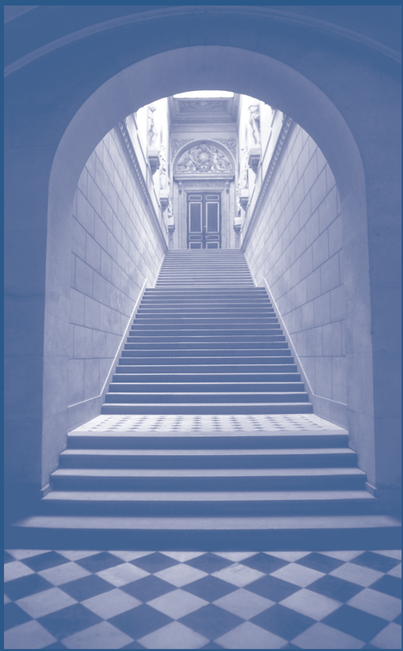
Audit Committees

Good Practices for Meeting Market Expectations



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PricewaterhouseCoopers (www.pwcglobal.com), the world's largest professional services organisation, helps its clients build value, manage risk and improve their performance.

Drawing on the talents of more than 150,000 people in 150 countries, PricewaterhouseCoopers provides a full range of business advisory services to leading global, national and local companies and to public institutions.

These services include audit, accounting and tax advice; management, information technology and human resource consulting; financial advisory services including mergers & acquisitions, business recovery, project finance and litigation support; business process outsourcing services; and legal services through a global network of affiliated law firms.

PricewaterhouseCoopers refers to the member firms of the worldwide PricewaterhouseCoopers organisation.

Preface

There is a recognition by business communities across the world that, if companies are to attract long-term capital, they need to demonstrate transparency both in their internal structures and in their communications with the market. Today's boards of directors are clearly being held to a high standard of performance.

A resourceful and dedicated Audit Committee, given full support by management, can enhance the credibility of businesses' communication and help to promote effective internal control. This booklet, *Audit Committees: Good Practices for Meeting Market Expectations,* is designed to assist existing and new committees in reacting to market demands for improved oversight of the financial reporting process.

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

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Why Audit Committees Matter

While audit committees have been established in some markets for many years, they are now becoming even more widely recognised as a key force in protecting the interests of investors and assisting the communication process.

At PricewaterhouseCoopers we firmly support the valuable role which audit committees can play – through effective and informed oversight – in helping to ensure high quality financial reporting, as well as effective internal control. We believe that every company listed on world equity markets should aim to have an audit committee with the type of good practice features described in this booklet.

We also believe that shareholders 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 critical questions of management. And if there is an audit committee, does it measure up?

Importance of Independent Oversight

There is a growing recognition of the role independent directors can play in providing a bridge between management and shareholders, notably in the areas of external financial reporting and internal controls. The existence of an audit committee to take prime responsibility for such matters can ease the pressure on management and on a busy board of directors. It can also provide an important focus for discussions with the company's internal and external audit functions.

Audit committees have been a feature of the American corporate scene for over two decades. They are now an increasingly common feature of companies in Europe, South Africa, Asia and the Pacific Region.

A survey of audit committee practice in major European companies undertaken by PricewaterhouseCoopers in 1997 found that, despite the absence of formal legal or stock exchange requirements in almost all countries, there was a high rate of voluntary adoption. Over 60% of the companies in the survey had audit committees, with adoption rates highest in the United Kingdom, followed by France and Switzerland.

The inspirational Cadbury Code of Best Practice in Britain, and the many equivalent codes in countries around the world, include recommendations relating to the establishment of audit committees (see opposite). As leading companies in these countries adopt the recommendations, the practices may be expected to spread to those territories and those companies not yet covered by similar codes of practice.

Pronouncements by government authorities, regulators and international bodies (for example, the European Commission) indicate that they view audit committees as a potentially powerful tool which can reinforce the independence of external auditors. The involvement of independent directors in the oversight of financial reporting and internal control matters is also encouraged in the developing international frameworks of corporate governance principles, for example those of the Organisation for Economic Co-operation & Development (OECD), the International Corporate Governance Network, and by a leading American proponent of improved corporate governance, CalPERS (the California Public Employees' Retirement System).

"While the responsibility for financial reporting, remuneration and nomination are those of the board as a whole, independent non-executive board members can provide additional assurance to market participants that their interests are defended"

OECD Global Corporate Governance Principles

Audit Committees: Mandatory or voluntary requirements in a sample of countries

Australia

The listing rules of the Australian Stock Exchange require companies to give a statement of the main corporate governance practices in place during the reporting period, and specifically whether the company had an audit committee as at the date of the directors' report. If a company does not have such a committee, it must explain why. Interim or preliminary announcements of results must also be accompanied by confirmation of whether the company has a formally constituted audit committee.

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. Further guidance is given in the 1994 "Dey Committee" Report 'Guidelines for Improved Corporate Governance in Canada'.

France

A voluntary code of practice – the "Viénot" Report on the Boards of Directors of Public Companies – was issued in June 1995, sponsored by two leading French employers' federations. It recommended that each company board should set up an audit committee composed of non-executive directors. The audit committee would pay special attention to internal controls and the appropriateness of accounting policies.

The Viénot recommendations have not been formalised by incorporation into Paris Bourse listing rules and adoption of the recommendations remains voluntary.

Germany

Corporate governance requirements, to the extent they exist, are enshrined in law. A Control and Transparency law (the "KonTraG") came into force in May 1998. It includes provisions for a company's Supervisory Board to take responsibility for the appointment of external auditors. External auditors are obliged to participate in the Supervisory Board meeting which reviews the annual financial statements, and to present the audit findings to the Board. Previously, the auditors' relationship was principally with executive management.

Hong Kong

The Hong Kong Stock Exchange has issued a Code of Best Practice on corporate governance. The code is not mandatory but listed companies must disclose compliance or non-compliance with the Code in their interim and annual accounts. The Code includes a recommendation that boards should establish an audit committee whose principal duties are to review and supervise the financial reporting process and internal controls. The audit committee should comprise a minimum of two non-executive directors, a majority of whom should be independent.

Japan

There is no code of corporate governance which commands official stock exchange endorsement. However, in May 1998 the Corporate Governance Forum of Japan, comprising representatives of industry, institutional investors and academics, issued a voluntary code of Corporate Governance Principles. The Forum recommended that, once corporate boards contain a higher proportion of independent directors, audit committees comprising non-executive directors should be established. The committee's functions include reviewing the company's risk management processes and compliance issues.

