What makes an effective Audit Committee?

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Director of Corporate Governance
UK Financial Reporting Council
Agenda

- Introduction
- Remit of the audit committee
- Composition of the audit committee
- Managing key relationships
- Other challenges
“Walk The Line” Report

- Published 2012
- Joint report by UK Financial Reporting Council and the Institute of Chartered Accountants in Australia
- Interviewed audit committee chairs of 60 companies in UK, Europe, US, Australia, Singapore
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Financial Reporting Council
Remit of the Audit Committee (1)

- General agreement on the responsibilities for financial reporting, including:
  - Monitoring the reliability of financial information
  - Reviewing the company’s internal financial controls
  - Overseeing the work of the external auditor, and making recommendations to the board on their appointment

Financial Reporting Council

FRC

Financial Reporting Council
Remit of the Audit Committee (2)

• There is less agreement on whether the committee has broader responsibilities for risk management.

• The BVB Corporate Governance Code says it does, unless this role is carried out by the board as a whole.

• Some arguments against: different skills and expertise needed; audit committee already overloaded.

• Some arguments for: creates gaps and overlaps; too many committees (especially for smaller boards).
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Composition of the Audit Committee

The three main issues are:

- Independence
- Financial expertise
- Other skills and qualities needed
Independence

• **EU Statutory Audit Directive**: there must be at least one independent member

• **BVB Corporate Governance Code**: all non-executives with “a sufficient number of independent directors”

• **UK Corporate Governance Code**: all the members must be independent
Financial expertise

- **EU Statutory Audit Directive**: at least one member must have “competence in auditing and/or accounting”
- **Draft EU Audit Regulation**: at least one member must have competence in auditing, and one other in auditing and/or accounting
- **BVB Corporate Governance Code**: nothing specific to the audit committee, but a general requirement for the board and committees to have “effective capacity”
Other skills and qualities needed

• Financial literacy (for all members)
• An understanding of the company’s business model and risk profile
• Relevant business experience (for example, sector or international experience, project management expertise)
• Willingness to ask awkward questions
• New ideas and new thinking
Audit Committee Institute survey (2013): What would most improve your Audit Committee’s composition and effectiveness?

- Additional expertise (e.g., IT, risk, M&A, industry knowledge): 64%
- Greater diversity of thinking, background, perspectives, and experiences among members: 50%
- Greater willingness and ability to challenge management: 43%
- Bringing “fresh thinkers” onto the committee: 42%
- More-engaged directors: 28%
- Better chemistry: 6%
- Other: 7%
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Managing key relationships

The audit committee’s main relationships are with:
  • The Board
  • Management
  • Internal audit
  • The external auditor
  • Shareholders
Relationship with the Board

• The relationship between the chairman of the board and the committee chairman
• Adequate reporting to/ discussion at board meetings
• Relationship with other board committees
Relationship with management

• Need to have a constructive relationship without losing independence
• Danger of the audit committee acting like managers
• Assessing the performance of the CFO
• Does internal audit report to management or the audit committee?
Relationship with the external auditor

- Does the external auditor consider they report to the audit committee or management?
  - Appointment
  - Agreeing the audit plan
  - Assessing the performance of the auditor
Relationship with shareholders

- The annual report – what information can/should audit committees provide?
- Attendance at the annual general meeting?
- Other direct contacts?
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Other challenges

• Managing the overall workload
• Managing meetings
• Reliability and availability of information
• Staying up to date
• Complexity of accounting standards
• Unrealistic expectations
Audit Committee Institute survey (2013):
Please rate your Audit Committee in the following areas:

<table>
<thead>
<tr>
<th>Area</th>
<th>Effective</th>
<th>Somewhat effective</th>
<th>Needs improvement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oversight of all financial communications, including financial and corporate reporting and disclosures</td>
<td>72%</td>
<td>23%</td>
<td>5%</td>
</tr>
<tr>
<td>Audit committee’s interactions and communications with the full board and other board committees</td>
<td>73%</td>
<td>23%</td>
<td>4%</td>
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<tr>
<td>Oversight of external auditor, including setting clear expectations and assessing performance</td>
<td>62%</td>
<td>32%</td>
<td>6%</td>
</tr>
<tr>
<td>Oversight of internal controls over financial reporting</td>
<td>60%</td>
<td>35%</td>
<td>5%</td>
</tr>
<tr>
<td>Prioritizing committee’s agenda to focus on the most important issues (versus “checklist” approach)</td>
<td>59%</td>
<td>35%</td>
<td>6%</td>
</tr>
<tr>
<td>Oversight of internal audit, including setting clear expectations and assessing performance</td>
<td>56%</td>
<td>34%</td>
<td>10%</td>
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<tr>
<td>Oversight of legal/regulatory compliance</td>
<td>53%</td>
<td>41%</td>
<td>6%</td>
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<tr>
<td>Oversight of risk, including understanding of audit committee’s risk oversight role</td>
<td>48%</td>
<td>43%</td>
<td>9%</td>
</tr>
<tr>
<td>Oversight of CFO, including assessing CFO’s performance and succession planning</td>
<td>45%</td>
<td>43%</td>
<td>12%</td>
</tr>
<tr>
<td>Staying up-to-date on changes impacting the company (accounting, risk, technology...)</td>
<td>39%</td>
<td>51%</td>
<td>10%</td>
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</tbody>
</table>