

Director's responsibilities:

How audit committee members add value

Audit Committee Guide
July 2015





Introduction

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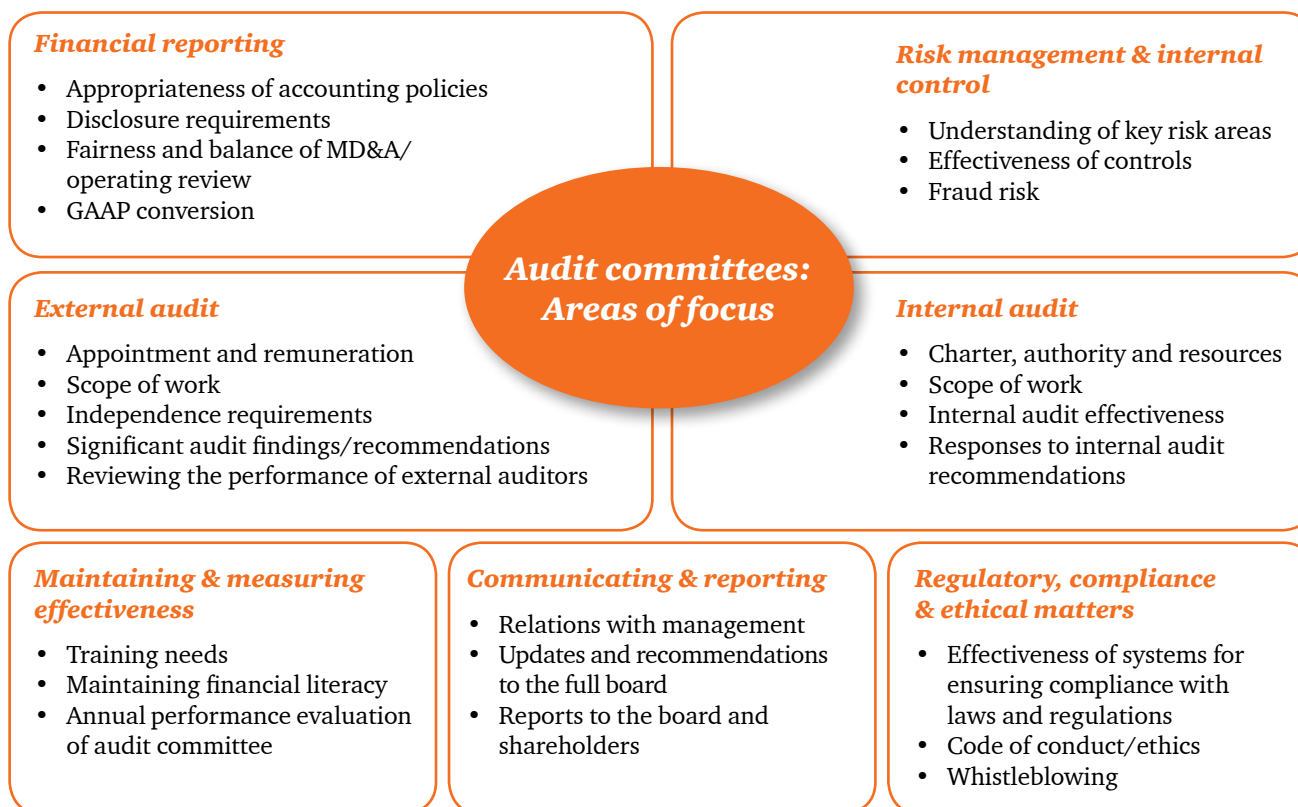
Whilst directors' responsibilities cannot be delegated, audit committees have an essential role to play in the governance of an organisation and ensuring the integrity and transparency of corporate reporting.

The PwC Audit Committee Guide is designed to help members of the audit committee work through the maze of director's responsibilities in a practical manner.



Introduction

Thousands of pages on corporate governance have been issued. However, regulations seldom provide helpful guidance on how the Audit Committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be focused? This guide is designed to help audit committees answer these questions.



The guide consists of:

- Introduction
- Setting up the audit committee
- Financial reporting: Reviewing financial information
- Risk management & internal control
- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Regulatory, compliance & ethical matters
- Compliance frameworks
- Materiality in audits

We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.

Introduction

Audit committees do not prepare financial reports, nor do they conduct audits. But they have an essential role to play in ensuring the integrity and transparency of corporate reporting.

The corporate reporting process consists of different elements in terms of providing financial information to capital markets. Management, the board and the external auditor have distinct but overlapping roles to play, and it is important for each group to understand the other roles as well as its own. The corporate reporting supply chain, illustrated on this page, shows the interrelationship between the elements.

Management's role is to be responsible for the day-to-day operations and business processes that deliver value for shareholders.

The **board's role** is to constructively challenge the strategy and business decisions taken by executive management, and to ensure that appropriate policies and systems are in place to control the business. The board's approval of the financial statements is the primary assurance to shareholders.

The **external auditor's role** is to provide an independent opinion on the presentation of the financial statements that have been prepared by management and approved by the board.

