters are already addressed by management, the external auditors should provide guidance on developments in accounting and auditing. Other requirements could be met by attendance at external courses and seminars.

Comments we have received from business executives indicate that the areas of financial risk management (especially treasury operations and the potential impact of complex financial instruments) and changes in accounting standards (particularly when many or all standards change at the same time) are two areas where information and training may be particularly valuable.

‘Audit committees shall be aware that the maintenance of professional competence requires a continuing reasonable awareness of developments and best practice in accounting, auditing and internal control, including relevant national and international pronouncements’

European Investment Bank, February 2002

Evaluating performance

Recent pronouncements on corporate governance have emphasised the need for boards and board committees to be able to demonstrate a high level of professionalism. This is reflected not only in recommendations for more training, but also for evaluating performance on a regular basis.

Evaluation can take place at the level of reviewing the performance of individual committee members, and assessing the effectiveness of the committee as a whole.

Reviews of performance could take place on the basis of self-assessment or by some means of independent or facilitated review. In the case of a review of the committee as a whole, an exercise supervised by an outside facilitator is likely to be most beneficial. The views of the external auditors can be helpful to the committee in assessing its own performance.

Any process for evaluating performance will not be successful unless an action plan is implemented to respond to areas identified for improvement.

Individual members

The chairman of the audit committee or the board should periodically review the performance of each audit committee member. Consideration should be given to an individual's:

- Business knowledge
- Specific areas of expertise
- Objectivity and independence
- Understanding of the duties and responsibilities of the committee
- Willingness to devote time to preparing for meetings
- Attendance at meetings.

Collective performance – does your committee measure up?

To assess its effectiveness, the committee should periodically (for example, annually) review what it has accomplished and whether it has fulfilled its responsibilities. One way a committee can assess itself is by evaluating its activities against its charter. The results of the evaluation should be discussed with the board. Among the topics to consider are the composition of the committee, conduct of meetings, activities, and relationships with auditors and management.

Audit committees should also take advantage of opportunities to benchmark their organisational procedures and activities with committees in similar companies. Conferences and seminars provide opportunities to network and learn from the experience of others.

Useful guidance is available on how to evaluate the audit committee's activities. The following pages provide a suggested audit committee work programme and self-assessment guide. A similar guide in also included in our report for the US Institute of Internal Auditors Research Foundation, entitled *Improving Audit Committee Performance: What Works Best, 2nd edition.*

Audit committee work programme and self-assessment guide: *Does your committee measure up?*

This guide can be used by audit committees, periodically, to determine how effectively they are meeting their responsibilities. It reiterates the good practice features discussed in this publication, and indicates who should be involved in each step.

It also contains a work plan which can be completed each year. Cross-references are provided to the relevant part of the Example Audit Committee Charter presented on pages 13 to 16.

To use the guide, indicate whether the practices in each of the following areas are currently being followed (yes or no). Also list suggested follow-up steps, if any.

Ref to charter	Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up steps necessary
	Authority			
2.1	Obtained board authority to perform activities within its terms of reference.	**Board**		
2.4	Has unrestricted access to members of management, employees and relevant information.	**Management**		
2.5,2.6	Has authority to establish procedures to deal with concerns of employees and complaints received by the company regarding accounting, internal control and auditing matters.	**Board**		
2.7,2.8	Received board authority to be responsible for appointment, compensation, retention and oversight of the work of the external auditor as well as approval of non-audit services.			
	Organisation – membership			
-	The board periodically reviews the mix of experience and skills of committee members to maintain an appropriate balance.	**Board/ chairman of committee**		
3.1	Committee members are appointed by the board or a nominating committee of the board.	**Board**		
3.2	The size of the committee is appropriate to the organisation.	**Board**		
3.2	[The majority of] [All] committee members are independent of management according to the regulatory / stock exchange definition and requirements.	**Board**		

Ref to charter	Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up steps necessary
3.4,3.5	The experience and qualifications of committee members are compatible with the duties of the committee, including the ability to understand financial statements. At least one of the members has accounting or related financial expertise.	**Board/ chairman of committee**		
3.6	Members serve an appropriate term of office.	**Board**		
	Organisation – meetings			
3.8, 3.9	Only committee members are entitled to attend meetings. Senior management and external and internal auditors are invited to attend meetings as necessary.			
3.10, 3.11	The committee meets regularly, with special meetings called as circumstances warrant. (At least 3 or 4 meetings each year are desirable.)			
3.12	Meeting agendas and supporting papers are prepared and distributed sufficiently far in advance to enable committee members to prepare for meetings.	**Committee secretary**		
3.13	Minutes of meetings are circulated on a timely basis to members of the board, audit committee, (and external and internal auditors where appropriate).	**Committee secretary**		
3.14	The chairman or another member of the committee attends the board meeting at which the financial statements are approved.	**Board/ chairman of committee**		
3.15	Members of the committee attend every meeting.			
3.16	The committee meets with in-house legal counsel on a regular basis.	**Legal counsel**		
-	New committee members are provided with sufficient background information and training to meet their responsibilities effectively.	**Chairman of committee/ committee secretary**		
-	The committee has adequate resources to discharge its responsibilities.	**Chairman of committee**		

