

## Part 3

# Accountability and Audit:

Audit Committee - Rigorous and effective oversight

**Summary of relevant sections of the Corporate Governance Code (“Code”) (Appendix 14 Main Board and Appendix 15 Growth Enterprise Market Listing Rules)**

**Code Section C.3 – Audit Committee: Principle**

The **board** should establish formal and transparent **arrangements** to consider **how** it will **apply financial reporting and internal control principles** and **maintain an appropriate relationship** with the issuer’s **auditors**. The **audit committee (“AC”)** established under the Listing Rules should have **clear terms of reference**.

- **Code Provisions:**

There are Code Provisions laying down detailed requirements on various aspects of the AC. In addition to requirements on **membership** (C.3.2) and **processes** (e.g. meeting minutes and secretary) (C.3.1), there are detailed Code Provisions setting out minimum requirements for the AC’s **terms of reference (C.3.3)**. These include an issuer’s **relationship with its auditors**, review of the issuer’s **financial information**, oversight of the issuer’s **financial reporting system** and **internal control procedures**, as well as their respective focus areas of review.

- **Corporate Governance Report (“CG Report”):**

An issuer’s **CG report** must include a **summary of the work of the AC during the year...**a report on **how** it meets **its responsibilities** in its review of...**half yearly** and **annual results** and **internal controls** systems...**other duties** under the Code (L.(d)(iv)).

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## 1. Analysis: Themes underlying the Code requirements

1.1 To us, the key is the **effectiveness** of an issuer's AC in discharging its responsibilities under the terms of reference. There are the following underlying themes:

- A. **AC members, in particular its chairman, must possess the right skills and experience to effectively carry out their responsibilities.**
- B. **A good process facilitates the working of the AC.**
- C. **The AC should carry out its responsibilities in an objective and conscientious manner, to effectively monitor the integrity of the company's financial reporting and maintain oversight of its internal control and risk management systems and other relevant internal processes, as stated in its terms of reference.**
- D. **In fulfilling its responsibilities, the AC should engage with and assess the effectiveness of the work of external and internal auditors.**

1.2 In addition, investors would also be interested to know:

- E. **How the AC's focus, including new areas of focus, during the year link to the issuer's strategy, development, and changing risks.**

1.3 **Evaluation of the effectiveness and performance of the AC.** As with the board as a whole, it would be useful for the AC to evaluate its own performance. Results of any evaluation and follow-up actions should be disclosed in the appropriate report to shareholders.



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## 2. How to provide meaningful disclosure in relation to the key themes

As discussed in the earlier section, the key to implementing the Code in this area is the effectiveness of the AC in discharging its responsibilities. In terms of disclosure, it would therefore be useful to **describe the approach taken by the AC** and, **in general terms, the factors considered and discussed** by it in dealing with each major area of its responsibilities. This should give report users, including investors, a **meaningful and convincing account** of the **rigorous approach** taken by the AC in discharging its duties.

Under each theme, we have included brief **commentary**. **Examples** are also provided to illustrate and highlight the relevant issues, where appropriate.

**Theme A: AC members, in particular its chairman, must possess the right skills and experience to effectively carry out their responsibilities.**

AC members typically need to have a good understanding of the business of the company and the industry in which it operates, and to have, at least, an overview of the internal and external risks faced by the company. In order to carry out their oversight role effectively, AC members also generally need to have a good understanding of areas such as financial reporting, internal controls and risk management, as well as regulatory compliance. The chairman, in particular, plays an important role. It would be useful to describe these matters in general terms.

