THE EVOLVING ROLE AND EXPOSURES OF AUDIT COMMITTEES

JOINT INITIATIVE OF CPA AUSTRALIA AND THE INTERNATIONAL GOVERNANCE AND PERFORMANCE RESEARCH CENTRE (IGAP) AT MACQUARIE UNIVERSITY

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EDITED BY

Nonna Martinov-Bennie and Amir Ghandar

OVERVIEW

The audit committee's role is crucial in assisting the Board in oversight and monitoring of the organisation's internal controls and corporate reporting processes.

Evolving risks, liability, technological advancements and complexity in reporting among a myriad of other factors have led to continuous change and a range of challenges for audit committee members in recent years.

This publication summarises insights on the challenges facing today's audit committees and ways forward, compiled from the keynote presentations and panel discussion at the Annual Forum held jointly by IGAP and CPA Australia on 25 October 2014. The insights in this publication are not intended as definitive answers or guidance, but rather are presented as prompters for further discussion and thought on these challenges.

ACKNOWLEDGMENTS

KEY NOTE PRESENTERS

Michael Coleman FCPA,
Audit Committee Chair of Macquarie Group, independent member of the Audit Committee of the Reserve Bank of Australia, ex-Chairman of the Financial Reporting Council (FRC) and Chair of the Reporting Committee for the Australian Institute of Company Directors

Alan Cameron AO,
Chairman of Property Exchange Australia Ltd, Westpac's insurance companies and Hastings Funds Management

PANEL PRESENTERS

Merran Kelsall FCPA,
Chairman of AUASB, member of IAASB, Director of RACV Ltd, Director of Super Partners Pty Ltd, Chairman of Australian Health Service Alliance Ltd and Commissioner, Taxi Services Commission

Karina Kwan FCPA,
CFO of Citibank, Australia and New Zealand

John Robertson,
Managing Partner of the New South Wales Assurance practice of Ernst and Young.

Jon Tyers,
General Manager, Internal Audit at Perpetual, Audit and Risk Committee Member at NSW Treasury and NSW Self Insurance Corporation, former Deputy Chairman of the Australian Auditing and Assurance Standards Board (AUASB)

Facilitated by Alex Malley FCPA,
CPA Australia Chief Executive

ORGANISED BY

Nonna Martinov-Bennie FCPA
(International Governance and Performance (IGAP) Research Centre, Macquarie University) and
Amir Ghandar FCPA (CPA Australia)

MASTER OF CEREMONIES

Nonna Martinov-Bennie FCPA
(IGAP Research Centre, Macquarie University)

AUDIT COMMITTEES: NOW AND THEN

THEN:

- Audit committees were first introduced in the United States in the 1940s.
- Historically, their role was to oversee the preparation of the financial statements and provide detailed review of the financial statements. In practice, audit committees largely focused on being satisfied that there was a good process behind the preparation of the financial statements.
- In Australia audit committees became prevalent in the 1990s. In 2003, the Australian Stock Exchange (ASX) introduced a requirement under its listing rules for the top 300 firms to have audit committees.

NOW:

- As 'gatekeepers' of the financial system, directors play a crucial role in helping ensure that markets function correctly and investors are confident and informed.
- However, due to changing expectations from regulators and markets, stakeholders are increasingly uncertain about the 'ideal' role of the audit committee.
- Audit committees' role has broadened with changing expectations, to include a greater focus on risk. The committee also faces commensurately greater scrutiny by regulators.
- An expectations gap is starting to appear between markets, regulators, governments, and audit committees about their actual and ideal function.
- Audit committees also have an important role in the discovery and/or prevention of fraud, whistle-blowers' protection, auditor rotation and representation letters.
- Audit committees are challenged by the increasing multiplicity of reporting.
  In addition to statutory financial reporting, contemporary audit committees also need to deal with a sustainability report, Chairman and CEO's analyst and investor presentations, continuous disclosures, etc.
- The operating and financial review, as part of the directors' report, needs to be meaningful, with information that links to the current state of the accounts and information about the possible future state.
- Directors' are concerned about increasing expectation to comment on companies' future prospects, and the potential liabilities associated with this commentary.
- Current changes in the UK require a stewardship report by audit committees that is subject to review by the external auditors. This is a whole new external role for UK audit committees, and Australia will need to keep watch on these developments.
- The new audit reporting standard will require the auditor's report to include a commentary on the key audit matters (KAMs) potentially impacting on the auditor and the audit committee dynamic.

CULTURE

- The ecosystem around the audit committee reflects the culture of the organisation. It is complicated by the fact that each organisation will have a different culture, a different set of strategic issues.
- Considering the culture within the organisation is crucial for audit committees. Culture is about what drives the people within the organisation, and is one key area where things can go wrong. A 'good' organisational culture means that if something does go wrong it gets escalated, it is understood, and it is dealt with.
- Audit committees need to address both the big picture and the small picture of organisational culture. They need to think about the principle of governance simplicity, the quality of conversations, the skills mix on the audit committee, and how all these aspects align against the strategic risks for the organisation.
- Industry culture is also very important. The whole board needs to have a good understanding of the industry in which the organisation operates and enough broad knowledge to be able to identify how the organisation can improve.
- A culture where information is suppressed – for, example, because people think they can't raise an issue – is problematic, because an issue that an audit committee or a board needs to hear about may not get escalated.
- The nature of the questions asked at an audit committee, and the sense that you get from the body language that people respond with, is critical. When you ask a simple question and you get a lot of information in return, it may be a reason for concern.
- While culture is often acknowledged as paramount to both the governance and the success of organisations, not enough attention has been paid to the impact of rapidly increasing regulation and pressures on culture. As the economy changes, and as company results come under pressure, culture and behaviour also change. It is important for the board to understand what effect the pressures on the organisation are having on management behaviour

