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Audit Committees
and Corporate Governance



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Introduction

In recent years, continuous change in the way that companies do business has become standard practice - globalisation, downsizing, reengineering, and technology are a few examples - and this change will continue at an accelerated pace. As the face of business changes so do information needs. This leads to questions over the reliability and relevance of traditional financial reporting and whether it has kept pace with the changes in stakeholder needs.

The role of the audit committee

In response to this dynamic environment, Boards of Directors are now placing increasing reliance on audit committees to oversee reporting and internal control. The audit committee's role includes challenging and, where possible, improving the relevance and reliability of an entity's financial reporting. The committee should also seek to enhance the effectiveness of the entity's internal control. In order to fulfil the role of the audit committee, its members need to be knowledgeable, dedicated and independent.

The corporate governance approach

In a corporate governance approach to financial reporting, audit committees are involved in the oversight of the entire financial reporting process. Throughout the year they learn and inquire about significant matters affecting financial

reporting, such as the development of generally accepted accounting practice, accounting estimates, information systems, internal controls and risks and uncertainties. To gain a full understanding of these issues the audit committee will need to consult with financial and operating management as well as the internal and external auditors.

The corporate governance approach to financial reporting requires a culture in which management accepts the function of the board of directors and its audit committee to oversee management.

Why have an audit committee?

The pre-eminence of corporate governance and the issues surrounding the personal liability for directors have seen an increased interest in the role of the board of directors in organisations. 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

Due to the onerous nature of all the tasks of directors it is usual to delegate some of these duties to management, particularly where these relate to the day-to-day running of the business and matters of detail. However, such delegation does not relieve directors of their responsibilities.

[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. Board members who have specialised skills can be used more effectively through their participation in the audit and other specialist committees (refer to Appendix A for examples of other specialist committees).

The establishment and operation of 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.

- It will assist in establishing and strengthening the independence and objectivity of the directors and the internal and external auditors.
- There will be improved communication and increased contact, understanding and confidence between directors, management and the internal and external auditors.
- There will be increased internal and external auditors' accountability as their performance will be under greater scrutiny.
- It will help to create a climate of discipline and control which will reduce the opportunity for fraud.
- A more cost efficient and effective external audit will result. This will benefit both the company and the auditor.
- The objectivity and credibility of financial reporting will be strengthened.

Furthermore, with appropriate communication, these benefits can be conveyed to stakeholders. It may be suitable to include a statement from the audit committee about its activities in the annual report.

... all organisations can benefit from audit committees

The benefits of the audit committee are not restricted to large publicly listed companies. The principles are just as applicable to any other corporate body, public or private organisation. Overseas these committees are used increasingly in hospitals, universities and other organisations where significant public funds are involved. While many comments in this booklet appear to be directed largely at companies, they are equally applicable to organisations such as those mentioned above.

Audit committee membership

Good practice in corporate governance indicates that audit committees should be:

limited in size ...

An audit committee usually comprises between three and five members. The committee should be kept small to encourage the active participation of each member. In the case of larger groups, it may be practical to have a number of audit committees - one for the main holding company and others for subsidiary companies or major operating divisions. However, the size rule should still apply to these committees.

dynamic ...

Members should rotate on a regular basis so that at any stage there is a mix of experienced and new members. A service period of two to three years is advisable. This is to ensure that the committee has a freshness of outlook.

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. The committee collectively requires an understanding of business risk management, internal

control, accounting and financial reporting, and other knowledge depending on the circumstances of the company. 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.

... 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.

Overseas pronouncements and corporate governance best practice emphasise the importance of non-executive directors. In Canada, a majority of non-executive directors is required by statute; in the United States the Treadway Commission recommended in 1987 that all publicly owned companies should have an audit committee consisting solely of independent directors. 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 judgement 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 judgement.

In New Zealand, the New Zealand Stock Exchange does not require publicly listed companies to have an audit committee. However, the Institute of Directors Code of Proper

Practice recommends that companies listed on the stock exchange and other large companies should have an effective audit committee appointed by the board, and that the audit committee should comprise, wholly or substantially, non-executive directors suitably qualified.

The audit committee: Terms of reference checklist

The terms of reference should contain the following information:

- ✓ the broad objectives of the committee
- ✓ the constitution and membership of the committee
- ✓ the number of members required for a quorum
- ✓ what authority the committee has in calling for information and in requiring management to attend meetings, and submit reports, etc
- ✓ its responsibilities
- ✓ the level of delegated authority
- ✓ details of available resources
- ✓ the minimum number of times it should meet each year
- ✓ who is required to attend meetings
- ✓ the keeping of formal minutes of meetings
- ✓ its specific duties
- ✓ what reports it is required to submit to the board and when
- ✓ procedures for self review

Terms of reference

An audit committee should assist the board of directors in carrying out its functions. It does not relieve directors of any of their responsibilities but can assist them to fulfil those responsibilities. To do this, its role should be objective and independent. It should operate as an overseer and a maker of recommendations and not one that intrudes into the area of management. The responsibilities of the audit committee should be outlined in the terms of reference which should:

outline the duties, authority and resources of the committee ...