The following part of the guide can be used as an annual work plan

Ref to charter	Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up steps necessary
	Internal Control			
4.1	Evaluate the 'control culture' established by management.			
4.2, 4.3	Understand the control systems implemented by management for approval of transactions, recording of data, and compliance of the financial statements with relevant standards and requirements.	**Management**		
4.4	Consider whether internal control recommendations made by external and internal auditors have been implemented by management.	**Management**		
4.5	Consider how management has reviewed the adequacy of controls surrounding electronic data processing and computer security.	**Management/ IT department**		
	Financial reporting			
4.6	Review the areas of greatest financial risk and how management is dealing with them.	**Management/ treasury**		
4.7	Review significant accounting and reporting issues and understand their likely impact on the financial statements.	**Management/ external auditors**		
4.8	Oversee the periodic financial reporting process and review the interim financial statements, annual financial statements and preliminary announcements prior to their release.			
4.9	Review management process for ensuring information contained in analyst briefings and press announcements is consistent with published financial information.	**Management**		
4.10	Meet with management and external auditors to review the financial statements and results of the audit.	**Management/ external auditors**		

Ref to charter	Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up steps necessary
4.11	Ensure that significant adjustments, unadjusted differences, disagreements with management and critical accounting policies have been discussed with external auditor.	**External auditors**		
4.12	Consider whether the narrative information included in the other sections of the annual report is understandable and consistent with the information in the financial statements.	**Management/ external auditors**		
-	Read the representation letters given by management to the external auditors and consider any specific representations therein.	**External auditors**		
	Compliance with laws & regulations			
4.13	Review management's procedures for monitoring the company's compliance with laws and regulations.	**Management**		
4.14	Review updates from management and legal counsel regarding compliance matters that may affect the financial statements.	**Management/ legal counsel**		
4.16	Review the findings of any examinations by regulatory agencies.			
	External audit			
4.17, 4.19	Review the qualification, performance and compensation of the auditors and make recommendations on appointment to the board.	**External auditors**		
4.18	Consider the independence of the external auditor, and any conflicts of interest that may arise.	**External auditors**		
4.20	Review the external auditors' proposed audit scope and approach. Enquire into reasons for subsequent changes to the audit plan.	**External auditors**		

Ref to charter	Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up steps necessary
4.21	Discuss any audit problems, including restrictions on the scope of the audit or denials of access to requested information.	**External auditors**		
4.22	Review reports made by the external auditors to management, and ensure that management responds to these findings.	**External auditors/ management**		
4.24	Meet privately with the external auditor on a regular basis.	**External auditors**		
4.25	Review policies for the approval of non-audit services and make recommendations.	**External auditors**		
-	Enquire as to any planned reliance on the work of internal audit by the external auditor.	**External auditors/ internal audit**		
-	Enquire as to the extent to which audit and accounting firms other than the principal auditors are used, and understand the rationale for using them.	**Management**		
	Internal audit			
4.27	Review the activities and structure of internal audit and approve the internal audit charter.	**Internal audit**		
4.28	Review and concur in the appointment, replacement or dismissal of the head of internal audit.	**Management**		
4.30	Meet privately with the head of internal audit on a regular basis.	**Internal audit**		
4.31	Review significant findings resulting from internal audit and ensure that management responds on a timely basis.	**Internal audit/ management**		
4.32	Review the internal audit plan with the director of internal audit, particularly with regard to the involvement in control systems and the financial reporting process.	**Internal audit**		
-	Review the staffing, training and budget of the internal audit function.	**Internal audit/ management**		

Ref to charter	Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up steps necessary
	The committee's own reporting responsibilities			
4.33, 4.34	Report committee activities to the board regularly.	**Board**		
4.35	Ensure that any reports on committee activities required by law and listing rules have been prepared.			
	Evaluating performance			
4.36	Periodically assess the performance of individual members and of the committee as a whole.	**Chairman of committee**		
4.37	Assess the achievement of the duties specified in the charter and report to the board.	**Board**		
	Charter			
4.38	Review the committee charter annually and discuss any proposed changes with the board.	**Board**		
4.39	Ensure the charter is approved/ reapproved by the board.	**Board**		

Appendix

Audit Committees: mandatory or voluntary requirements in 41 major countries

Argentina

Under new regulations (Decree 677/01) audit committees will be mandatory for some listed companies. The regulations set out the duties of audit committees and require that the audit committee should have a majority of independent non-executive directors. The regulations came into force in March 2002, and require companies to establish audit committees no later than 28 May 2004.

Australia

Audit committees will be compulsory for the ASX All Ordinaries Index, which equates to the top 500 companies on the Australian Stock Exchange (ASX), for the first financial year commencing after 1 January 2003. The structure, role and operation of committees must comply with the best practice recommendations determined by the ASX Corporate Governance Council. The Council also provides best practice guidance for other listed companies to set up an audit committee. Listed companies will be required to explain in the annual report any areas of departure from the best practice recommendations, and include reasons for the departure.

The best practice guidance recommends that the audit committee should have at least three members, all of whom should be non-executive directors – the majority should be independent and the chairman should be independent, and not the chairman of the board.

Austria

Audit committees are not a requirement for listed companies. Austrian company law requires that meetings of a committee of the supervisory board (the *bilanzausschuss*) be held to deal with financial reporting matters. All members of the supervisory board have to be independent non-executive directors.