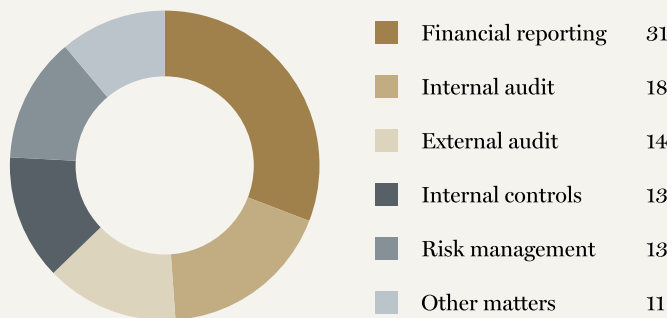


**Theme B: A good process facilitates the working of the AC.**

**Theme B: Example**

In the following international example, the company publishes an audit committee report signed off by its chairman. There is a chart setting out how the committee spent its time and the committee chairman also describes how he implemented processes to further enhance the effectiveness of the committee.

How the Audit Committee spent its time (%)



**Meetings**

The Audit Committee held five scheduled meetings during the year and details of members' attendance are set out on page •.

The chart above shows how we spent our time and our activities are described in detail on pages • to •.

In addition, I meet periodically with the Chief Financial Officer for business updates with particular emphasis on financial performance. In advance of each Audit Committee, I meet with key executives and the external auditor to ensure that the reporting and discussion will appropriately address the Audit Committee agenda matters. At the time of the half-year and full-year results, I have a private meeting with the external auditor to ensure that any issues they have identified are raised and discussed appropriately at the subsequent Audit Committee meeting. Furthermore, the Audit Committee has a private meeting with the external auditor at least once a year, without management being present, to discuss their remit and any issues arising from the audit.

*(Invensys plc, Annual Report 2013)*



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**Theme C: The AC should carry out its responsibilities in an objective and conscientious manner, to effectively monitor the integrity of the company's financial reporting and maintain oversight of its internal control and risk management systems and other relevant internal processes, as stated in its terms of reference.**

Under its terms of reference (including those terms required under the Code Provisions), the AC has responsibilities in the areas indicated below. In each case, it would be helpful to describe the factors considered and discussed by the AC, to illustrate the rigorous approach adopted by the committee.

### **Sub-theme (C.1): Financial reporting**

The AC is responsible for monitoring the integrity of the issuer's financial statements and annual reports and accounts, half-year reports and, if prepared for publication, quarterly reports. Amongst other things, significant financial reporting judgments should be reviewed (C.3.3(d)). After completing its review, the AC makes a recommendation to the board in respect of the approval of those financial statements and reports.

The AC's role in the process would be to act as a counterpoint to management by asking questions to ensure the appropriateness and quality of the information being provided for review and the material judgments taken.

The AC has a responsibility to consider the information in sufficient detail to be able to identify areas that require further clarification. The review would be guided by the AC's understanding of the processes that result in the information being produced. However, areas that may require special focus, some of which are also covered in the Code Provisions (C.3.3(d)(i)-(vi)), could include:

- How the company's accounting policies compare with those of similar companies in the same industry.
- Changes to accounting policies during the period.
- Areas requiring a high level of judgment or estimation.
- Major transactions conducted during the period and how they have been accounted for.
- Narrative disclosures describing sensitive matters, such as the going concern assumption, related party transactions, contingent liabilities or breaches of regulations, law and the related impact on the financial information, etc.



## Theme C: Example – sub-theme (C.1): financial reporting

In the following example, the AC report specifically highlights areas of focus when reviewing the financial information and how the AC members involved themselves so as to ensure that they felt comfortable with these:

### Financial Statements – Judgmental Issues

The Audit Committee paid particular regard to judgmental issues in respect of the Company's Financial Statements for the years ended 31 December 2011 and 2012 and for the six months ended 30 June 2012. Amongst other inputs, the management reports to the Committee and the audit reports submitted by external auditor summarised matters of the CLP Group for the years ended 31 December 2011 and 2012 and for the six months ended 30 June 2012, such as in respect of auditing and accounting matters, taxation issues and internal controls, together with the manner in which they had been addressed.

