

Role of Audit Committees

ANNUAL CONFERENCE of the IAA Lithuania

Torben Pedersen
25 March 2011
Vilnius, Lithuania

Role of Audit Committees

Agenda

- History
- Legal Basis (EU)
- Legal Basis (Lithuania)
- Why have an Audit Committee?
- Audit Committee Members
- Terms of Reference/Audit Committee Charter
- Duties of the Audit Committee
- When Should the Audit Committee Meet
- Attendance at Meetings
- Other Considerations

Role of Audit Committees

History

- Treadway Commission (USA) (1980's)
- Cadbury Report (UK) (1992)
- Sarbanes-Oxley (USA) (2002)
- 8th EU Company Law Directive on Statutory Audit (Directive 2006/43/EC - article 41)

Role of Audit Committees

Legal Basis (EU)

- 8th EU Company Law Directive on Statutory Audit (Directive 2006/43/EC - article 41)
 - Each public-interest entity shall have an audit committee.
 - The audit committee shall, inter alia:
 - (a) monitor the financial reporting process;
 - (b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
 - (c) monitor the statutory audit of the annual and consolidated accounts;
 - (d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

Role of Audit Committees

Legal Basis (Lithuania)

- Law of the Republic of Lithuania on Audit (Article 52)
 - An Audit Committee shall be formed in each public interest entity
 - The requirements for the Audit Committee shall be established by the appropriate supervisory authorities.
 - Duties of the Audit Committee:
 - 1) to monitor the financial reporting process;
 - 2) to monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
 - 3) to monitor the carrying out of audit;
 - 4) to monitor the independence and objectivity of the auditor or audit firm.

Role of Audit Committees

Why have an an Audit Committee?

- Board of Directors have a large number of responsibilities, both in terms of statute and stakeholder expectations.
 - These responsibilities include:
 - safeguarding the company's assets
 - maintaining adequate accounting records
 - developing and maintaining effective systems of internal control
- Audit Committees increase board effectiveness
 - The effectiveness of the board of directors can be increased if it sets up specialist committees to handle specific matters.

Role of Audit Committees

Why have an Audit Committee?

- An effective audit committee will assist directors in discharging their duties relating to the safeguarding of assets, the operation of adequate systems and controls, and the preparation of annual financial statements.
- An effective audit committee will also give rise to the following benefits:
 - Assist in establishing and strengthening the independence and objectivity of the directors and the internal and external auditors.
 - Improved communication and increased contact, understanding and confidence between directors, management and the internal and external auditors.
 - Increased internal and external auditors' accountability as their performance will be under greater scrutiny.
 - Help to create a climate of discipline and control which will reduce the opportunity for fraud.
 - The objectivity and credibility of financial reporting will be strengthened.

Role of Audit Committees

Why have an Audit Committee?

- All organisations can benefit from audit committees
 - Benefits not restricted to large publicly listed companies.
 - The principles are just as applicable to any other corporate body, public or private organisation.
 - E.g. in certain countries audit committees are used increasingly in hospitals, universities and other organisations where significant public funds are involved.

Role of Audit Committees

Audit Committee Structure

● Best practices

● Limited in size

- Usually 3-5 members.
- Small - to encourage the active participation of each member.

● Dynamic

- Members should rotate on a regular basis
- A service period of two to three years is advisable.
- It is important that members have an enquiring mind, a reasonable understanding of the complexities involved and an appreciation of the business and the industry concerned. **Common sense and objectivity** are two essential attributes of members of the committee.
- Ideally, a committee will have a mix of skills and experience. It is essential that at least one of the members has the necessary financial expertise in order to properly assist and advise the committee in the execution of its duties and responsibilities.
- Members should be encouraged to attend professional development courses to help keep them up to date with current issues relevant to their position.

Role of Audit Committees

Audit Committee Structure

- Best practices

- Independent

- Ideally, the audit committee should contain a majority of non-executive directors. The chair of the committee should be a non-executive director who is not also the chairman of the board.
 - The advantages of having a majority of non-executive directors on the committee include the following:
 - It will usually be easier to obtain candid feedback on the performance of financial management. The presence of executive directors may inhibit discussion of sensitive issues.
 - Non-executive directors, who are less likely to be caught up in detail, may be better able to see the wider picture for effective decision making.
 - Executive directors may not have or may be seen not to have the necessary degree of independence.