Companies may optionally establish audit committees in accordance with the voluntary *Austrian Corporate Governance Code.*

Belgium

There is no requirement for listed companies to have audit committees. Non-mandatory recommendations have been issued by the Brussels Stock Exchange, drawn up by the Belgian Commission on corporate governance, on how audit committees should conduct their activities. Under the recommendations, membership of the committee should be confined to non-executive directors, with a majority of independent directors.

A new Corporate Governance Law has been enacted, that permits companies to establish audit committees of their boards of directors. Where a committee is established, its roles and responsibilities should be formally defined in the company's statutes.

Brazil

Although audit committees are not required, Brazilian corporate law requires all public companies to establish a *conselho fiscal*. This committee is appointed by the shareholders to evaluate the actions of the board of directors, review the company's financial statements and annual report, and to consider action to be taken in the event of any instances of fraud or error.

In September 2002 the Brazilian Institute of Corporate Governance (IBGC) issued its revised Code of Corporate Governance Best Practices, which recommends that audit committees be established for all companies. Adoption of the code is voluntary. It does not include detailed guidelines on audit committee duties, composition or reporting.

Canada

By law, Canadian public companies are generally required to have an audit committee of at least three members, the majority of whom must be independent. Both the Toronto and Montreal stock exchanges have issued rules requiring listed companies to give a 'statement of corporate governance practices' in their annual reports or information circulars. The statement should normally include discussion of the board sub-committees, including the audit committee, their mandates and their activities.

The Ontario Securities Commission is expected to release rules in 2003 for the role and composition of audit committees. These rules are expected to resemble rules of the American stock exchanges and the provisions of the Sarbanes-Oxley Act 2002.

Chile

Audit committees are only required for banks, in accordance with the Chilean Banking Law and the specific regulations established by the Chilean Superintendence of Banks.

They are not required for other listed companies. However, the law requires large listed companies to establish a special Directors' Committee, with the power to review financial statements prior to publication, examine reports from the external auditors, consider related party transactions, and to review the remuneration policy for executive management. The principal purpose of the Directors' Committee is to safeguard minority interests, and it does not in practice discharge the responsibilities of a typical audit committee.

China

Chinese companies have a two-tier board structure comprising a supervisory board and a management board. In accordance with recent requirements of the China Securities Regulatory Commission (CSRC), the management board must contain a number of independent directors, and Chinese companies may also optionally appoint an audit committee.

If an audit committee is established, the majority of the committee members must be independent directors. One of the independent directors of the committee must be an accounting professional. The principal responsibilities of the audit committee include recommending the appointment or dismissal of the external auditor, supervision of the internal audit function and reviewing financial information and disclosures.

Czech Republic

The *Corporate Governance Code,* approved in 2001, recommends that listed companies set up an audit committee. The code is not mandatory. The Czech Securities and Exchange Commission strongly encourages all companies listed on the Prague Stock Exchange to adopt the Code and to include a statement of compliance in their annual reports. The Code recommends that audit committees should include between three and five members, the majority or all of whom are independent.

Denmark

Audit committees are not a requirement for listed companies. Supervisory boards have legally-defined oversight responsibilities for financial matters, and some listed companies have set up audit committees drawn from members of the supervisory board. For those audit committees established 'voluntarily', there is no tradition of public reporting on their activities.

A special committee of the Copenhagen Stock Exchange has been set up to discuss corporate governance matters – and further pronouncements on audit committees are expected in the next year.

Finland

There is no legal requirement for companies to establish audit committees. Some Finnish companies have two-tier board structures and the supervisory board has oversight responsibilities under law for financial matters. However, more large companies are setting up audit committees on a voluntary basis. There are no general guidelines regarding membership or independence of the audit committee. The Helsinki Stock Exchange does not require listed companies to have an audit committee, but in the event that they do so, prefers that such committees are composed of independent members. Audit committees customarily report to the board, while the supervisory board reports to the shareholders.

France

A series of corporate governance reports in France has recommended the voluntary adoption of audit committees. The Viénot reports of 1995 and 1999, and most recently the *Rapport Bouton* of September 2002, state that each company board should set up an audit committee with a proportion of independent members. The Bouton Report recommends that at least two-thirds of the audit committee members should be independent board directors and that no executive officer be part of its membership. It also recommends that members have appropriate financial expertise.

Currently, these recommendations are voluntary and have not been formalised by incorporation into the law or the Paris Bourse (EuroNext Paris) listing rules. However, companies are recommended by the stock exchange regulator, the Commission des Opérations de Bourse (COB), to state in their annual report the status of implementation of the recommendations and, in the case of non-compliance, why they have not implemented them.

Germany

The Stock Corporation Act in Germany requires public companies to implement a two-tier board system. As a result of the 1998 Corporate Control and Transparency Act (KonTraG), the supervisory board (Aufsichtsrat) is responsible for the appointment of external auditors and for establishing committees of the board for specific purposes, such as forming an audit committee.

A government commission appointed by the Ministry of Justice adopted the *German Corporate Governance Code (Kodex)* in February 2002. Subsequently the Transparency and Disclosure Act (TransPuG) was passed in July 2002, requiring companies by law to give an annual statement of compliance or non-compliance with the code in their reports.

