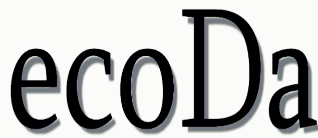

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Confédération Européenne des Associations d'Administrateurs
European Confederation of Directors' Associations

Roundtable Discussion on Audit Committees
18 March 2009
Overview

Speakers:
Roger Barker, IoD
Patrick Zurstrassen, ILA
Tim Copnell, KPMG
Claude Cargou, ECIIA

Tim Copnell, KPMG

After a quick overlook at the CG codes across Europe and their recommendations regarding Audit Committees (all addressing similar recommendations like independence, financial experience and oversight over the financial reporting process), Tim addressed the barriers for adoption and the need for active market and shareholders.

Then, he went through the details of the directive, focusing on a number of areas like the concept of independence and the question of competence ("not an end but a whole").

The 8th directive remains unclear on some specific points. For instance, the statement that "each public-interest entity shall have an audit committee" does not specify what "public-interest entity" means. Moreover, if the directive states that "at least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing", no definition about "independence" or "competence in accounting" is given; should it be different from financial competence? "Independence" should be understood as bravery, ability to go against the majority.

Tim focused also on the different functions of audit committees. The functions assigned to the audit committee may be carried out by:

– the board (or supervisory board) provided that any executive chairman is not the chairman for the audit committee deliberations
– a body performing equivalent functions to an audit committee, established and functioning according to provisions in place in the relevant Member State.

The audit committee shall, inter alia:

- monitor the financial reporting process;
- monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- monitor the statutory audit of the annual and consolidated accounts;
- review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity;
- make the recommendation upon which the proposal to appointment the statutory

auditor is based.

The statutory auditor shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.

Member States may exempt certain entities from the obligation to have an audit committee:

- subsidiary undertakings (if an audit committee or similar exists at group level)
- certain investment undertakings
- certain entities acting solely as issuers of asset-backed securities
- certain credit institutions.

Roger Barker, IoD

Roger Barker focused on the UK experience, he stressed on the basic requirements of the UK legislation and the lay out by guidelines. He also highlighted the need to ensure dialogue with shareholders.

The 8th directive is non prescriptive, it is important to see how it will be implemented. The original proposals were reduced in the final directive which remains principle-based. Audit Committees do not have to start from the scratch; they can continue doing what they were doing.

In 2003, a group of practitioners developed some guidelines: the Smith Report, which has proved to be straightforward and very successful.

The FRC Guidance on Audit Committees specifies:

1. Establishment of the audit committee (including discussion of the committee's membership, resources and procedures)
2. Relationship between the audit committee and the main board
3. Responsibilities of the audit committee
4. Communication between the audit committee and shareholders.

The Smith Guidance requires proportionality ("*Audit committee arrangements need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company").* This means that smaller companies may be tempted to look at large companies to get a model. It is important to develop specific models.

Regarding retaining Board Equality, it is stated that *"nothing in the guidance should be interpreted as a departure from the principle of the unitary board. All directors remain equally responsible for the company's affairs as a matter of law"*. There is no difference between board members and the whole board is responsible as such.

Regarding the Limits of the Audit Committee, it specifies that *"it is not the duty of audit committees to carry out functions that properly belong to others, such as the company's management in the preparation of financial statements or the auditors in the planning or conducting of audits. To do so could undermine the responsibility of management and auditors".* The Audit Committee has to define its sphere of responsibilities and should not set over the financial management department and the auditors. Audit Committees have a significant role, they must not however develop the view that everything is on their shoulders.

As an important function of Audit Committees is to develop relations with external shareholders, new guidelines were issued by the Enhanced Disclosure Working Group of

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Leading Investors.

Key issues were developed from the investor perspective:
- Information flows to the audit committee
- Risk and internal controls
- Valuation of assets and liabilities
- Write downs and impairment provisions
- Securitisation, off-balance sheet and contingent liabilities
- Internal and external auditors
- Executive compensation and risk
- Substance not form
- Audit committee charter
- Audit committee membership

Audit Committees have also a role to play on Executive Remuneration: "*The audit committee should provide (a) a brief but informative description of its interaction with the compensation or remuneration committee in respect of executive compensation policies and practices and (b) comfort that the compensation policies and practices for top executives are appropriate for maintaining a robust control environment".* A new code on remuneration states that people of Risk Management should ensure that performance measures are risk-adjusted. It should be interlinkage between Audit Committees and Remuneration Committees to have remuneration risk relevant.

The new recommendations developed the past years have taken the Audit Committees away from their initial function which was mainly to develop relations with auditors. Their range of responsibilities is now linked to Risk Management. Risk Management is however still a task for the CEO as the Risk Chief Officer.