THE AUDIT COMMITTEE CHARTER

- The terms of reference of the audit committee are generally in a formal charter approved and minuted by the board. The charter needs to be of appropriate length with the terms of reference sufficiently detailed. The terms need to clearly define and establish the role and responsibilities of the committee and its relationship to the board. The terms need to be reviewed annually to ensure that the committee in its role remains relevant to the needs of the organisation.
- Charters reference important matters that come within audit committees' areas of responsibility, including: risk management and compliance processes; the review of related party transactions; and, reports to regulators requiring board approval. In practice the charter often operates as a checklist for the committee – a long, rather than short, charter is the norm.

SOME LESSONS LEARNED FROM RECENT CASES[1] IN AUSTRALIA

- An effective audit committee takes the primary role in monitoring financial reporting and the internal and external audit functions. However, all directors are personally responsible for the financial statements.
- Directors need to ask the right questions and be appropriately sceptical.
- The performance of the committee needs to be reviewed.
- The independence of the audit committee cannot be in question, both with respect to management and the auditors.
- It is desirable for the audit committee to meet periodically with the external auditors separately from management.
- The audit committee needs: an adequate basis on which to discharge its function; adequate time to prepare; access to the auditors; and in the absence of management, opportunity to independently debate and consider the relevant issues.
- With regard to financial statements, the audit committee might look at the detail, but then the board as a whole has to consider and satisfy itself.
- The generally accepted practice that all directors are present the whole time at audit committee meetings needs to be reconsidered: It does not necessarily produce the right outcome. HIH's audit committee met immediately before a board meeting, and the whole board was regularly invited to attend. As a result, the audit committee operated as little more than an extension of the board.
- Papers and other material should be distributed well in advance of a committee meeting. While seemingly simple, several cases highlight that there needs to be adequate time to discuss each agenda item.

[1] See in particular ASIC v Healey [2011] FCA 717

MANAGING MULTIPLE COMMITTEES

- Many larger entities have multiple committees such as an audit committee, a risk committee and a compliance committee, which can create challenges. Others, especially smaller entities, have an audit and risk committee combined.
- Whether committees are separate or combined depends on specific circumstances. Where they are separate, the responsibility of audit committee versus risk committee needs to be considered and clearly articulated.
- The existence of multiple committees can create issues of overlap and gaps. Mechanisms need to be put in place to ensure proper communication of information to all the committees.
- The ASX Corporate Governance Council does not insist on separation between audit and risk committees. The Australian Prudential Regulation Authority requires separation of audit and risk committees for certain entities.
- The audit committee is a committee of the board and as such all directors are equally responsible for the company's affairs. Disagreements within the board, including disagreement between the audit committee's members and the rest of the board, are usually best resolved at board level.
- In Australia in the private sector, the audit committee represents a sub-section of the board and all audit committee members are either independent non-executive directors or independent directors with no operating responsibilities. Good governance practice dictates that the chair of the board does not also chair the audit committee and the managing director and chief executive are not members.

AUDIT COMMITTEES AND AUDIT QUALITY

- According to the International Auditing and Assurance Standards Board's (IAASB) Framework for Audit Quality (2014), audit quality depends on a whole series of issues. These include: the context in which the audit is being undertaken, the interactions between the external and the internal auditors, the interactions with community, and the inputs and outputs.
- The Australian Securities and Investments Commission (ASIC) expect individual members of audit committees to satisfy themselves that auditors are providing a high quality audit.
- It is difficult for directors to satisfy themselves about the quality of an audit, unless there has actually been an issue. A good starting point is to obtain the transparency report that the audit firm lodged with ASIC. Among other things, these reports describe the audit firm's processes, systems and culture.
- In Australia, ASIC plays a role in promoting audit quality through its regular reviews of selected audit firms and their audits. ASIC is encouraging directors to seek information from their auditor about whether the audit firm has been the subject of an ASIC review and the findings of that review.
- Audit committees' and management's assessment of audit and audit quality take a different perspective. Management is typically more focused on timelines, on audit staff being the same and causing least disruption, and whether audit partner rotation was successful. Directors are more concerned with information and the level of comfort provided by the auditor.

TECHNOLOGY

- The risks associated with rapidly developing technology are a core concern for boards and often the burden of addressing such risks often falls to the audit committee.
- Technology is changing how businesses and their customers communicate – for example, the propensity for negative sentiment over brand and product to be rapidly disseminated, effectively 'going viral'. Keeping up with such risks is a challenge for audit committees and boards.
- The potential for technology to disrupt how boards operate is clear, particularly when thinking and talking about technology has not been traditionally central to the Board's operations. It can be difficult for board members to understand exactly how technology works and what their responsibilities are in regard to managing the associated risks of current and future systems, and where, for example, issues over cyber fraud and cyber security might arise.

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