The code recommends the establishment of audit committees, comprising members of the supervisory board, to deal with issues of accounting, auditing (engagement, independence, significant audit matters and audit fees) and risk management. The chairman of the audit committee should not be a former member of the company's management board. The audit committee should report to the supervisory board.

Greece

There is no requirement for listed companies in Greece to have audit committees. New corporate governance legislation enacted in November 2002 requires the presence of independent directors on the board, but there is no specific provision for audit committees.

The Capital Market Commission issued good practice *Principles on Corporate Governance in Greece* for listed companies in 1999 that encourage formation of audit committees. The principles state that audit committees should have clear terms of reference from the board, and should be made up of at least three non-executive directors.

Hong Kong

The Stock Exchange of Hong Kong operates two markets: the Main Board (MB); and the Growth Enterprise Market (GEM). Audit committees are not currently a mandatory requirement for companies listed on the MB, but are a requirement for GEM issuers. GEM audit committees need to be comprised of a majority of independent non-executives (or all independent directors if there are only two members.) For MB issuers, a *Code of Best Practice on Corporate Governance* issued by the stock exchange recommends the establishment of an audit committee and requires listed companies to disclose compliance or non-compliance in their interim and annual accounts with the code.

In January 2002, the Hong Kong Stock Exchange decided to amend the MB rules to make audit committees compulsory. The proposed rule requires the committee to comprise at least three non-executive directors with a majority (including the chairman) being independent non-executive directors. At least one committee member should have an appropriate qualification or experience in financial reporting. Issuers should also disclose information relating to their audit committees in their annual reports. These proposals are intended to be implemented in 2003.

Hungary

There is no code or listing rule requiring listed companies to establish audit committees. Under the Company Law (CXLIV/1997), public limited companies should establish a supervisory board, to be responsible for the supervision of management, it has the right to examine the books and records of the company. The supervisory board is required to submit a written opinion on the financial statements to the general meeting.

India

In February 2000, the Security and Exchange Board of India (SEBI) added a new Clause 49 to its listing rules requiring listed companies to have audit committees comprising three or more non-executive independent directors, at least one of whom should have financial and accounting knowledge. The SEBI rules also provide guidance on the constitution, roles and responsibilities and frequency of meetings for audit committees.

The Companies Bill 2003, which is awaiting enactment, proposes that every public company with a paid-up capital of 50 million rupees should establish an audit committee of the board. The audit committee should consist of no fewer than two independent directors.

Indonesia

Audit committees are mandatory under the listing rules of the Jakarta Stock Exchange, and for large or strategically important state-owned enterprises. In addition, the Indonesian Code for Corporate Governance recommends that all companies should have audit committees. Indonesia has a two-tier board system comprising a board of directors and a board of commissioners. The board of commissioners has the responsibility to establish the audit committee. For listed companies, the audit committee must comprise one independent commissioner (as chairman of the committee) and at least two other external members.

The audit committee reports directly to the board of commissioners. A report of the activities of the audit committee should also be included in the annual report.

Ireland

The Listing Rules of the Irish Stock Exchange currently require Irish listed companies to follow the same Combined Code requirements as UK listed companies. These require companies to include a 'comply or explain' statement of compliance or non-compliance with the code, including the recommendation to establish an audit committee.

A proposed new Companies Bill was published in early 2003. Under its provisions, each public limited company would be required to establish an audit committee composed wholly of independent non-executive directors. Each large private company would also be required either to establish an audit committee, or to explain in its annual report why it had not.

Italy

The Italian Stock Exchange recommends that companies set up a board committee for internal controls (similar to an audit committee). The majority of the 'internal controls committee' is composed of independent directors whose duties include review of the scope of work of the external and internal auditors and reporting to directors on the adequacy of the internal control system.

The Italian corporate governance structure also provides for the position of s*indaci* or 'statutory auditor' in most companies. This individual performs certain legally-prescribed oversight and corporate secretarial responsibilities.

Under new legislation (the 'Vietti law') put forward by the government, companies will in the future have the option of pursuing one of three corporate structures: a unitary board plus board committees such as an audit committee; a two-tier board structure of management and supervisory boards; and the traditional structure of directors plus *sindaci*.

Japan

The Japanese Commercial Code was amended in 2002, with effect from 1 April 2003, to allow large corporations the voluntary option of establishing audit committees. Companies that do not take up this option must continue with the practice of appointing a 'statutory auditor' in addition to the board of directors. The role of the statutory auditor is to monitor the behaviour and activity of the directors. Large corporations (having capital of JPY 500 million or more or liabilities of JPY 20 billion or more) must have a board of at least three statutory auditors, one of whom must be independent.

Companies opting to adopt the new code provision must establish an audit committee, and dissolve the board of statutory auditors. The audit committee is elected by the board of directors, and must consist of at least three directors, a majority of whom should be independent. The audit committee monitors the performance of directors and management, and has the authority to propose the appointment or dismissal of the external auditor to the shareholder's meeting.