Netherlands

A voluntary code of practice – the Peters Committee report – was published in June 1997, sponsored by the Amsterdam Stock Exchange. The report recommended that a company's Supervisory Board, or an audit sub-committee of the board, should supervise the quality of external financial reporting, monitor compliance with laws and internal controls, and oversee the external audit relationship.

Compliance by companies with the Peters Recommendations is not mandatory, but companies are expected by the market to explain in annual reports how they have complied with the recommendations.

New Zealand

In January 1999 the New Zealand Stock Exchange amended its listing rules. Annual reports of listed entities are now required to contain "a statement of any corporate governance policies, practices and processes, adopted or followed by the issuer". It is for each issuer to decide what governance policies, practices and processes are appropriate for disclosure.

Singapore

The Singapore Companies Act sets out basic requirements in relation to the composition, duties and responsibilities of audit committees. These are supplemented by a Best Practices Guide on audit committees issued by the Stock Exchange of Singapore. Listed companies are required to disclose the functions of the audit committee in the Directors' Report. In addition, listed companies should disclose, in the annual report, whether and how they have complied with the Best Practices Guide and should provide sufficient disclosure of their corporate governance processes and activities.

South Africa

The "King" Report on Corporate Governance was issued in 1994. This voluntary code recommends the establishment of audit committees comprised of a majority of non-executive directors.

The Johannesburg Stock Exchange requires listed companies to give in their annual reports a statement of compliance or non-compliance with the code recommendations. This has effectively mandated the requirement for an audit committee. Other regulatory entities, such as the Registrar of Banks, also require audit committees that meet certain prescribed criteria.

Thailand

In January 1998 the Stock Exchange of Thailand issued a Notification to listed companies, requiring them to have an audit committee comprising at least three directors, each of whom should be independent and at least one of whom should have knowledge of accounting or finance.

The Notification also sets out seven prescribed duties and responsibilities of audit committees, including the requirement to disclose, as part of a company's annual report, a report on the supervisory activities undertaken by the Committee.

United Kingdom

The 1992 Cadbury Committee report on corporate governance was superseded in June 1998 by the Hampel Committee's "Combined Code". Both voluntary codes recommended the establishment of audit committees comprising at least three non-executive directors, the majority of whom should be independent.

The London Stock Exchange requires UK listed companies to make a statement of compliance with the Combined Code in their annual report. 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.

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 & savings institutions also are required to have audit committees under the Federal Deposit Insurance Corporation Improvement Act 1991. For companies regulated by the FDIC Improvement Act and listed on the NYSE, the committees should comprise wholly of independent directors. In other cases, the requirements will be met if a majority of committee members are independent.

An Evolving Role

Latest developments indicate that the audit committee's role and responsibilities are constantly evolving and expanding. When first established audit committees tended to be responsible simply for:

- reviewing the company's annual audited financial statements and recommending that the board of directors approve them
- overseeing the relationship with the external auditors and internal auditors; and
- reviewing internal control management letters.

New challenges, however, are contributing to an expansion of the role of audit committees. These challenges include:

- Globalisation of markets, which has led to new business opportunities and increased competition
- Increasing use of technology, including networks, the internet, and electronic data interchange, all of which have changed the way organisations use and communicate information
- The increasing complexity of transactions, accounting standards, and regulatory requirements
- Economic difficulties in many parts of the world, and some highly publicised business failures, which have led to a questioning of the credibility of the corporate reporting process
- Heightened interest in the quality of earnings, and the resulting responsibility of management for full and fair disclosure of results and financial condition
- Greater public interest in, and concern about, corporate ethics
- New calls for the oversight of companies' risk management processes

These new challenges have been most keenly felt in the USA. In late 1998, the Chairman of the Securities Exchange Commission (SEC) called for improved board oversight of the financial reporting process of public companies. In response to this concern, various US bodies sponsored the formation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee").

The Committee reported in February 1999 and although the recommendations have yet to be adopted, they do demonstrate the latest thinking in this area. In the appendix to this booklet, the 10 principal recommendations of the US Blue Ribbon Committee are set out in full.

The guiding principles for audit committees, according to the US Blue Ribbon Committee, are common sense fundamentals that apply regardless of an individual company's situation. These include:

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

These principles are developed in the following sections of this booklet. The purpose of this guidance is 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.

However, when properly structured and given a clear mandate, audit committees can be of great benefit to all companies and shareholders. By playing a proactive role, audit committees can enhance the credibility of financial reports and strengthen communication between auditors and management. This will, in turn, improve the quality of information reported to the market.

"experience has shown that... audit committees have proved their worth and developed into essential committees of boards of directors"

European Commission – 1996 Green Paper on Auditing

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 the previous chapter, we summarise the requirements in selected countries to illustrate the range of different approaches. In addition, each audit committee will have different responsibilities, depending on local business culture and the particular needs of the board and management.

In some markets, two-tier board structures are commonplace (for example in Germany and the Netherlands), consisting of a Management Board to take charge of operations, and a Supervisory Board with general oversight responsibilities. In these countries, the membership of the audit committee would logically be drawn from the Supervisory Board. The key requirement is that there should be appropriate independent director involvement in the review of the company's financial reporting process and internal controls.

Regardless of how the functions of the audit committee are organised, there are several steps which companies can take that will contribute to their effectiveness, including:

- Establishing a written charter/terms of reference
- Selecting qualified committee members
- Considering the independence and objectivity of committee members
- Determining the term of office of committee members
- Appropriately scheduling meetings
- Allocating sufficient resources
- Providing an orientation for new committee members

Each of these aspects is discussed in the following pages.

Charter

Audit committees should have a written charter (or terms of reference) that provides a clear understanding of the committee's role. A well-written, detailed charter will provide a framework of the committee's organisation and responsibilities which can be referred to by the board, committee members, management and internal and external auditors.

Consideration should be given to making the charter available to shareholders, perhaps by inclusion in the annual report.

The committee's charter should define:

- Overall purpose and objectives
- Organisation – size, frequency, and timing of meetings
- Roles and responsibilities (including qualifications and terms of office)
- Relationship with management, and internal and external auditors
- Reporting responsibilities
- Authority to conduct special investigations (if appropriate)

The charter should be reviewed and approved (and revised as necessary) by the board.
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. The board should ensure that the charter responds to the company's changing needs.