The duties and responsibilities of the audit committee must be established so as not to impinge on management and to ensure objectivity. The committee should be established by a written resolution of the board of directors which should set out the terms of reference. The terms of reference should record clearly and concisely the duties, authority and resources of the committee. The specific duties will vary with the structure and philosophy of each board and the unique structure and nature of each company. However, a checklist of the basic requirements of the terms of reference are set out on the opposite page.

The Cadbury Committee on corporate governance best practice in the United Kingdom strongly recommends that listed companies should formally appoint an audit committee. It further recommends that audit committees act as committees of the main board with written terms of reference. This view was also adopted by the Treadway Commission in the United States, and the Institute of Directors in New Zealand under their code of proper practice.

be periodically reviewed ...

The terms of reference should be periodically reviewed in order to assess the relevance and the requirements of the committee. Any changes should be approved by the board.

... communicated to relevant parties

The committee's terms of reference should be effectively communicated to management, as well as internal and external audit.

Audit committees' duties checklist

High level duties:

- ✓ Review the effectiveness of the company's systems of internal control.
- ✓ Monitor management's response to reported weaknesses in controls, deficiencies in systems and recommendations for improvement.
- ✓ Satisfy itself that the internal and external audit plans make provision for effectively addressing the critical business risk areas.
- ✓ Consider the quality of financial information produced.
- ✓ Review the financial statements and interim reports, including the accounting policies adopted, prior to approval by the board. Ensure compliance with internal systems and statutory requirements.
- ✓ Prepare and submit formal reports on its activities to the board.
- ✓ Communicate to shareholders on its activities.

Internal audit duties:

- ✓ Liaise with and review the operations of the internal audit function.
- ✓ Review the objectives of the internal audit function including the internal audit charter.
- ✓ Review significant matters reported by the internal auditors.
- ✓ Review significant differences of opinion between management and the internal auditors.
- ✓ Assess the adequacy of performance of the internal audit function including available resources.
- ✓ Review the co-operation and co-ordination between the internal and external audit functions.

External audit duties:

- ✓ Make recommendations on the appointment or retention of auditors and their fees.
- ✓ Consider and resolve differences of opinion between management and auditors.
- ✓ Evaluate the performance of auditors and of financial management.

Other best practice duties:

- Monitor the ethical conduct of the company, its executives and senior officials.
- Direct and supervise investigations into any matters within its scope, for example, evaluation of the effectiveness of the company's internal controls, cases of employee fraud, misconduct or conflict of interest.
- Review management's philosophy towards control of corporate assets and the efficient and effective utilisation thereof.
- Monitor the legal compliance of the entity.

Duties of the audit committee

In principle, an audit committee should be advisory in nature and not a prescriptive executive committee. 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.

The duties of the committee should be carried out primarily at meetings of the committee supplemented by consultations and follow-up action, as and when needed. In order to perform these duties, the committee should have unlimited access to internal and external advisors when necessary.

Committee duties: high level

The audit committee, in effecting its high level duties, should:

address areas of weakness and deficiency in systems and controls ...

Management, external auditors and internal auditors all assess the effectiveness of the internal control systems. The audit committee should review identified weaknesses in controls, deficiencies in systems, recommendations for improvement and management's response thereto.

The auditors should be encouraged to raise any pertinent issues on the operations in general and not necessarily restrict themselves only to

audit related items that are included in their formal reports.

assess and react to critical risk areas ...

The committee should adopt a risk based approach to internal control whereby it identifies the business risks and ensures that appropriate procedures and controls are in place to mitigate or manage these risks.

The audit committee should consider whether there are any areas of major risk that require special attention or monitoring by the auditors.

... 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 board is also responsible for ensuring that these documents fairly present the matters reported and comply with all necessary disclosure requirements.

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 judgement

Duties of the audit committee continued.

- 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

Committee duties: internal audit

The audit committee, in effecting its internal audit duties, should:

... **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.

In many companies the internal audit function is expanding. 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.

Committee duties: external audit

There are a number of duties that the audit committee should perform with respect to the external audit, they should: **appoint and review auditors ...**

Once the audit committee has reviewed the results of an audit and has considered related matters, the 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 (the committee should satisfy itself that an effective audit can be conducted for the set fee)
- 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.

assess differences of opinion ...

Auditors are expected to be independent and to exercise their best judgement 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 judgement.