The **audit committee** – a subcommittee of the main board acting under delegated authority – provides key links between these groups. It can ease pressure on a busy board because it can take time to address financial reporting and internal control issues. And by providing a primary focus for discussions with internal and external auditors, it enables both sets of auditors to boost their independence.

The PwC Audit Committee Guide is designed to help audit committee members answer these questions. In this section we set out an overview of the audit committee's responsibilities.



1. Requirement to have an audit committee

The audit committee is an essential part of the corporate reporting process. In New Zealand, the New Zealand Exchange (NZX) requires issuers listed on the NZSX/NZDX to establish a properly constituted audit committee (NZX Listing Rule 3.6).

The NZX Listing Rules requires all issuers to establish an audit committee and stipulates its minimum membership and responsibilities. In addition, the Reserve Bank of New Zealand (RBNZ) requires New Zealand incorporated banks and licensed insurers to establish an audit committee. These requirements are supported by the Corporate Governance in New Zealand Principles and Guidelines (SC 9 Principles), published by the Securities Commission and grandfathered by the Financial Markets Authority (FMA). The principles and guidelines do not impose any additional legal requirements, but do offer guidance on best practice corporate governance. The Controller and Auditor General has also published a Good Practice Guide for Audit Committees in the Public Sector, which also sets out principles and good practices needed to set-up and effectively operate an audit committee.

In Australia, the Australian Securities Exchange (ASX) Corporate Governance Council's (ASX CGC's) Principles of Good Governance and Best Practice Recommendations provide additional requirements for Australian companies, which while similar to New Zealand requirements, do include more stringent rules and disclosure requirements.

NZX Listing Rules and Securities Commission Corporate Governance in New Zealand Principles and Guidelines

Structure the audit committee so that it consists of:

- only non-executive directors
- a majority of independent directors
- an independent chair, who is not chair of the board
- at least three members
- at least one member with an accounting or financial background.

Commentary and guidance

The audit committee should be of sufficient size, independence and technical expertise to discharge its mandate effectively.

Importance of independence

The ability of the audit committee to exercise independent judgement is vital. International practice is moving towards an audit committee comprised of only independent directors.

The audit committee should have a formal charter.

Commentary and guidance

Charter

The charter should clearly set out the audit committee's role and responsibilities, composition, structure and membership requirements. The audit committee should be given the necessary power and resources to meet its charter. This will include rights of access to management and to auditors (external and internal) without management present and rights to seek explanations and additional information.

Responsibilities

The audit committee should review the integrity of the company's financial reporting and oversee the independence of the external auditors.

1. Requirement to have an audit committee

NZX Listing Rules and Securities Commission Corporate Governance in New Zealand Principles and Guidelines

Technical expertise

The audit committee should include at least one member who has financial expertise (ie is a qualified accountant or other financial professional with experience of financial and accounting matters).

In Australia there is a slightly more stringent requirement that all members should be financially literate (ie are able to read and understand financial statements) and some members who have an understanding of the industry in which the entity operates. However, recent court cases such as Centro Properties Group and Nathans Finance Limited have reinforced that directors must have sufficient financial literacy to ensure they can adequately monitor and supervise the company's business. The Institute of Directors in New Zealand (IoD) also highlights that while the audit committee can assist the board, it cannot relieve the board of its responsibilities¹.

Meetings

The audit committee should meet often enough to undertake its role effectively. The IoD recommends that at least three meetings are held per year.¹ The audit committee should keep minutes of its meetings and these should ordinarily be included in the papers for the next full board meeting after each audit committee meeting.

Reporting

The audit committee should report to the board. The report should contain all matters relevant to the committee's role and responsibilities, including:

- assessment of whether external reporting is consistent with committee members' information and knowledge and is adequate for shareholder needs
- assessment of the management processes supporting external reporting
- procedures for the selection and appointment of the external auditor and for the rotation of external audit engagement partners
- recommendations for the appointment or removal of the external auditor
- assessment of the performance and independence of the external auditors. Where the external auditor provides non-audit services, the report should state whether the audit committee is satisfied that the provision of those services has not compromised the auditor's independence.
- assessment of the performance and objectivity of the internal audit function, and the results of its review of risk management and internal control systems.

1. IoD Principles of Best Practice for New Zealand Directors.

1. Requirement to have an audit committee

USA requirements

In the USA, the Sarbanes-Oxley legislation of 2002 required the Securities and Exchange Commission (SEC) to set rules in relation to audit committees. Under current SEC rules, all national exchanges (eg the NYSE and NASDAQ) must require member companies to have an audit committee, with independent members and specified responsibilities, before they are permitted to list. The rules apply to non-US companies listing with these exchanges and set out specific requirements in relation to constitution and activity. Some provisions are permitted for foreign registrants, such as allowing certain employees or government representatives to be audit committee members.



Australia requirements

In Australia, the Australian Securities Exchange requires companies in the S&P/ASX All Ordinaries Index to have a properly constituted audit committee. If an entity is in the S&P/ASX 300 Index at the beginning of its financial year, it must follow the recommendations on the composition, operation and responsibilities of the audit committee. If a listed company does not establish an audit committee, the ASX requires that the company discloses how its alternative approach ensures the integrity of the financial statements of the company and the independence of the external auditor, and why an audit committee is not considered appropriate.