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
- Periodically (at least annually) reviewed to ensure that the committee's objectives are being met
- Adopted as a framework for reporting the committee's activities to the board

Included on the following pages is an outline of an example 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 will assist the board in fulfilling its oversight responsibilities. The audit committee will review the financial reporting process, the system of internal control and management of financial risks, the audit process, and the company's process for monitoring compliance with laws and regulations and its own code of business conduct. In performing its duties, the committee will maintain effective working relationships with the board of directors, management, and the internal and external auditors. To perform his or her role effectively, each committee member will obtain an understanding of the detailed responsibilities of committee membership as well as the company's business, operations, and risks.

2. Authority

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

- Seek any information it requires from :
  - any employee (and all employees are directed to co-operate with any request made by the audit committee)
  - external parties

- Obtain outside legal or other professional advice

- Ensure the attendance of company officers at meetings as appropriate

3. Organisation

Membership

3.1 The audit committee will comprise [number] members, of which [number] will be non-executive directors

3.2 Each member should be capable of making a valuable contribution to the committee

3.3 [The majority of] / [All] members should be independent of management

3.4 The chairman of the audit committee will be nominated by the board from time to time

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

3.6 A quorum for any meeting will be [number] members

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

Attendance at Meetings

3.8 The audit committee may invite such other persons (e.g. the CEO, CFO, head of internal audit) to its meetings, as it deems necessary

3.9 The internal and external 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. Special meetings may be convened as required. Internal audit or the external auditors may convene a meeting if they consider that it is necessary

3.11 The proceedings of all meetings will be minuted

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 the management of risk and ensuring that all employees have an understanding of their roles and responsibilities

4.2 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

4.3 Gain an understanding of whether internal control recommendations made by internal and external auditors have been implemented by management

Financial Reporting

a) General

4.4 Gain an understanding of the current areas of greatest financial risk and how management is managing these effectively

4.5 Consider with the internal and external auditors any fraud, illegal acts, deficiencies in internal control or other similar issues

4.6 Review significant accounting and reporting issues, including recent professional and regulatory pronouncements, and understand their impact on the financial statements

4.7 Ask management and the internal and external auditors about significant risks and exposures and the plans to minimise such risks

4.8 Review any legal matters which could significantly impact the financial statements

b) Annual Financial Statements

4.9 Review the annual financial statements and determine whether they are complete and consistent with the information known to committee members; assess whether the financial statements reflect appropriate accounting principles

4.10 Pay particular attention to complex and/or unusual transactions such as restructuring charges and derivative disclosures

4.11 Focus on judgmental areas, for example those involving valuation of assets and liabilities; warranty, product or environmental liability; litigation reserves; and other commitments and contingencies

4.12 Meet with management and the external auditors to review the financial statements and the results of the audit

4.13 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

c) Preliminary Announcements, Interim Financial Statements and Analysts' Briefings

4.14 Be briefed on how management develops preliminary announcements, interim financial information and analysts' briefings; the extent of internal audit involvement; and the extent to which the external auditors review such information

4.15 Assess the fairness of the preliminary and interim statements and disclosures, and obtain explanations from management and internal and external auditors on whether:
- Actual financial results for the interim period varied significantly from budgeted or projected results
- Changes in financial ratios and relationships in the interim financial statements are consistent with changes in the company's operations and financing practices
- Generally accepted accounting principles have been consistently applied
- There are any actual or proposed changes in accounting or financial reporting practices
- There are any significant or unusual events or transactions
- The company's financial and operating controls are functioning effectively
- The preliminary announcements and interim financial statements contain adequate and appropriate disclosures

Internal Audit

4.16 Review the activities and organisational structure of the internal audit function and ensure no unjustified restrictions or limitations are made

4.17 Review the qualifications of internal audit personnel and concur in the appointment, replacement, reassignment or dismissal of the director of internal audit

4.18 Review the effectiveness of the internal audit function

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

4.20 Ensure that significant findings and recommendations made by the internal auditors are received and discussed on a timely basis

4.21 Ensure that management responds to recommendations by the internal auditors

External Audit

4.22 Review the external auditors' proposed audit scope and approach and ensure no unjustified restrictions or limitations have been placed on the scope

4.23 Review the performance of the external auditors

4.24 Consider the independence of the external auditor, including reviewing the range of services provided in the context of all consulting services bought by the company

4.25 Make recommendations to the board regarding the reappointment of the external auditors

4.26 Meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed privately

4.27 Ensure that significant findings and recommendations made by the external auditors are received and discussed on a timely basis

4.28 Ensure that management responds to recommendations by the external auditors

Compliance with Laws and Regulations

4.29 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

4.30 Obtain regular updates from management and company's legal counsel regarding compliance matters

4.31 Be satisfied that all regulatory compliance matters have been considered in the preparation of the financial statements

4.32 Review the findings of any examinations by regulatory agencies

Compliance with the Company's Code of Conduct (if appropriate)

4.33 Ensure that the code of conduct is in writing and that arrangements are made for all employees to be aware of it

4.34 Evaluate whether management is setting the appropriate "tone at the top" by communicating the importance of the code of conduct and the guidelines for acceptable behavior

4.35 Review the process for monitoring compliance with the code of conduct

4.36 Obtain regular updates from management regarding compliance

Reporting Responsibilities

4.37 Regularly update the board about committee activities and make appropriate recommendations

4.38 Ensure the board is aware of matters which may significantly impact the financial condition or affairs of the business

Other Responsibilities

4.39 Perform other oversight functions as requested by the full board

4.40 If necessary, institute special investigations and, if appropriate, hire special counsel or experts to assist

4.41 Review and update the charter; receive approval of changes from the board

4.42 Evaluate the committee's own performance on a regular basis

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, which should be outlined in the audit committee's charter.

"While all members of the audit committee must have the ability to ask probing questions about the corporation's financial risks and accounting... a director's ability to ask and intelligently evaluate the answers to such questions may not require 'expertise' but rather hinges on intelligence, diligence, a probing mind, and a certain basic 'financial literacy'"

US Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

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:

- Integrity
- Dedication of time and energy
- Understanding of the business, its products, and its services
- Knowledge of the company's risks and controls
- Inquisitiveness and independent judgment
- Ability to offer new or different perspectives and constructive suggestions

Although not paramount, it is beneficial for at least one member to have accounting or related financial management expertise. This could have arisen through past employment in finance or accounting, a professional qualification in accounting, or any other comparable experience including being a senior officer with financial oversight responsibilities.

It is important that all members have the ability to read and understand basic financial statements, including a company's balance sheet, income or profit statement, and cash flow statement.

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

The board should periodically review the mix of characteristics, experiences, and skills of 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; preparation for, and attendance at, meetings; and informal meetings with other groups.

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 their committee activities. When evaluating potential candidates for the committee, boards will therefore want to consider the number of directorships 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.