Role of Audit Committees

Audit Committee Structure

- Best practices

- Independent (cont'd)

- The advantages of having a majority of non-executive directors on the committee include the following: (cont'd)
 - In Canada, a majority of non-executive directors is required by statute;
 - The New York Stock Exchange, the American Stock Exchange, and the NASDAQ all require their member companies to have an audit committee with a majority of independent directors.
 - In the United Kingdom, the Cadbury Report recommends that non-executive directors be able to exercise independent judgment on key issues such as strategy, performance, resources, key appointments and standards of conduct. They should therefore be independent of management (apart from their directors' fees and shareholdings) and of any business or other relationship that could materially interfere with the exercise of their independent judgment.

Role of Audit Committees

Terms of Reference/Audit Committee Charter

- The responsibilities of the audit committee should be outlined in the terms of reference (approved by the Board) which should:
 - outline the duties, authority and resources of the committee
 - be periodically reviewed to assess the relevance and the requirements of the committee. Any changes should be approved by the Board.
 - be communicated to relevant parties, i.e. effectively communicated to management, as well as internal and external audit.

Role of Audit Committees

Duties of the Audit Committee

- In principle, an audit committee should be advisory in nature and not a prescriptive executive committee, i.e.
 - The audit committee should not perform any management functions or assume any management responsibilities as this could prejudice the objectivity of the committee.
 - The committee should make recommendations exclusively to the board.

Role of Audit Committees

Duties of the Audit Committee

● **Committee duties: high level**

- address (identified) areas of weakness and deficiency in systems and controls, recommendations for improvement and management's response thereto.
- ensure quality financial information
 - The board of directors is responsible for the issue of annual financial statements and, if a public company, for interim reports. The audit committee can perform a valuable service by first reviewing such financial information and then making recommendations to the board.
 - In forming a recommendation, the committee should consider:
 - the appropriateness of the accounting policies and any change to these policies
 - the treatment of transactions which are significant, unusual or require substantial judgment
 - whether the financial statements comply with all relevant statutory and other requirements
 - the completeness, clarity and transparency of disclosures
 - written representation from management and lawyers
 - whether the entity meets the going concern assumption and can continue to operate in the foreseeable future
 - In addition to reviewing the annual financial statements and the interim report, the audit committee can assist the board by:
 - monitoring compliance with the financial conditions of loan covenants
 - reviewing special documents such as prospectuses as and when prepared

Role of Audit Committees

Duties of the Audit Committee

● **Committee duties: internal audit**

● review and co-ordinate internal audit

- The committee should review the nature of the work performed by internal audit to ensure that it is achieving the objectives set out in its terms of reference.
- It is necessary to co-ordinate the activities of the external and internal auditors to avoid duplication of effort, thereby obtaining maximum benefit from internal audit activities. A properly functioning audit committee will be in a good position to facilitate this co-ordination effectively.
- It is appropriate for the head of the internal audit department to be directly responsible to the chairman of the audit committee.

Role of Audit Committees

Duties of the Audit Committee

● **Committee duties: external audit**

- appoint and review auditors
- performance of the auditors should be evaluated. The committee will then be in a position to consider whether or not they feel that the existing auditors should be retained.
- furthermore, it may be appropriate for the audit committee to:
 - make a firm recommendation each year for either retention or replacement of the existing auditors
 - advise management on the fees payable to the auditors
 - recommend to the board which firm should be appointed as auditors to existing or newly acquired businesses
 - set the scope of the audit
 - each year the audit committee should meet with management and the external auditors to review and agree on the scope of the audit procedures and related matters.
 - auditors have certain duties imposed on them by statute and by professional standards. Accordingly, there are certain minimum procedures which auditors have to perform and which are not negotiable. However, procedures which go beyond their minimum statutory and professional duties are negotiable and subject to agreement.

Role of Audit Committees

Duties of the Audit Committee

● **Committee duties: external audit**

- Furthermore, it may be appropriate for the audit committee to:
(cont'd)
 - assess differences of opinion ...
 - auditors are expected to be independent and to exercise their best judgment in fulfilling their tasks. As a consequence, differences of opinion will inevitably arise from time to time on matters such as the appropriateness of policies, the best format of disclosure and estimates based on judgment.
 - these will usually be settled by discussions between management and the auditors. The audit committee should discuss these differences of opinion with the auditor and management regardless of whether or not they have been settled.
 - evaluate the performance of the auditors
 - the duties of the audit committee and their dealings with auditors and senior management place the committee members in a strong position to evaluate how well they have performed their respective duties. This will allow them to provide valuable input to the board of directors.

