

This series presents the PricewaterhouseCoopers Point of View on a range of auditing, accounting and regulatory issues affecting our clients and our profession. This paper represents the view of PricewaterhouseCoopers Australia.

Audit Committee Effectiveness

Audit committees in the spotlight

Now more than ever, the capital markets tend to punish unpredictability in corporate performance. Unpleasant surprises of any kind – whether these are erroneous financial statements, ethical scandals or inadequately anticipated/improperly managed risks – have the potential to wreak havoc among corporate reputations and share price values.

In this environment, audit committees should consider taking the initiative – looking to go beyond compliance, and actively seeking to identify ways in which they can enhance the quality of governance that exists in their organisations.

By fulfilling their functions as effectively as possible, committees can play an important role – helping to minimise the likelihood and impact of conditions in which unpredictability might otherwise thrive.

Our Point of view is that companies should not only be looking at ways in which they can build greater effectiveness into the way their audit committees work, but also taking into account the benefits of communicating these activities to the markets.

In this paper, we suggest six ways in which this effectiveness might be improved – and ways in which the markets can be presented with a full picture of those activities.

Getting to the heart of effectiveness

Audit committees are required to review their effectiveness, helping to ensure that they meet the expectations of the committee members themselves, the board, the shareholders, the regulators and the capital

markets. However, in some companies, the assessments are geared towards a ‘checklist’ approach, with the emphasis on structure.

Companies could benefit from broadening their outlook. Audit committees must have the right structure and process in place. But without strong leadership and good group dynamics to promote a culture of challenge and engagement, they may be unable to fulfill their role effectively.

Six suggestions for improving effectiveness – and what to tell the markets

Based on examples of good practice that we have seen in various companies, we have identified six areas where there may be room for improvement in the effectiveness of audit committees around process, leadership and dynamics, as well as the factors that could be communicated to the markets in respect of each of these.

1 Getting a grip on risk

It is established best practice for audit committees to plan how they will fulfil their oversight responsibilities over the course of the year, updating their working agendas on a regular basis to reflect new developments. Effective work-plans will be inherently risk-orientated, reflecting the company’s current situation and strategic priorities.

In the context of the current and emerging corporate governance environment, it is important to ensure that the audit committee’s oversight of risk is not too broad – and to communicate to stakeholders how this is being achieved. Rather than leaving all risk management oversight to the audit committee, some companies are forming

a risk committee, or designating the entire board as being responsible for ensuring that there is an effective risk identification and management process. This helps audit committee members by focusing their oversight on specific (rather than all) risks.

Regardless of the structure the board has adopted to oversee risk, the markets might be told about:

- Whether the audit committee is overseeing the effectiveness of the risk identification and management process, and if not, where at board level this oversight is carried out.
- Which specific risks are within the scope of the audit committee and how the oversight of business risks is apportioned (eg, between the board, the audit committee, the risk committee and the nomination and remuneration committee, where appropriate).
- How the board deals with assigning oversight of new risks that arise.
- How assurance is obtained over the effectiveness of the risk management process, as well as over the integrity and appropriateness of the risk information being presented to the board, the audit committee and other oversight committees. Audit committees can obtain assurance over the information presented to them from a number of sources, in addition to internal audit. These would include management's own assessments (if robust), legal and compliance departments and even external parties (including actuaries, valuers and auditors).
- How the audit or risk committee periodically assesses these various sources of assurance, as well as how it judges whether they are, in aggregate, sufficient.

2 Understanding the business

Among the many good practices already performed by the most effective audit committees, getting out and about to 'kick the tyres' of the business is one

of the best. By visiting a selection of the company's locations, meeting local management and employees, functional groups (including the internal auditor) and possibly also the local external audit team, the committee can obtain invaluable insights into the business. These will aid decision-making back at headquarters, as well as helping to highlight critical areas for discussion in regular audit committee meetings.

Information that could be communicated to the markets includes:

- The existence of the site visits programme and how locations to be visited are determined.
- The programme's main focus (eg, understanding a new business unit, focusing on risk management, agreeing scope of audit work, getting to know local management).
- The functions of the people who have been met (and who have presented to the committee) during this programme.
- Key developments resulting from the visit (and whether or not they have strengthened the audit committee, or caused it to change its practices in some way).

3 Injecting objectivity into the reporting process

CEOs and CFOs make inherently subjective assessments and judgements every time a company produces external reports. Audit committees have a valuable role to play in overseeing this process, helping to inject objectivity and independence into CEO/CFO decision-making. By ensuring that management forms a disclosure committee (as has been the practice for SEC registrants as a result of the Sarbanes-Oxley legislation), with members drawn from the senior executive (including risk, internal audit, legal and compliance), and with the views of advisors and auditors being made available to all members of the disclosure committee, assurance can be provided that everything that should be considered for disclosure has, indeed, been considered objectively.