Research by PricewaterhouseCoopers in 1997 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. As always, 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.

"A director's greatest virtue is the independence which allows him or her to challenge management decisions and evaluate corporate performance from a completely free and objective perspective. A director should not be beholden to management in any way..."

Chairman of the National Association of Corporate Directors in the USA.

Independent Directors

The audit committee is responsible for overseeing the financial reporting process and, in doing so, it may need to challenge the judgment of management or take positions that may be contrary to those of management. Although the committee reports to the board, it must act in favour of the shareholder body as a whole. Because of this oversight role, independence is an essential quality for audit committee members.

A committee composed wholly of independent directors is optimal.

The concept of independence is not easy to define, though most major investors and representative bodies have developed frameworks or guidance for their own purposes.

Relationships which are sometimes seen in the US markets as impairing an audit committee member's independence include the following:

- Current or prior employment at the company (the period in which the prior employment occurred can vary considerably – it is quite common, however, for investors to concentrate on the last five years)
- Receipt of compensation from the company (or its affiliates) except for director's fees consistent with the committee duties undertaken
- Being a member of the immediate family of the management team
- Being a major shareholder or representative thereof
- Being a director or major shareholder of a significant customer or supplier

A director who has one or more of the above relationships may still be appointed to the audit committee if it is considered that membership is in the best interests of the company and its shareholders as a whole. For clarity, however, the nature of such a relationship which might be seen to prejudice independence and the reasons for appointment should be disclosed to the shareholders.

Term of Office

The number of years that members serve on a committee varies. A common term is one to three years, with possible reappointment for a second term, but longer or open terms are also possible. It is rare for committee members to rotate on a regular basis, hence a programme that evaluates the committee members' performance is useful.

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 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.

The term of office for committee members should be included in the charter.

Meetings

Frequency

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

The number of meetings the committee holds is influenced by its objectives and scope of activities. Holding regular meetings provides the opportunity to review and discuss financial information on a timely basis. It is helpful to schedule most meetings (particularly those at which the financial statements are reviewed) well in advance of the corresponding board meeting, to allow time for making any changes the committee suggests. Generally, meetings correspond with major phases of the financial reporting, external audit, and internal audit cycles.

"... I've heard of one audit committee that convenes only twice a year, before the regular board meeting, for 15 minutes and whose duties are limited to a perfunctory presentation. Compare that situation with the audit committee which meets twelve times a year before each board meeting; where every member has a financial background; where there are no personal ties to the chairman or the company; where they have their own advisors; where they ask the tough questions of management and external auditors; and, where, ultimately, the investor interest is being served"

Arthur Levitt, Chairman, US Securities and Exchange Commission

PRICEWATERHOUSECOOPERS

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

The Audit Committee self-assessment guide on pages 51 to 59 includes a section which could be used as an annual work plan for the committee.

Participants

In addition to 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 external auditors
- Senior management, including the chief financial officer (CFO)

Attendees should be limited to those who are familiar with, or responsible for, the topics on the agenda.

Agenda

To maximise effectiveness, a detailed written agenda should be prepared for meetings. It should be distributed to committee members in advance to allow proper consideration of enclosed papers.

The committee should refer to its charter regularly to ensure that meeting agendas are designed to meet the committee's objectives.

Resources

Audit committees must have access to the resources necessary for them to fulfil their duties. This will usually mean continuing administrative and secretarial support. Occasionally other resources may be required (for example, when conducting special investigations), such as access to legal advisors and other outside specialists.

New Member Orientation

Committee members should be provided with sufficient background information and training. Although they will normally be directors of the board, the amount and nature of information and knowledge which will be required to fulfil their audit committee role will be different to that necessary for their board functions.

The education process should begin as soon as the candidate is appointed to the committee. New members should meet with financial management to 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 49 considers the committee's continuing training needs – "Maintaining Quality".

Background Information for New Committee Members

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

The Company

- The audit committee's charter – its role in overseeing company policies, financial reporting, and other special areas
- The background and qualifications of senior executives and financial management
- The company's financial and operational controls
- Important accounting policies and the reasons for their use
- Any statutory reporting requirements to which the company is subject
- Areas of particular concern to the company, including risk areas
- Foreign and domestic operations
- The company's involvement in litigation
- Contingencies facing the company
- Any planned systems modifications
- Annual and interim earnings trends
- The company's code of conduct and the audit committee's role in overseeing management's monitoring of compliance with that code
- Company staff available to support the audit committee
- External advisors available to support the audit committee

Internal Auditors

- The responsibilities of the internal audit function
- The number of internal auditors and their qualifications
- The reporting relationship of the internal audit department to the audit committee
- The kind of information the audit committee receives from the internal audit department
- The current year's internal audit plan
- Results of independent reviews of the internal audit function

External Auditors

- The scope of the external audit
- The committee's relationship with the external auditors
- The kind of information the audit committee receives from the external auditors
- The types and timing of reports issued by the external auditors

Responsibilities of The Audit Committee

"The mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent and probing in fulfilling its oversight responsibilities"

Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission)

The audit committee normally undertakes, on behalf of the board, responsibility for oversight of internal control, financial reporting 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 of the company's internal control and risk management systems
- Year-end preliminary announcement and financial reporting package, including annual financial statements; any narrative to be given in the annual report on the financial position of the company; significant accounting and reporting issues; and the audit findings, including any significant suggestions for improvements provided to management
- Interim financial statements and the process management uses to prepare such periodical financial information
- Process for monitoring compliance with relevant laws and regulations, and, with the company's legal counsel if appropriate, any legal matters that could have a significant impact on the company's financial statements
- Process for monitoring compliance with any internal code of conduct.

These functions are described in further detail below. A more detailed list of possible committee responsibilities is given in the "Example Audit Committee Charter" on pages 14 to 17.

Internal Control

A well-designed and implemented internal control system provides the right environment for the efficient running of an entity's operations, its compliance with applicable laws and regulations and will reduce the risk of financial statements being materially misstated.

The prime responsibility for good internal control is with the board. However the audit committee's involvement is important and can help to reinforce a strong "control culture" in the business.

The audit committee has oversight responsibility for internal control, exercised through reports from and discussions with management, internal audit, and the external auditors. The audit committee should gain an understanding of the degree to which the internal and external auditors review controls. It should also understand the risks to which the company is exposed and the processes implemented to manage those risks.

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 be briefed on the specific nature of the engagement and should review with the independent accountant the basis for the report.

Audit Committee Responsibilities...