Korea

Under the Commercial Code of Korea, audit committees can be established voluntarily by resolution of the board of directors. However, under the Securities and Exchange Act article 191-7, listed companies in KOSDAQ (whose total assets exceed 2 trillion Korean won) should set up an audit committee. The act specifies that the audit committee should comprise at least three directors, two-thirds of whom should be independent non-executives.

Further guidance on how the committee should operate is included in the Securities and Exchange Act. The Commercial Code further specifies that the audit committee should maintain records of its activities and, if significant, should report them at shareholder meetings.

Luxembourg

Audit committees are not a requirement for listed companies. Luxembourg commercial law does not recognise the audit committee as a separate body within the company.

However, the banking supervisor has issued a circular (98/143) that encourages the establishment of an 'audit committee' in banks. The audit committee is composed of at least three members of the board of directors who are not involved in managing the business. The audit committee deals principally with internal audit matters – external and internal auditors may participate in the meetings.

Malaysia

The Kuala Lumpur Stock Exchange (KLSE) has required listed companies to have audit committees since 1993. The listing rules were revised in 2001 and now require audit committees to have at least three members, a majority of whom must be independent directors. The chairman of the audit committee must be an independent director and at least one member of the committee should have an accounting or financial background. Companies are required to include in their annual reports a narrative statement of how they have applied the principles set out in the *Malaysian Code on Corporate Governance,* and a statement of compliance or non-compliance with the best practices outlined in the code. Reasons should be given for any non-compliance.

The KLSE listing requirements also state that company annual reports must include a report by the audit committee, disclosing: committee composition; terms of reference; number of meetings held in the year; summary of activities and an explanation of the mechanisms (including internal audit) that enable the committee to discharge its responsibilities effectively. If the audit committee is of the view that any matter reported to the board of directors has not been satisfactorily resolved, resulting in a breach of the listing requirements, the audit committee is required to report such matters to the KLSE promptly.

Mexico

In 2001 the Securities Market law *(Ley Del Mercado De Valores)* was issued by the Mexican Securities Commission. It requires that listed companies establish an audit committee with a majority of independent directors. As a general rule, the chairman of the audit committee should be an independent director.

The *Code of Best Practices* issued alongside the law recommends that the audit committee should number between three and seven persons. The law and the code indicate the role and responsibilities of the committee, including: recommending to the board the appointment and terms of service of the external auditor; assisting the board in reviewing financial information for publication; and helping to oversee the internal control systems and evaluating their effectiveness.

Netherlands

A voluntary code of practice – the *Peters Committee report* – was published in 1997 and contains 40 recommendations regarding corporate governance for listed companies in the Netherlands. It recommends the appointment by the supervisory board of directors (many large Dutch companies have a two-tier board structure) of an independent audit committee, composed of members of the supervisory board.

Compliance with the Peters recommendations is not mandatory, but most large companies have adopted the recommendations.

A new Corporate Governance Committee (the Tabaksblat Committee) was recently established. Its draft report, published in July 2003, recommends listed companies should establish an audit committee under the supervisory board. The report also recommends the corporate law be changed to include a requirement that listed companies give a statement of compliance or non-compliance with the Tabaksblat Code.

New Zealand

Audit committees are not currently a requirement for listed companies. However, in 2002 the New Zealand Stock Exchange issued a proposed rule change on corporate governance. The proposed rule incorporates a *Corporate Governance Best Practice Code* and requires all listed companies to have an audit committee comprising at least three directors, with a majority of independent directors. At least one member of the committee should have an accounting or financial background. No implementation date for the proposed rule has yet been announced.

Norway

There is no requirement, either in law or in listing rules, for listed companies to have an audit committee. However, voluntary guidance on corporate governance is expected to be introduced during 2003.

Poland

The law requires companies to have a two-tier board structure, with a management board and a supervisory board. The Warsaw Stock Exchange issued a voluntary corporate governance code *Best Practices in Public Companies in 2002.* The code does not specify the need for audit committees but it defines responsibilities for the supervisory board that are similar to audit committee responsibilities. At least half of the members of the supervisory board should be independent members. The management board has to state whether the company complies with the voluntary corporate governance code.

In practice, some of the larger and more progressive organisations have established sub-committees of the supervisory board to carry out responsibilities similar to those of an audit committee (based on a charter that blends local legal requirements and Polish and international good governance practices).

Portugal

Listed companies are not required to have audit committees. By law, companies have to follow a different model by which the shareholders establish a 'fiscal board', comprising certified auditors, as well as the management board. Companies may also voluntarily establish an audit committee, as a committee of the management board.

Rules issued by the securities regulator, the Comissão do Mercado de Valores Mobiliários require listed companies to include in their annual reports disclosures relating to their governance.

Russia

A *Corporate Behaviour Code* was developed through the efforts of regulators, the business community and professional advisers, and recommended by the government in 2001. Compliance with the code is voluntary. The code recommends that boards of directors establish an audit committee for the purposes of implementing and monitoring controls over the financial and business activities of the company.

The Code recommends that the audit committee should consist wholly of independent directors. If this is not possible, the audit committee should be chaired by an independent director. Members of the audit committee should understand the basics of financial accounting and reporting.