As expressed by Sir Adrian Cadbury in 2002: *"If audit committees are to provide the degree of assurance that boards and investors are looking for, their members will have to devote considerably more time to their duties and be appropriately rewarded for so doing".*

Claude Cargou, ECIIA

Mr Cargou referred to the first draft of outcomes from the working group set up by IFA and IFACI. He focused on the effectiveness of internal control. He pointed out the role of the different actors to ensure this effectiveness.

Monitoring the effectiveness of the company' risk management systems is a very broad assignment from risk identification and assessment to risk management and check of the efficiency of the internal control procedures
- internal control,
- internal audit where applicable
- risk management systems.

This is.

The question is how can the audit committee achieve its reinforced role? The Audit Committee is ideally placed since it has free access to any individual information, data and it can ask for external resources with management agreement. However, the Audit Committee has limited member resources and time and it is very difficult to encompass a very large organisation.

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The main ingredients to be successful are:

- Build an Audit Committee with the right profiles (skills & behaviours) and good understanding of the business,
- Develop a strong interaction with Internal Audit (it is existing but it has to be reinforced),
- Review carefully the company risk mapping (a difficult exercise) and risk assessment,
- Get a sense of the risk culture in the field,
- Discuss with management out of formal committees,
- Be flexible – a yearly approach is out of date,
- Require well structured information from the company (the flow of information has to be changed, it is quite easy to drown the AC with too much information),
- Build a network of Audit Committees in large organisations to be closer to the business (need for hierarchy and pyramid),
- Think in terms of system, view all the risk stakeholders as a combination (the control environment is the result of many stakeholders – it is important to have a view on the way stakeholders interact).

Patrick Zurstrassen, ILA

Mr Zurstrassen illustrated concrete cases and gave a practical testimony. He stressed the importance of preparing good and accurate documentation and presented typical meeting agendas by identifying general issues applicable to a variety of companies. He explained how decisions are made by committees and how the members report. He suggested then desirable changes and pointed out the limitations between wishes and reality.

The origins of audit committees are diverse:

- transformation of audit review boards to match emerging practices of AC,
- some spontaneous moves,
- better compliance with listed companies' codes of conduct adopted within the frame of the EC Corporate Governance Bolkenstein Plan,
- percolation of listed head companies' AC practices down to major affiliates, especially if public interest companies,
- anticipation of the effective impact of the 8th Directive, but with several exclusions [SME: staff; sales; own funds].

Audit committees are committees of the board or autonomous bodies with the duty of examining the effectiveness of financial reporting, internal control and risk management. They have to approve the audit plan/budget and monitor its execution.

They might be composed of independent, non-executive only, or at least of people with accounting background.

They meet around five times per year. Due attention has to be paid to their agenda. They are assessing their effectiveness through external or internal processes. They must report to the board and disclose in the annual report.

The preparation of AC meetings is very demanding. It requires face to face meetings at least 2-3 weeks in advance of the AC meeting with the internal audit head, the external audit senior partner, the corporate secretary and some surrounding experts. The scope of the meeting is to verify minutes of previous AC meetings, the action points of previous AC meetings, to review the AC meeting agenda, to overview existing tabled documents, and to convene experts in attendance and specify other required documentation.

The main tasks for the Chairman are to approve the minutes, to follow up the action points and to report on self-assessment of AC members (proposals for the reviewing of the principles/chart of AC) while the CFO will pay attention to the financial situation (including B/S and accounts, MIS reporting, solvency situation and capital adequacy) and the external audit will dedicate attention to the quarterly management report (main issues, results, accounts, audits, internal control, RM, compliance, litigations, miscellaneous). Internal Audit has to focus on internal audit report including management letter, review of latest audit missions, status of unsatisfactory rated missions, review of the current audit plan, adequacy of audit resources, approval of next year's audit plan, etc. The Chief Compliance deals with the compliance quarterly report including follow up of previous period, incident reports, relations with authorities and regulators; regulatory news. The Chief Risk Officer is responsible for Global Risk Management reports, including evolutions in RM organization and structure, review of RM charter as well as specific reports on financial risks committees [ALM; counterparty; pricing and valuation of assets] and as reports and statistics on operational risks [including Basel II dimension].

Based on experience, the positive impact of audit committees can be summarized as follows:

- Bring to management expert external views / « checks and balances »,
- Delegation: take load from the board shoulders,
- Create corporate self-discipline,
- Facilitate communication and authority between all experts,
- Independent review and judgment,
- Contribute to harmonize audit and monitoring processes within a group.

The weak points of the Audit Committee are the following:

- AC did not prevent occurrence of significant financial, counterparty and fraud risks,
- Board delegation to AC may create loss of ownership on accounting, audit and risk issues at level of board,
- Expensive processes better tailored for larger industrial and financial groups. Models for SME to be developed,
- Audit competence gap among board members. Continued education needed in most countries.

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