- ✓ Evaluate whether senior management is setting the appropriate tone by communicating the importance of internal control and the management of risk
- ✓ Consider how management is held to account for computer systems and applications, the security of those systems, and contingency plans
- ✓ Gain an understanding of whether internal control recommendations made by internal and external auditors have been implemented by management

Financial Reporting

Annual Financial Statements

The audit committee will review the annual financial statements and assess whether they are complete and consistent with the information known to committee members.

The audit committee should meet with management and the external auditors to review the financial statements for the year 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 preparation of disclosures, going concern disclosures (if applicable), internal controls 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 and/or unusual transactions and to judgmental areas, particularly those areas where different assumptions and judgments could have a significant effect on the financial statements. Examples of such areas include restructuring charges, acquisitions, derivative disclosures, valuation of assets, warranty obligations, environmental liabilities or litigation provisions.

Pages 30 to 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 the annual financial statements and determine whether they are complete and consistent with the information known to committee members. Assess whether the financial statements reflect appropriate accounting principles
- ✓ 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

Preliminary Announcements, Interim Financial Statements and Analysts' Briefings

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 statements within its remit.

There are significant benefits in the audit 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 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.

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 internal and external audit involvement in the review of such information
- ✓ Obtain explanations from management and the auditors as to whether generally accepted accounting principles have been consistently applied, and whether the preliminary announcements and interim financial statements contain adequate and appropriate disclosures

Illustrative Questions for Reviewing Annual 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 adequate and appropriate?
- What significant recommendations have been made to management (by internal and / or external auditors) for improvements to the reporting process? How has management responded? Are there any significant areas that still require attention?
- What evidence has management considered in order to satisfy itself that the business is a going concern (i.e. 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?
- 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?
- What are the overall impressions of the conservativeness or aggressiveness of the accounting policies adopted and the underlying estimates?

C. Financial Statements

- Were there significant financial statement variances between years? What caused these variances?
- Are there any unusual accounting accruals?
- Were there any prior-period adjustments? What were the circumstances?
- Were there any unusual transactions completed during the year that are not evident from the financial statements? How were these transactions 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?
- Are there appropriate disclosures regarding going concern issues?
- Is the company in danger of not complying with the provisions of loan agreements, senior debt, and equity issues?
- How did management satisfy itself about the value of long-term investments?
- Has the company invested in any "exotic" types of financial instruments?
- Has the value of marketable securities or other financial instruments changed significantly since year-end?
- How does the average age of accounts receivable at year-end compare with the preceding year?
- How is the allowance for doubtful accounts determined? Is the collectibility of any large individual amount in question?
- Are any significant or unusual amounts due from officers or employees? Are there any other significant related party transactions?
- 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 consideration was given to possible problems resulting from expropriation of, or restrictions on the use of, assets?
- 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?

D. General Questions

- Are there any problems developing that did not require accounting recognition or disclosure this year, but may next year if conditions do not improve?
- What is your greatest concern about the financial condition of the company?

E. Conduct of the Audit

- Did the actual scope of the audit differ from pre-audit plans? Why?
- Did management restrict or limit the scope of the audit in any way?
- Did management cooperate during the course of the audit and were the auditors provided with appropriate access to management?
- Was there any difficulty in obtaining written representations from the board of directors or executive management?
- Were there any significant adjustments to the financial statements made as a result of the audit?
- Were there any unrecorded adjustments resulting from the audit?

Regulatory, Legal and Tax Matters

The audit committee is generally assigned responsibility for oversight of the company's process for monitoring compliance with laws and regulations which have a financial impact. In this regard, 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 financial statements. This will also involve reviewing regulatory reports received by the company.

Included within this responsibility is consideration of the risk of fraudulent activity occurring. The company should consider whether:

- The appropriate "tone at the top" has been set. The attitude of senior management and the directors through actions and words can be one of the most effective deterrents to fraud and other illegal activity
- There is explicit focus on fraud risk. A process should be established to specifically focus the board's attention on business behaviour and the risk of fraud
- There is effective communication. Open and ongoing communication between management, the board, employees and advisors is an important factor in fraud risk assessment and detection.

Audit Committee Responsibilities...

- ✓ Review system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up of any fraudulent acts or accounting irregularities
- ✓ Obtain regular updates from management regarding compliance
- ✓ Assess whether all regulatory compliance matters have been considered in the preparation of the financial statements
- ✓ Review the findings of any examinations by regulatory agencies

Business Ethics and Corporate Codes of Conduct

There is increasing recognition by companies that a business' reputation 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, it is unsurprising that many more companies are now devoting considerable resources to ethical programmes.

The attitudes and behavior of the board and senior management usually set the tone for the corporate behaviour. Internal control systems are designed primarily to protect against errors or dishonesty, but even the best-designed systems cannot guarantee that the controls will not be violated, misunderstood, or misinterpreted. If the board does not take such control systems seriously or pays little attention to this area, the risk of the systems being misused increases.

Well-defined ethical standards and written guidelines for acceptable business behaviour help establish a climate that encourages accurate financial reporting and a sense of fiduciary responsibility among employees.

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

"It takes 20 years to build a reputation and five minutes to ruin it"

Warren Buffet, Chairman, Berkshire Hathaway Inc

In developing a code, the board will need to ensure that it fits the company's circumstances and takes into account the business environment of the various countries in which it operates. Management may consult the audit committee in designing a code or setting the guidelines for business behavior.

For a code of conduct to be successful, it must not consist merely of 'mission statements' or general text about corporate citizenship. It will cover practical processes and performance measures which allow the company's staff to understand what the overall objectives mean for them. There will also need to be a programme for monitoring compliance with the code and for enforcing instances of non-compliance.

On the following page is a guide to help create a corporate code of conduct.

Audit Committee Responsibilities...

- ✓ Review any steps taken by the board to establish a formal written code of conduct
- ✓ Evaluate whether there is an appropriate "tone at the top" and whether the board emphasises the importance of the code
- ✓ Review the programme for monitoring compliance with the code of conduct
- ✓ Periodically obtain updates from management regarding compliance

Outline of a Corporate Code of Conduct

The overall content of a corporate code of conduct could be broken down into five categories:

- The company's commitment to its employees, shareholders, and communities
- Ethical standards in dealing with customers, vendors and other relevant parties
- Company expectations of management and employees
- The privacy of:
  - Information about outsiders that the company maintains
  - Company information
  - Employee information
- Compliance with laws and regulations

Within these areas the following specific subjects could be included:

- Fiduciary responsibility
- Integrity of advertising
- Acceptable standards for company products and services
- Possible conflicts of interest matters, such as using confidential information to make personal investments, receiving money or gifts from outsiders, borrowing from suppliers, holding outside employment, using company facilities for personal matters, outside interests or relationships or family and business relationships
- Political contributions and activities
- Improper transactions and payments
- Fairness in employee relations
- Employee safety
- Security of company assets and records
- The company's role and that of its employees in community activities

Specific examples should be used to illustrate acceptable and unacceptable behaviour, to ensure that there is a clear understanding of what is meant.