Singapore

The audit committee is a requirement of the Singapore Companies Act. There is also a *Code of Corporate Governance* (CCG) that provides guidance and best practices on how audit committees should conduct their activities. Though compliance with the code by companies listed on the Singapore Stock Exchange (SGX) is voluntary, the SGX requires companies to disclose the extent of compliance or non-compliance from 1 January 2003 onwards. Companies must also disclose their corporate governance practices, in their annual reports, with specific reference to the code.

The CCG states that the audit committee should comprise at least three non-executive directors, the majority of whom, including the chairman, should be independent. Two of the members should have accounting or related financial management expertise or experience.

South Africa

The *Code of Corporate Practices and Conduct* contained in the King report (the *King Code 2002*) recommends the appointment of an audit committee comprising a majority of independent non-executive directors. The chairman of the audit committee should be an independent non-executive (though not also the chairman of the board) and should attend the general meeting to respond to questions from shareholders about the committee's activities. The majority of the audit committee's members should be financially literate.

All companies with securities listed on the Securities Exchange South Africa (JSE), and some other types of organisations, are expected to adhere to the provisions of the *King Code 2002*. Companies should provide a narrative statement of how they have applied the principles set out in the code, together with a statement of compliance or non-compliance with the code. Other regulatory bodies, such as the Registrar of Banks, also require audit committees that meet certain prescribed criteria.

Spain

The *Law on Measures relating to the Reform of the Financial System* (Law 44/2002, effective November 2002) requires that companies whose shares or debentures are listed on an official market should have an audit committee. Non-executive directors, appointed by the board of directors, should comprise the majority of the audit committee.

The detailed responsibilities of the committee should be set out in company articles of association, but should at a minimum include: oversight of the company's reporting processes and internal control systems; supervision of internal audit; communications with the external auditor; recommending the appointment of the external auditor to the board; and reporting to the general meeting on matters regarding the committee's responsibilities.

The National Securities Market Commission (CNMV) has also issued a 'standard report on governance in listed companies', for use by those companies that have implemented the recommendations in the voluntary *Corporate Governance Code* ('Olivencia report').

Sweden

Neither the law nor the listing rules of the Stockholm Stock Exchange require audit committees for listed companies. The Swedish Shareholders' Association has proposed a voluntary corporate governance code *Corporate Governance Policy – Guidelines for Better Control and Transparency for Owners.* It recommends that the board should appoint an audit committee from among the non-executive board members. The committee should consist of a minimum of three members. Guidance is also given on the committees' responsibilities, particularly the relationship with the external auditors.

In late 2002 the government appointed a Trust Commission to report on various matters including corporate governance. The commission's report, to be delivered in October 2003, may include recommendations in relation to audit committees, but these are unlikely to be incorporated in the law.

Switzerland

Audit committees are not a legal requirement. However in July 2002, the Swiss Exchange (SWX) issued a directive requiring listed companies to disclose information on their corporate governance practices in their annual reports, including information on the activities of board committees.

In addition, a *Swiss Code of Best Practice for Corporate Governance* has been published. It recommends that boards of listed companies should set up audit committees. The audit committee should consist of non-executive, preferably independent, members of the board. A majority of its members, including the chairman, should be financially literate.

Taiwan

Audit committees are not mandatory for listed companies. However, the Taiwan Security and Exchange Committee (SEC) requested that all listed companies have independent non-executive directors with a financial or legal background on their boards.

Corporate structure in Taiwan also provides for the position of 'supervisor'. This individual performs certain oversight responsibilities with respect to the board of directors and the external auditors, but these functions are not clearly identified by company law or SEC regulations.

Thailand

The Stock Exchange of Thailand (SET) has issued guidelines that require listed companies to establish an audit committee of the board of directors. The committee should comprise a minimum of three independent directors, at least one of whom should be a financial or accounting expert.

A notification by SET prescribes the duties and responsibilities of audit committees, including the requirement to disclose their supervisory activities in the company's annual report.

Turkey

Audit committees became a requirement for listed companies from 1 January 2003, in accordance with a communiqué issued by the Capital Markets Board (CMB). The CMB requires audit committees to have at least two members, with a majority being independent (if only two, both must be independent.) The findings and recommendations of the audit committee should be reported to the board of directors.

The Corporate Governance Workshop Group of TUSIAD (Turkish Society of Industrialists) has drafted a code of corporate governance that is expected to become effective in the near future. According to the draft code, the audit committee should comprise three members and all should be independent. Committee members should have an adequate knowledge of finance, accounting and basic company law.

United Kingdom

The Financial Services Authority requires UK listed companies to make a statement of compliance with the Combined Code on Corporate Governance in their annual reports. A new version of the Combined Code was published in July 2003. It incorporates the key recommendations of the Audit Committees Combined Code Guidance ('Smith Report'), published in January 2003.

The Code recommends establishment of an audit committee comprising at least three, or in case of smaller companies two, members. All members of the committee should be independent non-executive directors and the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

Although, strictly, the Code is voluntary, the public disclosure requirement has the effect of requiring UK listed companies to justify not having an audit committee. The new Code will apply for reporting periods beginning on or after 1 November 2003.

United States of America

The American and New York Stock Exchanges require listed companies to have an audit committee, as does the National Association of Securities Dealers (NASD). Banks and savings institutions are also required to have audit committees under the Federal Deposit Insurance Corporation Improvement Act.