During the Relevant Period the major judgmental issues included, by way of example, the accounting treatment of the flooding at Yallourn and changes in the tax consolidation rules in Australia, as well as the deferred taxation in India and the impairment review of Jhajar Power Station. In August 2012 members of the Committee visited Australia and reviewed at first-hand the situation at Yallourn. For the purposes of their review of the Financial Statements ended 31 December 2012 the Audit Committee visited India at the end of January 2013 and met local management and local external auditors to consider judgmental issues regarding the accounting treatment of the Company's investments and activities in India.

*(CLP Holdings Limited, Annual Report 2012)*



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## Sub-theme (C.2): Review of internal controls and risk management

Under the Code Provisions (C.3.3(e)), the AC's terms of reference make it clear that the committee has a continuing responsibility for reviewing the issuer's financial control, internal controls and risk management systems. Again, it is important for report users to appreciate the **processes carried out by the AC** in performing its **reviews**, including the types and sources of appropriate **assurance provided** by management, external and internal auditors, where applicable.

(See the separate section on “**Accountability and Audit – Internal Controls**”)

**Theme D: In fulfilling its responsibilities, the AC should engage with and assess the effectiveness of the work of external and internal auditors.**

In discharging its responsibilities, the AC will interact with, and assess the effectiveness of the work done by the internal auditors and external auditors. It would be useful to list the issues considered and discussed by the AC in each case, so that report users can feel reasonably assured that the AC has fulfilled its role diligently.

**Sub-theme (D.1): Interaction with internal auditors**

Typically, the AC has oversight of the internal audit function (or other similar function), with the head of internal audit reporting directly to the AC. The AC will seek to satisfy itself that the internal auditors have carried out an appropriate scope of work, focused on the areas considered by the AC to be the most important or high risk areas within the organisation and that their findings are being appropriately addressed by the management. The AC may also be interested in the level of coordination between the internal and external auditors.

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**Theme D: Example - sub-theme (D.1): interaction with internal auditors**

The following is an international example of how the AC interacts with the internal auditors:

**Internal audit**

A substantial agenda item at each Committee meeting is the monitoring and reviewing of the scope, extent and effectiveness of the activity of the Group Internal Audit department. Reports from the Group Audit Director usually include updates on audit activities, progress of the Group audit plan, the results of any unsatisfactory audits and the action plans to address these areas, and resource requirements of the internal audit department. Further we receive summaries of investigations into known or suspected fraudulent activities by both third parties and employees. We hold private discussions with the Group Audit Director as necessary throughout the year and I also meet with the Group Audit Director outside the formal committee process.

*(Vodafone Group plc, Annual Report 2012)*



## Sub-theme (D.2): Interaction with external auditors and review of their effectiveness

Under the Code Provisions, the AC has specific responsibilities with regard to an issuer's external auditors, including making recommendations on their appointment, re-appointment and removal (C.3.3(a)-(c)). One of the areas that report users may therefore be interested in is how the AC evaluates the effectiveness of the external auditors, and the factors considered.

### Theme D: Examples – sub-theme (D.2): external auditors

#### Example 1

In the following international example, the AC chairman explains the details of the discussions with the external auditors:

##### External audit

The effectiveness of the external audit process is dependent on appropriate audit risk identification and at the start of the audit cycle we receive from Deloitte LLP a detailed audit plan, identifying their assessment of these key risks. For 2012 the primary risks identified were in relation to goodwill impairment, provisioning for current tax liabilities and deferred tax asset recognition due to the inherent management judgement required in these areas. These risks are tracked through the year whenever we receive reporting from Deloitte LLP.

We hold private meetings with the external auditor at each Committee meeting to provide additional opportunity for open dialogue and feedback from the Committee and the auditor without management being present. Matters typically discussed include the auditor's assessment of business risks and management activity thereon, the transparency and openness of interactions with management, confirmation that there has been no restriction in scope placed on them by management, independence of their audit and how they have exercised professional scepticism. I also meet with the external audit partner outside the formal committee process throughout the year.