Administrative matters relating to the code might include:

- Channels for communicating information on potential fraud to management (confidentiality and other factors that would encourage uninhibited communications should be considered)
- Mechanisms to follow up on reports of suspected non-compliance with the code to determine exactly what occurred and who was responsible, as well as a means of letting employees know the results of such investigations
- Mechanisms for review and approval of relationships that may appear to be, but are not, conflicts of interest
- An ongoing programme of communicating to employees their responsibilities under the code
- Provisions for continuous monitoring of compliance with the code

Working with Auditors

Internal and external auditors have knowledge and experience that can assist the committee in performing its functions. To fulfil its responsibilities, the audit committee needs to communicate with both groups of auditors.

Internal Auditors

A PricewaterhouseCoopers 1997 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.

"Companies without a strong internal audit function will be unable to provide an audit committee with sufficient information to fulfil its responsibilities"

European Commission – 1996 Green Paper on Auditing

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

Qualifications of the Internal Audit Function

The audit committee should focus attention on the adequacy, qualifications, and abilities of the internal audit staff. 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
- Have appropriate professional qualifications – the company should encourage internal auditors to become members of professional associations, and to seek professional certification where appropriate

Audit Committee Responsibilities...

✓ Review the activities and organisational structure of the internal audit function

✓ Assess the qualifications of the director of internal audit and other internal audit staff

✓ Review the effectiveness of the internal audit function

The committee may 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 academic and professional credentials, computer and systems 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.

Internal Audit Effectiveness

The audit committee may 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 get involved in the planning and implementation of new information systems?
- 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?

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 specialist IT and treasury auditors. Another advantage for some companies is that it can enhance the independence of internal audit from operational management.

A further option the audit committee may consider is 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.

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 and conform with all relevant national or international generally accepted accounting principles.

Since the audit committee's primary interest is reliable financial reporting, communication with the external auditors on a regular basis is important.

Audit Committee Responsibilities...

- ✓ Review the proposed audit scope and approach
- ✓ Consider the findings from the financial statements audit
- ✓ Review the performance of the external auditors
- ✓ Consider the independence of the external auditors

The audit committee may utilise the knowledge and experience of the external auditors by meeting with them to receive regular updates on developments affecting financial reporting.

The committee should meet privately with the external auditors at least once each year to ensure free and open communications.

In some countries, generally accepted auditing standards include specific requirements for communication between the external auditor and the audit committee. The International Auditing Practices Committee is also developing similar proposals. The audit committee should ensure that where such requirements exist, relevant matters are communicated on a timely basis.

Proposed Audit Scope and Approach

The audit committee's review of the proposed audit scope and approach enables it to obtain an understanding of what it can expect from the external audit. Page 44 sets out sample questions which may be relevant. The audit committee should also be available for consultation should the external auditors so require. 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 may have imposed on the scope of the audit.

Findings from the Financial Statements Audit

Normally, the audit committee, management, and the external auditors meet to review the financial statements and the results of the audit.

The external auditors often develop suggestions for improvements to the company's operations and internal control. The committee should ask management to report on any significant suggestions received and on plans to respond to them. Ideally, this review will be performed before the financial statements are released. The audit committee also should question whether recommendations made in the prior year were implemented.

In the USA, the Blue Ribbon Committee has recommended that the external auditors discuss with the audit committee their judgments about the quality, not just the acceptability, of the company's financial accounting principles. The discussion could include such issues as the clarity of the company's financial disclosures, and the degree of aggressiveness or conservatism of the company's accounting policies and underlying estimates.

The intention of this recommendation is to encourage open and frank discussion between the committee and external auditors and this objective should form the basis of all such discussions.

"An audit committee is unique in that it provides a forum where directors, management and auditors can deal together with issues relating to the management of risk and with financial reporting obligations. Although auditors have a responsibility to report to stakeholders, their objective views can also be of value to the directors who are elected to govern the entity on behalf of those stakeholders"

Audit Committees: Best Practice Guide – Australian Accounting Research Foundation, Australian Institute of Company Directors and Institute of Internal Auditors – Australia, 1997

Performance of the External Auditors

Whether assessing the company's current auditors or evaluating new ones, a number of areas can be considered, including:

- 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 in conjunction with management and make a recommendation to the board. It is the board which normally recommends the appointment to the shareholders.

The committee also may 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 which were contrary to management's preferences.

To evaluate external audit performance, the committee will normally take informal soundings from senior management regarding the quality of services. 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.

Annually, along with the reappointment of the external auditors, the audit committee usually reviews management's analysis of the external audit fee. In this regard, the audit committee considers whether the fee is fair compensation for a comprehensive and competent audit. This review may also consider other services provided by the external auditors.

"A high priority should be given to the audit committee's annual review of the audit, as part of a system of continuous improvement in the audit process..."

The Institute of Chartered Accountants of Scotland, October 1998

Independence of the External Auditors

While the audit committee focuses primarily on the effectiveness of the audit, it also should be aware of other services the auditing firm can provide. Management may engage the auditing firm for a variety of special services and audit quality is enhanced by the increased knowledge the auditors gain from performing these services.

To perform their work effectively, external auditors must be objective and independent of the company. The audit committee should therefore 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 independence and objectivity of the auditors has not been compromised.

"it is appropriate to enhance the independence of the auditor by increasing the role of non-executive directors in his appointment"

European Contact Group of large accounting networks in its response to the July 1996 EC Green Paper on Auditing

Sample questions the Audit Committee may ask the External Auditors regarding Audit Approach

- What are the objectives of your audit?
- What are the company's financial reporting requirements and what is the expected timetable for meeting them?
- Which areas do you plan to emphasise in your audit? Why?
- To what extent will you assess the company's system of internal control?
- How will this year's financial statements be affected by recent changes in accounting principles and/or regulatory requirements?
- How will any recent actions by the company, such as mergers and acquisitions, restructurings, changes of business strategy, changes in financing arrangements, or other unusual transactions, affect your audit or your report?
- How will your audit address the company's computer systems and applications?
- How will you coordinate your work with the internal auditors?
- Which company locations will you visit this year? Do you rotate visits of company locations? If so, 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?
- What are your responsibilities with regard to detecting material errors, fraud, and illegal acts?