For non SEC-registrants and smaller companies, the same result could be achieved by establishing clear relationships between the audit committee, management and the auditors, ensuring that the audit committee has a clear understanding of areas of subjectivity and the range of possible views with respect to them.

By announcing the formation of such a disclosure committee, together with details of its composition and schedule throughout the year, companies would be ensuring that their financial reporting has greater credibility among stakeholders in the capital markets.

4 Overseeing the C-suite

Recent corporate collapses have consistently pointed to failings in the C-suite (for example CEO, CIO, CFO etc). Audit committees have a crucial role to play, restoring trust among shareholders by putting in place monitoring processes designed to pre-empt these types of failings. Of central importance to its oversight function are the ways in which the audit committee gauges the 'health' of the corporate culture and ethics and assesses the behaviours of the senior management team leading that culture.

The following items could be communicated to the markets:

- How the committee gauges the candour, adequacy and timeliness of reporting (on issues including strategy and/or milestone deviation, undisclosed related-party transactions, code of ethics violations, etc) from business units and functional heads to the board. In practice, this will often be achieved via confidential anonymous culture surveys.
- How the committee monitors the process through which the 'health' of the organisation's culture is assessed so as to ensure that this is being done thoroughly and thoughtfully. The committee should also ensure that there are action plans in place to address any important issues that emerge.

- The existence of an in-house whistle-blowing process and the frequency with which issues are reported to the audit committee, as well as the policy for such reporting.

5 Honing effectiveness

Keeping abreast of fast-changing commercial developments represents a major challenge. Audit committees can only be effective if they have the knowledge needed to evaluate the information on which they are basing their decisions.

In practice, most members of audit committees will sit on a number of boards and will therefore be receiving information and education from a wide range of sources. This means that they will probably already be well supplied with information on:

- Governance rule changes and how they will impact the audit committee's work – including its responsibilities and membership.
- Evolving regulatory requirements, if the audit committee's mandate includes overseeing compliance with laws and regulations.
- Accounting and reporting developments, and the effects on the company's financial statements.

The important point is therefore to ensure that they are provided with all the support they need to plug any gaps and correct any deficiencies they feel they might have.

Focused education and development programmes to address company-specific learning needs are especially important. For example, audit committees in mining companies will need to know about any changes in health and safety/ environmental legislation that apply in any of the jurisdictions where the company has (or plans to locate) its business.

To ensure that the committee members develop robust knowledge of the company's lines of business, it can be helpful to have a different business unit

manager attend each meeting to describe the business strategy, operations and key risks, with finance people outlining any related impacts on accounting estimates and judgements. This can often be achieved during one of the regular site visits (see above).

To highlight the ways in which their audit committees are honing their effectiveness, companies could communicate the schedule of planned sessions to the markets. Companies might consider reporting audit committee targets for development, as well as how these targets will be met (in-house training sessions, together with external education, such as conferences, tailored courses and 'directors' colleges').

6 Regularly assessing how the audit committee is doing

Regular reviews of audit committee effectiveness are a requirement in many countries. Whilst there is no such requirement in Australia, many leading companies are performing such reviews. However, few companies provide the markets with any details of their approach to these assessments, or of the improvements that are being targeted as a result.

Each committee member might be asked to assess the committee's procedure and performance, with each director providing feedback on committee structure; the appropriateness of committee assignments and committee chair assignments; the effectiveness of committee decision making and the relationship and quality of communication between the committee and the board, management and external stakeholders. The result of the evaluation would be discussed with the chair, and recommendations for improving committee operations would be made.

If the assessment includes individual committee members, the factors might cover independence and integrity; knowledge and expertise; participation and input; preparation; availability;

and teamwork. Having completed the assessment process, whether via self-assessment, peer assessment or assessment facilitated by third parties, the chair would discuss his or her evaluation with each committee member, identifying areas for improvement.

By communicating the requirements that are placed on the audit committee, as well as the ways in which ongoing, systematic performance assessments of the entire committee – and those of individual members, if such assessments are done – track performance against these requirements, companies would shed real light on audit committee effectiveness, in terms of current performance and future opportunities for improving operations and procedures.

Time for action

Each of the above recommendations can play an important role in improving audit committee effectiveness and, as a result, help to minimise the likelihood and impact of unpredictability. However, while some companies might already be moving towards good practice in a number of these areas, few have taken the initiative in a convincing fashion, and even fewer have started to communicate the full scope of these activities to the markets.

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