Rules issued by the Securities and Exchange Commission to implement provisions of the Sarbanes-Oxley Act 2002 require audit committee members to meet specified independence criteria and carry out specified responsibilities. Audit committees must comply with the new rules by the earlier of their first annual shareholders' meeting after 15 January 2004, or 31 October 2004.

The rules also apply, with limited dispensations, to foreign private issuers listed on the US markets, with compliance required by 31 July 2005.

Appendix

Stock exchange requirements for audit committees

The table below summaries the requirements of major stock exchanges for audit committees. These reflect the latest rules – in some cases the rules are not yet fully effective.

Required by listing rules	**US**	**US**	**UK (1)**	**Hong Kong**		**Germany**	**France**	**Japan**
	New York Stock Exchange (NYSE)	**NASDAQ**	**London Stock Exchange**	**MB Market**	**GEM Market**	**Deutsche Boerse (3)**	**EuroNext Paris (4)**	**TSE (5)**
Audit committee	Yes	Yes	Comply or explain	Yes (2)	Yes	Comply or explain	Voluntary	Voluntary
Independent members	All members	All members (6)	All members	Majority (2)	Majority	-	-	-
Number of members	At least three	At least three (6)	At least three (7)	At least three (2)	At least three (2)	-	-	-
Financial expertise	At least one	At least one	At least one	At least one (2)	At least one (2)	-	-	-
Public reports by committee	Yes	Yes	Yes	Not specified	Not specified	-	-	-

1) The Financial Services Authority (FSA) is responsible for the listing rules of the London Stock Exchange (LSE). The FSA requires UK listed companies to make a statement of compliance with the Combined Code, which recommends establishment of an audit committee in their annual reports. The table reflects the provisions of the new Combined Code on Corporate Governance published in July 2003. The new Code will apply for reporting periods beginning on or after 1 November 2003.

2) Information based on draft revisions of the listing rules, which are intended to be implemented in 2003.

3) Audit committees are not required by stock exchange rules of the Deutsche Boerse, but listed companies are required by law to state whether they comply with the Kodex (which recommends establishment of audit committees).

4) EuroNext Paris does not require the establishment of audit committees, but the French exchange regulator (COB) has recommended listed companies to state the status of implementation of audit committees in their annual reports.

5) Audit committees are not required by the rules of the Tokyo Stock Exchange (TSE), but may optionally be established under the Commercial Code.

6) With exceptions for small business filers.

7) In the case of smaller companies the required number of members is at least two.

Appendix

UK Combined Code requirements – audit committees

The Financial Reporting Council published a new version of the UK Combined Code on Corporate Governance on 23 July 2003. The Code incorporates guidance on audit committees (the 'Smith Guidance') developed by a group chaired by Sir Robert Smith. The new Code will apply for reporting periods beginning on or after 1 November 2003. The requirements from the Code in relation to audit committees are shown below. UK listed companies that do not comply with these provisions should include an explanation as to why they have not done so in the statement of compliance required by the listing rules.

Main principle

The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code provisions[1]

Establishment and role

- The board should establish an audit committee of at least three, or in the case of smaller companies[2] two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

- The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

  - to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them

  - to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors or by the board itself, the company's internal control and risk management systems

  - to monitor and review the effectiveness of the company's internal audit function

  - to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor

  - to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements

[1] The Smith guidance issued with the Code suggests means of applying these Code provisions.
[2] A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

– to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm

– to report to the board, identifying any matters in respect of which it considers that action or improvement is needed, and making recommendations as to the steps to be taken.

Relationship with the board

- The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.[3] A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

Whistleblowing

- The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. 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.

The internal audit process

- The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

The external audit process

Appointment

- The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or reappointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

Independence, including the provision of non-audit services

- The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

[3] The requirement to make the information available would be met by making it available on request and by including the information on the company's website.

Appendix

US Sarbanes-Oxley Act and NYSE listing rules

Sarbanes-Oxley Act

The Sarbanes-Oxley Act was enacted on 30 July 2002. The Act establishes new standards for corporate accountability that significantly impact on the audit committee's responsibilities. In many instances, the Act directs the Securities and Exchange Commission (SEC) to adopt required rules.

The following are key sections which affect the role and responsibilities of the audit committee, based on the related SEC rules.

Section 202 – Pre-approval requirements

- Effective 6 May 2003, all auditing services and non-audit service provided to issuers by the auditor of the issuer shall be pre-approved by the audit committee of the issuer

- The pre-approval requirement is waived with respect to the provision of non-audit services if:

  – the aggregate amount of all non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the non-audit services are provided;

  – such services were not recognised at the time of the engagement to be non-audit services; and

  – such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee to whom authority to grant such approvals has been delegated by the audit committee

- Approval by an audit committee of a non-audit service to be performed by the auditor shall be disclosed to investors in periodic reports, as well as the audit committee's pre-approved policies and procedures.

Section 204 – Auditor reports to audit committees

- Effective 6 May 2003, each registered public accounting firm that performs for any issuer any audit required shall timely report to the audit committee of the issuer:

  – all critical accounting policies and practices to be used;

  – all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

  – other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

Section 205 – Confirming amendments

- The term 'audit committee' means:
  - a committee (or equivalent body) established by and among the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
  - if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

Section 301 – Public company audit committee

Audit committees must comply with these rules by the earlier of the first annual shareholders' meeting after 15 January 2004 or 31 October 2004.