Working with Management

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

Ongoing Communications

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 related accruals, if any, 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 controls over financial reporting
- The company's human resources and compensation policies, and procedures for reviewing officers' expenses and benefits
- Insurance cover for directors and senior officers

Improved Decision-making

In our 1997 survey of European companies' attitudes to audit committees, most companies surveyed felt that the existence of the audit committee did help 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 companies there was a concern that the audit committee added to the demands placed on management resources, and therefore costs. Indeed a small number were worried that audit committees could add an unnecessary tier to the management structure, or that they would create unwanted and additional bureaucracy.

However, the increased proliferation and status of audit committees in companies throughout the world belies such concerns about their value. It is generally accepted that the commercial advantages of a well set-up audit committee, such as the improvement in the company's decision-making process, outweigh any cost or management resource considerations.

"The Board's knowledge of financial, economic and information-related matters is enhanced. This allows a better exchange of information between management and shareholder representatives"

Director of Control and Administration, Spanish airline company

Reporting Responsibilities

Because they have been delegated oversight responsibilities, audit committees have a duty to report their activities to the board. In some countries consideration is also being given as to whether a formal report to shareholders would be beneficial.

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 written record of the activities and actions taken by the committee, addressed to the board, 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 actions.

"The audit committee will normally consider financial controls. The board may also request the audit committee to provide a single focal point for some or all of the wider review of internal control. In this event, it may be necessary for the audit committee to draw together the results of the work of the board and/or other board committees in reviewing specific risks (e.g. safety and environmental issues)"

Guidance for Directors of Listed Companies on Internal Control – UK, April 1999

Shareholders

At present, few countries require the audit committee to report directly to shareholders, for example at the annual general meeting (AGM). However, the Blue Ribbon Committee in the USA has attempted to move this issue along by recommending that a letter from the audit committee should be included in the annual report. This letter would include a statement that, following review and discussion with management and the external auditors about the quality of accounting principles applied and significant judgments made, the audit committee believes that the company's financial statements are fairly presented in conformity with generally accepted accounting principles.

Such formal reporting to shareholders goes considerably further than current practice, but does indicate a growing belief that audit committees should play a more active role in encouraging greater transparency in financial information reported to the market.

"every board should set up an accounts or audit committee, and should inform the AGM of its existence and the number of times it has met during the year"

Viénot report recommendation – France, July 1995.

Maintaining Quality

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 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 self-evaluation.

Training needs

The type of continuing training which may be appropriate could include:

- Financial and risk management
- Treasury operations and controls
- Accounting and corporate reporting developments
- Developments in wider business sector trends, business politics 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 area of financial risk management (and especially treasury operations and the potential impact on the business of complex financial instruments) is one area where information and training may be particularly valuable.

Evaluating Performance

In some countries, it is becoming common for boards and senior management to look for ways of measuring and assessing their own performance. The audit committee has not been left out of this process, and several good practice guides have been published on how committees can:

- Evaluate the performance of individual committee members
- Conduct a self-assessment of the performance of the committee as a whole

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

Individual Committee Member's Performance

The chairperson of the audit committee or the board could 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

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 composition of the committee, training and resources, meetings, activities, and relationships with auditors and management.

Useful guidance is available on how to evaluate the audit committee's activities, for example our report in 1993 for The Institute of Internal Auditors Research Foundation ("IIA") in the USA entitled "Improving Audit Committee Performance: What Works Best". This report contained guidance on self-assessment and a form to assist the process. The IIA is currently updating its research and plans to issue further guidance.

Included on the following pages is a suggested audit committee work programme and self-assessment guide which adopts some of the best features of the earlier research.

Audit Committee Work Programme and Self-Assessment Guide: Does your Committee Measure Up?

This form 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.

The guide also contains, under the "Responsibilities" heading, a work plan which can be completed each year. Cross-references are provided in the guide to the relevant part of the Example Audit Committee Charter presented on pages 14 to 17.

To use the form, 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 The board has authorised the committee to seek information required from any employee and external parties, to obtain outside advice and to require employee attendance at meetings	**Board**		
Organisation – Charter			
– The committee operates to a written charter, or terms of reference, setting forth its duties and responsibilities			
4.41 The charter is approved by the board, reviewed periodically, and modified as necessary	**Board**		
Organisation – Membership			
3.2 The experience and qualifications of committee members are compatible with the duties of the committee, including the ability to understand financial statements	**Board/ Chairman of Committee**		
– The board periodically reviews the mix of experience and skills of committee members to maintain an appropriate balance	**Board/ Chairman of Committee**		
3.1 The size of the committee is appropriate to the organisation. (A size of three to six members, excluding any representatives of management, is optimal)			

Ref to Charter/ Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up Steps Necessary
3.3 [The majority of] [All] committee members are independent of management	**Board**		
3.4 Committee members are appointed by the board or a nominating committee of the board	**Board**		
3.5 Term of membership on the committee is at the discretion of the board, but maintenance of continuity while bringing a fresh perspective to the committee, is considered	**Board**		
Organisation – Meetings 3.10 The committee meets regularly, with special meetings called as circumstances warrant. (At least 3 or 4 meetings each year is desirable)			
3.8 Senior management and external and internal auditors are invited to attend meetings as necessary			
– Written meeting agendas are prepared	**Committee Secretary**		
– Meeting agendas are distributed in advance together with sufficient background information to enable committee members to prepare for meetings	**Committee Secretary**		
3.11 All proceedings are minuted	**Committee Secretary**		

Ref to Charter/ Practice		Also involved	Is practice being followed? Yes/No/NA	Follow-up Steps Necessary
–	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 **Internal Control** 4.1	Evaluate the "control culture" established by management			
4.2	Consider how management has reviewed the adequacy of controls surrounding electronic data processing and computer security	**Management/ IT department**		
4.3	Review with the internal and external auditors their assessment of weaknesses in internal controls and the effectiveness of internal control systems	**Management/ Internal audit/ External auditors**		
4.3	Consider whether internal control recommendations made by internal and external auditors have been implemented by management	**Management**		

Ref to Charter/ Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up Steps Necessary
Financial Reporting – General			
4.4 Review with management the current areas of greatest financial risk and how management is dealing with them	**Management/ Treasury**		
4.5 Consider with the external and internal auditors the possibility of fraud, illegal acts or deficiencies in internal control	**Management/ Internal audit/ External auditors**		
4.6 Review significant accounting and reporting issues and understand their likely impact on the financial statements	**Management/ External auditors**		
4.8 Meet when appropriate with company legal counsel to discuss legal matters that may have a significant impact on the company's financial statements	**Legal counsel**		
Financial Reporting – Annual Financial Statements			
4.9 Assess whether the financial statements are complete and consistent with information known to the committee			
4.9 Make enquiries of management and the external auditors about the appropriateness of accounting principles followed by the company, changes in accounting principles, and the reasons for changes not mandated by accounting standards	**Management/ External auditors**		