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.

Committee duties: additional notes from best practice

Best practice suggests that the audit committee should also:

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 behaviour 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

- compliance with the regulations of any other applicable statute and of controlling bodies, such as the New Zealand Stock Exchange

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

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. The committee should be authorised by the board to obtain outside legal or other independent professional advice in the provision of these special investigations.

ensure efficient and effective use of corporate assets ...

The executive management of the organisation needs to implement policies and procedures to give effect to the efficient and effective use of corporate assets. The audit committee should ensure that these policies and practices are implemented and maintained.

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. The Cadbury report recommends that 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.

When should it meet?

This depends very much 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.

Attendance at 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.

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.

Areas in which communication with the audit committee may be required include:

- the level of the auditor's responsibility in terms of generally accepted accounting practice
- the initial selection of, and any changes in, significant accounting policies and practices, especially in controversial or emerging areas for which there may be a lack of authoritative guidance
- management's method of preparing sensitive accounting estimates, and the auditor's opinion as to the adequacy of these estimates
- audit adjustments, whether booked or not, that could materially affect the company's financial results
- disagreements with management about matters that impact on the company's financial statements or the auditor's report
- illegal acts, irregularities and errors detected, as well as reporting responsibilities in terms of the Companies Act 1993 and the Financial Reporting Act 1993
- serious difficulties encountered in dealing with management
- the auditor's responsibility with regard to other information published with the audited annual financial statements

Conclusion

Experience has shown that a properly constituted audit committee can make an effective and valuable contribution to the process by which an organisation is directed and controlled. Audit committees have been established by a number of organisations in New Zealand. Many of these organisations are listed on the Stock Exchange or are subsidiaries of listed companies. The benefits of the audit committee are not limited to large listed companies. The principles are applicable to any corporate body, public or private organisation.

The audit committee should be established through written terms of reference that will outline the committees duties and responsibilities. However, care must be taken that the duties of the committee do not impinge on management.

The duties of the audit committee are extensive and can be quite onerous. Therefore, care must be taken in the selection of members of the audit committee. Members should maintain independence. A limited length of service of members is desirable in order to aim for a vigorous and dynamic committee.

The experience of sitting on the audit committee can be very rewarding. It is an opportunity for members to broaden their knowledge and experience, as they participate as a team in providing specialised guidance to the firm. Likewise the company will benefit from the establishment of an effective audit committee.

Appendix A:

Other committees of the board

Some of the more common committees are described below:

Remuneration committee

The role of the remuneration committee is to set the levels of remuneration for senior executives and board members of the company.

Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. Directors should not be involved in fixing their own remuneration.

The remuneration committee should operate by making recommendations to the board, rather than by discharging functions on behalf of the board. However, it would be a rare occurrence for the board to dissent from the recommendations of the committee.

The company's annual report should contain a statement of remuneration policy. Section 211 of the Companies Act 1993 requires disclosure in the annual report of the remuneration and other benefits received by each director.

Nomination committee

The adoption of a formal procedure for appointments to the board, with a nomination committee making recommendations to the full board, is good practice.

Companies should establish nomination committees to make recommendations to the board on all new board appointments.

Executive committee

This committee has the power to act for the board between board meetings. In the past, the executive committee was a powerful force, performing many deliberative responsibilities and making many decisions on behalf of the full board.

It is now believed that an executive committee detracts from the effectiveness of the full board. Furthermore, information technology now allows full board meetings to be more accessible despite geographical location differences. This is the reason for the falling number of executive committee meetings in companies world wide.

Finance committee

This committee is also being used with less frequency. The financial affairs of companies are so vital that all board members should be involved in reviewing and evaluating financial performance.

Some companies appoint special finance committees when unusual matters, such as financial restructuring or new stock offerings, are being reviewed. Companies with significant capital expenditures may use finance committees for in-depth reviews of major capital projects to save the full board's time.

Corporate governance committee

The corporate governance committee is being established in organisations under many guises. Its function has become increasingly important as pressure is exerted on boards to ensure companies are performing.

Generally, the corporate governance committee will have the following functions:

- select new directors for election by shareholders (old nomination committee function)
- see that newly appointed directors are properly trained

- approve changes in board size, age limits, number of meetings, or basic procedures
- approve compensation of board members
- appoint committee chairs and all committee members each year after discussion with the CEO
- review the function of new, temporary, or standing committees
- co-ordinate the performance evaluation of the board members and the CEO

Other committees

Boards may create a number of other specialised committees such as Public Affairs, Social Responsibility, Environmental Affairs, or Employee Benefits. Most boards manage to function with standing committees for Audit, Remuneration, and Nominating (or Corporate Governance), with a stand-by Executive committee for emergencies.

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