Role of Audit Committees

Duties of the Audit Committee

● **Committee duties: additional best practice**

● **report on its activities, recommendations and decisions ...**

- The audit committee should prepare and submit a formal report on its activities, recommendations and decisions to the board of directors at least annually. The report should be prepared in summary form under headings appropriate to its terms of reference.
- In addition, copies of the minutes of each meeting of the committee should be sent to board members and other relevant parties.

● **monitor compliance with ethical conduct ...**

- A number of statutory, common law and other requirements cover the ethical behavior of directors, managers and officers of companies. These include:
 - declaration by directors of the nature and extent of their interests in contracts
 - compliance with the requirements of the company's constitution
- In addition, some companies have established a clearly defined and documented code of ethics.
- The audit committee is the appropriate body to monitor compliance with any applicable ethical requirements and, indeed, to assist in the development of such a set of requirements. They should also consider and make recommendations on any:
 - potential conflicts of interest or questionable situations of a material nature
 - identified violations of ethical conduct

Role of Audit Committees

Duties of the Audit Committee

● **Committee duties: additional best practice (cont'd)**

- **instigate and conduct special investigations ...**
 - From time to time, a need may arise for an investigation into:
 - breakdowns in systems or controls
 - a conflict of interest or other ethical problem.
 - In these instances, the audit committee may well be the most suitable body to direct or control the investigation.
- **ensure efficient and effective use of corporate assets**
- **ensure legal compliance risks are minimised**
 - The audit committee should:
 - review all significant transactions which do not form part of the entity's normal business
 - obtain assurances from management in respect of relationships with regulatory authorities
 - review company compliance with statutory requirements
 - review current and pending litigation or regulatory proceedings in which the company is involved in any way
- **be accountable to shareholders**
 - the committee should consider the method and content of communications of its activities to shareholders. E.g. membership of the committee should be disclosed in the annual report and the chairman of the committee should be available to answer questions about its work at the Annual General Meeting.

Role of Audit Committees

When Should the Audit Committee Meet?

Depends on the specific circumstances and requirements of each company or group. However, the committee should meet at least twice a year. The rationale for the number of meetings revolves around reporting requirements. If a company is not listed, two meetings would appear to be sufficient. If it is listed, then four would be appropriate.

The committee should meet:

- **prior to the commencement of the external audit ...**

- This meeting should take place early in the financial year and deal with:

- internal controls and the work of internal audit

- the scope of the external audit, the timing of the visit and any other related matters

- what reports are required to be submitted by the auditors and the deadlines

- the audit fee budget

- **on completion of the audit**

- This meeting will usually take place once the detailed audit procedures have been completed and the draft statutory annual financial statements have been prepared. The matters which should be covered include:

- a review of the annual financial statements before recommending them for approval by the board

- discussing significant deficiencies in systems and weaknesses in controls

- a review of the audit and all significant matters arising

- a review of the performance of the auditors and of financial management

For companies that are listed, further meetings would be required to review the interim report, and any other regulatory reports, before being approved by the board for publication.

Role of Audit Committees

Attendance at Audit Committee Meetings

- The financial director, the head of internal audit and a representative of the external auditors would frequently be required to attend the meetings of the audit committee.
- Other directors, officers or members of staff should also be requested to attend as and when needed.
- Preparation for meetings
 - A formal agenda, together with any necessary documentation, should be sent to all those who are to attend at least a week before each meeting.
 - This will allow for adequate preparation and contribute to more effective meetings.
 - A schedule of meetings should be determined in advance, having regard to the financial reporting cycle, and circulated to the relevant parties. This will give all parties the opportunity to suggest items for inclusion on the agenda.

Role of Audit Committees

Other Considerations

- There should be a clear line of communication between the audit committee and the internal and external auditors.
- Notwithstanding any contact with the audit committee, it is important that auditors maintain a professional and frank relationship with management. One of the ways of achieving this is to have a clear understanding by the directors, management and auditors of the functions of the audit committee and its terms of reference.
- Accordingly, auditors and management should be given copies of the terms of reference of the audit committee. In addition, the chairman of a newly established audit committee could meet with both parties and discuss the operation and objectives of the committee.
- If these steps are combined with an attitude of candid but positive communication, then there is sound basis for establishing a constructive audit committee which can add value to the organisation.
- External auditors must communicate with the audit committee
- The external auditor should ensure that matters relating to the conduct of the audit are communicated to those individuals responsible for the monitoring of the financial reporting process.

Role of Audit Committees

Q & A

Q & A

Role of Audit Committees

Thank You for Your
Attention!

Torben Pedersen

Mobile: +370 685 16060

E-mail: ttpedersen@yahoo.com