Ref to Charter/ Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up Steps Necessary
4.11 Focus on judgmental areas, for example valuation of assets and liabilities, significant accounting accruals, reserves, or other estimates made by management having a material impact on the financial statements	**Management**		
4.10 Focus on complex and / or unusual transactions such as restructuring charges, derivative disclosures	**Treasury**		
4.12 Enquire of management and the external auditors if there were any significant accounting and reporting issues during the period and how they were resolved	**Management/ External auditors**		
– Review the representation letters given by management to the external auditors and ask whether any difficulties were encountered in obtaining the letter or any specific representations therein	**External auditors**		
4.13 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**		
Financial Reporting – Preliminary Announcements, Interim Statements and Analysts' Briefings 4.14 Consider how management develops the preliminary results announcement, interim reporting and analyst briefings, and review the extent of auditor involvement	**Management/ Internal audit/ External auditors**		

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Ref to Charter/ Practice		Also involved	Is practice being followed? Yes/No/NA	Follow-up Steps Necessary
4.15	Review preliminary results announcement and interim statements before they are released	**Management/ external auditors**		
Internal Audit				
4.16	Review the activities and structure of internal audit and approve the internal audit charter	**Internal audit**		
4.17	Review and concur in the appointment, replacement or dismissal of the director of internal audit	**Management**		
4.18	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. Review subsequent changes to the internal audit plan	**Internal audit**		
–	Review the staffing, training and budget of the internal audit function	**Internal audit/ Management**		
4.19	Meet privately with the director of internal audit on a regular basis	**Internal audit**		
4.20-4.21	Review significant findings resulting from internal audit and ensure that management responds to these findings	**Internal audit/ Management**		

Ref to Charter/ Practice	Also involved	Is practice being followed? Yes/No/NA	Follow-up Steps Necessary
External Audit 4.22 Review the external auditors' proposed audit scope and approach. Enquire into reasons for subsequent changes to the audit plan	**External auditors**		
– Enquire as to the degree of coordination of work between the external auditor and the internal audit function to ensure it is appropriate under the circumstances	**External auditors/ Internal audit**		
4.26 Meet privately with the external auditor on a regular basis	**External auditors**		
4.27 4.28 Review reports made by the external auditors to management, and ensure that management responds to these findings	**External auditors/ Management**		
4.24 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**		
4.24 Consider the independence of the external auditor, including reviewing management's plans for engaging the audit firm to perform other services during the year, considering the types of services that may be rendered and the projected fees	**Management/ External auditors**		

Ref to Charter/ Practice	Also Involved	Is practice being followed? Yes/No/NA	Follow-up Steps Necessary
Compliance with Laws & Regulations 4.29 Review management's procedures for monitoring the company's compliance with laws and regulations. If this oversight is performed by another committee of the board, consider the financial statement implications of the applicable laws and regulations	**Management**		
4.30-4.32 Review with management and legal counsel as appropriate, the findings of any regulatory examinations, and consider the financial statement implications	**Management/ Legal Counsel**		
Compliance with Code of Conduct 4.35 Review periodically the programme established by management to monitor compliance with the company's code of conduct	**Management**		
The Committee's own Reporting Responsibilities 4.37 The committee reports its activities to the board regularly	**Board**		
Maintaining Quality – Consideration is given to the ongoing training needs of committee members			
– The chairperson assesses the effectiveness of individual audit committee members	**Chairman of Committee**		
4.42 The performance of the committee as a whole is periodically assessed	**Chairman of Committee**		

Appendix

US Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

The Blue Ribbon Committee was created in October 1998 by the New York Stock Exchange and the National Association of Securities Dealers in response to concerns expressed by SEC Chairman Arthur Levitt, who called for improved board oversight of the financial reporting process of public companies. The Committee's goal was to make recommendations to the Securities Exchange Commission, self-regulatory organisations, auditors and corporations on how best to accomplish this task.

Membership

Members of the Committee were:

Ira Millstein (Co-Chair)	–	Senior Partner, Weil Gotshal & Manges LLP
John Whitehead (Co-Chair)	–	Retired Co-Chairman and Senior Partner, Goldman, Sachs & Co.
James Schiro	–	CEO, PricewaterhouseCoopers
John Biggs	–	Chairman, President & CEO, TIAA-CREF
Frank Borelli	–	Senior Vice President, CFO & Director, Marsh & McLennan Companies
Charles Bowsher	–	Former Comptroller General of the U.S. and Member of the Public Oversight Board
Dennis Dammerman	–	Senior Vice President – Finance and CFO, General Electric Company
Richard Grasso	–	Chairman and CEO, New York Stock Exchange
Philip Laskaway	–	Chairman and CEO, Ernst & Young LLP
William Steele	–	Chairman and CEO, Pfizer
Frank Zarb	–	Chairman and CEO, National Association of Securities Directors

The Report

The Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, issued in February 1999, focused on the financial reporting and audit committee oversight processes. The report provides 10 principal recommendations for changes in functions and expectations, not only for audit committees but also for external and internal auditors, management and the full board. The Committee emphasised that the recommendations are an integrated set of objectives that should be implemented in their entirety to achieve the intended results.

Recommendations

The first two recommendations are aimed at strengthening the independence of the audit committee:

Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organization in any of the past five years;
- a director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of independence for listed companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

The second set of recommendations is aimed at making the audit committee more effective:

Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to all disclosure referenced in this Recommendation 5.

The final group of recommendations addresses mechanisms for accountability among the audit committee, the outside auditors, and management:

Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boiler-plate.

Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.

Other Publications

The following series of publications on International Accounting Standards has been published by PricewaterhouseCoopers and is available from your nearest PricewaterhouseCoopers office:

International Accounting Standards – A Pocket Guide

International Accounting Standards – Similarities and Differences – IAS, US GAAP and UK GAAP

International Accounting Standards – Illustrative Corporate Financial Statements

International Accounting Standards – Illustrative Bank Financial Statements

International Accounting Standards – Disclosure Checklist – 1998/99

International Accounting Standards – Applying IAS 12 (Income Taxes) in Practice

International Accounting Standards – Applying IAS 34 (Interim Financial Reporting) in Practice

Understanding IAS – Analysis and Interpretation of International Accounting Standards

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