Responsibilities

- The audit committee, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work and each such registered public accounting firm shall report directly to the audit committee.

Independence

- Each member of the audit committee shall be a member of the board of directors and shall otherwise be independent
- In order to be considered to be independent, a member of an audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:
  - accept any consulting, advisory or other compensatory fee from the issuer
  - be an affiliated person of the issuer or any subsidiary thereof.

Complaints

- Each audit committee shall establish procedures for:
  - the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters; and
  - the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

Authority to engage advisers

- Each audit committee shall have the authority to engage independent counsel and other advisers as it determines necessary to carry out its duties.

Funding

- Each issuer shall provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation:
  - to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and
  - to any advisers employed by the audit committee.

Section 302 – Corporate responsibility for financial reports

Effective 29 August 2002, the quarterly and annual certifications required of CEOs and CFOs state that:

- The signing officers have disclosed to the issuer's auditor and the audit committee:
  - all significant deficiencies in the design or operation of internal controls (specifically those relating to financial reporting) which could adversely affect the issuer's ability to record, process, summarise, and report financial data, and has identified for the issuer's auditors any material weaknesses in internal control
  - any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

Section 407 – Disclosure of audit committee financial expert

- Beginning in their annual reports for fiscal years ending on or after 15 July 2003, each issuer must disclose whether or not, and if not, the reasons why not, the audit committee of that issuer has at least one member who is a financial expert, as such term is defined by the US Securities and Exchange Commission.

Summary of NYSE listing rules

In August 2002, the NYSE submitted proposed listing standards to the SEC. Following various changes, a further amended rule proposal was submitted to the SEC in April 2003. The SEC has not yet approved the rules. The proposed NYSE standards have implications for boards and audit committees. The proposed standards include additional independence requirements for audit committee members and extension of the audit committee charter.

Membership

- Each company is required to have a minimum three-person audit committee, composed entirely of independent directors.

Charter

The committee must have a written charter that addresses:

- The committee's purpose, which, at a minimum, must be to:
  - assist the board oversight of:
    - the integrity of the company's financial statements
    - the company's compliance with legal and regulatory requirements
    - the independent auditor's qualifications and independence
    - the performance of the company's internal audit function and independent auditors; and
  - prepare the report that is required by the SEC's proxy rules to be included in the company's annual proxy statement, or, if the company does not file a proxy statement, in the company's annual report filed on Form10-K with the SEC
- The duties and responsibilities of the audit committee; and
- An annual performance evaluation of audit committee.

Duties and responsibilities

The audit committee must:

- Directly appoint, retain, compensate, evaluate and terminate the company's independent auditors
- Establish procedures for the receipt, retention and treatment of complaints on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters
- Obtain advice and assistance from outside legal, accounting or other advisers as the audit committee deems necessary to carry out its duties, and
- Receive appropriate funding, as determined by the audit committee, from the listed company for payment of compensation to the outside legal, accounting or other advisers employed by the audit committee.

Additional duties and responsibilities

The duties and responsibilities of the audit committee must be, at minimum, to:

- At least annually obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality – control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company

- Discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under 'Management's Discussion and Analysis of Financial Condition and Results of Operations'

- Discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies

- Discuss policies with respect to risk assessment and risk management

- Meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors

- Review with the independent auditor any audit problems or difficulties and management's response

- Set clear hiring policies for employees or former employees of the independent auditors

- Report regularly to the board of directors.

Internal audit

- Each listed company must have an internal audit function.

Other publications

The following publications on corporate practices and International Financial Reporting Standards have been published by PricewaterhouseCoopers and are available from your nearest PricewaterhouseCoopers office:

- The Board Agenda – Good Practices for Meeting Market Expectations
- Reporting Progress – Good Practices for Meeting Market Expectations
- World Watch – Newsletter on Governance and Corporate Reporting
- International Accounting Standards – A Pocket Guide
- International Financial Reporting Standards – Illustrative Bank Financial Statements
- International Financial Reporting Standards – Illustrative Corporate Financial Statements
- International Financial Reporting Standards – Disclosure Checklist
- International Accounting Standards – Understanding IAS 29
- International Accounting Standards – Understanding IAS 39
- International Accounting Similarities and Differences – IAS, USGAAP and UKGAAP

The latest news, discussions and IFRS publications issued by PricewaterhouseCoopers can be found at www.pwc.com/ifrs

The following publications, which can be obtained online, contain comprehensive descriptions of the US Sarbanes-Oxley Act, related SEC rules, and proposed US exchange rules, as well as impacts on audit committees:

- Current developments for Audit Committees 2003 – available at www.pwc.com/uscorporategovernance
- Sarbanes-Oxley Act of 2002 – Current Proposals by NYSE, Amex and NASDAQ; Board and Audit Committee Roles in the Era of Corporate Reform – available at www.cfodirect.com
- Sarbanes-Oxley Act of 2002; Strategies for Meeting New Internal Control Reporting Challenges – available at www.cfodirect.com

Notes

www.pwc.com/corporatereporting