*(Vodafone Group plc, Annual Report 2012)*

#### Example 2

In the following international example, further details are provided as to the process that the AC follows in order to conclude on the effectiveness of the external auditors:

PricewaterhouseCoopers LLP ('PwC') has served as the Company's auditors since 1983. The partner engaged on the audit is changed regularly. The services provided by PwC have been reviewed periodically and the Audit Committee is satisfied that they remain appropriately independent and are best placed to conduct the Company's audit for 2013/14. The Committee therefore recommended PwC be reappointed as the Company's auditors.

It is essential for the Committee to be able to have an honest and open relationship with both its external and internal auditors. This relationship is developed and maintained through regular private meetings with both PwC and the Head of Internal Audit. Further information on the role of the external auditors and our Non-audit Service Policy can be found on page •.

The Committee assessed the effectiveness of the external audit process by means of a detailed questionnaire completed by key stakeholders including the Board, the Executive Committee, members of senior management and Internal Audit. The questionnaire assesses the external audit in the following areas: qualification; expertise and resources; operational effectiveness; independence and leadership. The results are rated against an ideal standard and compared to prior years to assess the consistency of performance.

*(Tesco plc, Annual Report 2013)*



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**Theme E: How the AC's focus, including new areas of focus, during the year link to the issuer's strategy, development, and changing risks.**

As in the case of the board as a whole, report users would be interested in understanding more about the year-on-year focus areas of the AC. For instance, they may want to know how the AC's work during the year links with the company's strategy, development and changing risks.

**Theme E: Examples**

**Example 1**

In the following international example, the company describes the changing external (macro environment) and internal (expansion overseas) changes, which underline the sharpened focus of its AC:

The continuing effects of an uncertain global political and economic environment make it even more important to maintain a sharp focus on the robustness of the company's internal control and compliance models...

During 2012, the Committee's agenda has included the usual review of our financial results and controls, our business operations across the world and their management of risk, as well as focusing consideration on new emerging risks. At each meeting, a proactive approach was taken to the identification and discussion of emerging risks...

In line with the Group's strategy to expand further and deeper into emerging markets, members of the Committee visited the Group's [Indian] operations in [Delhi] and were pleased to have the opportunity to meet with locally based executives. During this visit, gain a deeper understanding of the distinctive business and cultural dynamics of this emerging market and to learn at firsthand how risk management is embedded in our operations in India.

*(GSK, Annual Report 2012)*

**Example 2**

In the following international example, the company obtained its stock exchange listing a few years ago. It describes the different circumstances, and so the changing focus of its AC, since its initial public offering:

The role of your Audit Committee has developed substantially over the last five years since our listing on the Stock Exchange. Initially, we focused on financial accounting and reporting together with internal controls, concentrating on the judgemental areas in the financial statements. This remains our first priority but we have increasingly focused on the oversight of management's processes to implement the risk management framework. We have refined our methodologies to assess transactions with any related party, including access to independent advisers, to address the requirement to ensure that any such transaction is on terms that are reasonable for all our shareholders. We have facilitated a deeper understanding of the processes of internal and external audit and fostered greater coordination between them to ensure that all the audit resources available to us are focused on the risks inherent in our strategy set out on pages • of the Annual Report...

The above, however, is history; our priorities over the next few years, in addition to our normal review of financial statements and related accounting policies, are:

- Continuing to monitor the implementation of the risk management controls to ensure that they are embedded within the organisation.
- Ensuring that the internal control environment responds effectively to the organisational growth of the Group as implementation of our strategy unfolds and that internal audit is appropriately aligned in accordance with the suggestions included in independent report that we commissioned this year.
- Monitoring the embedding of robust third party contractor processes.
- Ensuring that the procedures for managing transactions with the controlling shareholder and related parties keep pace with emerging regulation and best practice.

*(Fresnillo plc, Annual Report 2012)*