Requirements of other regimes

Audit committees are now a regular feature in almost all major capital markets, either through regulation or expected practice. In addition, the International Organisation of Securities Commissions and the Organisation for Economic Co-operation and Development (OECD) have indicated that they view audit committees as a potentially powerful tool that can improve the reliability and transparency of financial information. While one size will not fit all markets, or indeed companies within those markets, the value of an audit committee is undeniable.

2. Setting up the audit committee

To be effective, an audit committee needs to be well prepared and set up. A clearly written charter helps the audit committee, board and others to understand their respective roles and responsibilities, and is an essential starting point.

Having clear membership and selection criteria is a key element of effectiveness, as the audit committee will only be as good as its members.

Audit committee members are usually board members, so they will already have qualities relevant to the company and its business. However, for the specific audit committee work, additional skills and attributes are required, such as independence from management, appropriate financial expertise or knowledge, sufficient time and energy for the additional work, and a questioning attitude.

The chair has specific responsibilities in relation to setting agendas and ensuring the effective operation of the audit committee. This is done by ensuring that agenda papers provide concise and clear direction to assist the members' deliberations, and by managing the members' interactions.



3. Overview of responsibilities

Generally, the responsibilities of the audit committee can be categorised into a few key areas, as shown below.



3. Overview of responsibilities

Financial reporting: reviewing financial information



The audit committee is normally responsible, on behalf of the board, for ensuring the integrity of the company's financial reports. This important role includes reviewing draft financial statements and other price-sensitive material before publication. Time for these reviews and any follow-up work will need to be factored into the company's timetable for releasing such material.

These reviews must be sufficient to allow the audit committee to explain to the rest of the board how the company proposes to report its financial results. Therefore, to be able to review financial statements effectively, audit committee members need to understand the accounting concepts that affect the reporting status, and also need to be able to constructively challenge management and the external auditor on key subjective or complex areas.

Working with the external auditor



The audit committee is the primary focus for the company's relationship with the external auditor. Its role includes making recommendations to the board on the appointment of the auditor, agreeing audit fees, reviewing the scope of audit work, and reviewing the external auditor's independence.

The external auditor can provide important information and direction for the audit committee on how it is fulfilling its financial reporting and risk management/internal control responsibilities. It can also assist the audit committee to assess the information provided to it and the financial reporting implications of policies or estimates selected by management.

Risk management & internal control



Risk management

Risks are uncertain future events – both positive and negative – that could affect cash flows, profitability, shareholders' returns and the company's reputation. The board, management and the audit committee have different but interrelated roles in relation to risk.

It is the board's responsibility to establish the parameters for determining company strategy – including the company's risk appetite – and to approve policy in relation to that strategy. Management's responsibility is to develop procedures for taking and managing risk, including the risk profile, in line with board policy.

The audit committee's role is to review the company strategy and risk profile and consider and monitor whether management's risk management activities and procedures, particularly as they affect financial reporting, are in line with this.

Internal controls

For risks that are accepted, management will establish a control system. A well-designed and implemented internal control system provides the right environment for efficiently running an entity's operations.

The audit committee needs to understand and evaluate the financial reporting control systems implemented by management. This includes controls over the integrity of the financial accounting systems and records, and controls to ensure fair presentation and disclosure of financial information in accordance with standards. The OECD further recommends that the audit committee oversees the enterprise-wide risk management system and that the head of risk management reports directly to the audit committee to ensure risk management functions are independent of profit centres.

3. Overview of responsibilities

Understanding internal audit



The internal audit function has traditionally reported to management and the CEO. Increasingly, however, the importance of a reporting line to the audit committee is being emphasised and best practice guidelines are that this is a direct reporting line.

A strong, positive relationship with internal audit can give audit committee members an insight into control elements relevant to their work, qualifications, resources, scope of work including any limitations imposed by management, and findings of reviews undertaken.

Maintaining & measuring effectiveness



The work of the audit committee can be detailed and members need to ensure their knowledge and awareness remains up to date (particularly where financial accounting standards and wider reporting issues are concerned). This may involve educational or training sessions for audit committee members in addition to other meetings.

As with all elements of the corporate reporting chain, accountability is important for effective operation. The audit committee should regularly evaluate its performance against the responsibilities set out in its charter. This assessment can take place on an individual basis and/or collectively. It is usual for the results of the evaluation to be reported to the board as well as being used by the audit committee for improvement.

Communicating & reporting



The audit committee needs to have a constructive working relationship with management. This is an area that can require substantial and ongoing work. Management is the primary source of information for the audit committee, but as the audit committee has different priorities than those of management, the way management presents material may not always be in the most useful form for the audit committee. The chair and committee secretary can take a key role in working with management on the format of information presented.

The audit committee works under delegated authority from the main board of directors and needs to report to the board on its activities, findings and other relevant matters. Commonly this is done orally, although increasingly boards are looking for written reports or presentations to assist their understanding. Some audit committees are also asked to report on behalf of the board to shareholders, either at the annual general meeting or in the annual report.

3. Overview of responsibilities

Regulatory, compliance and ethical matters

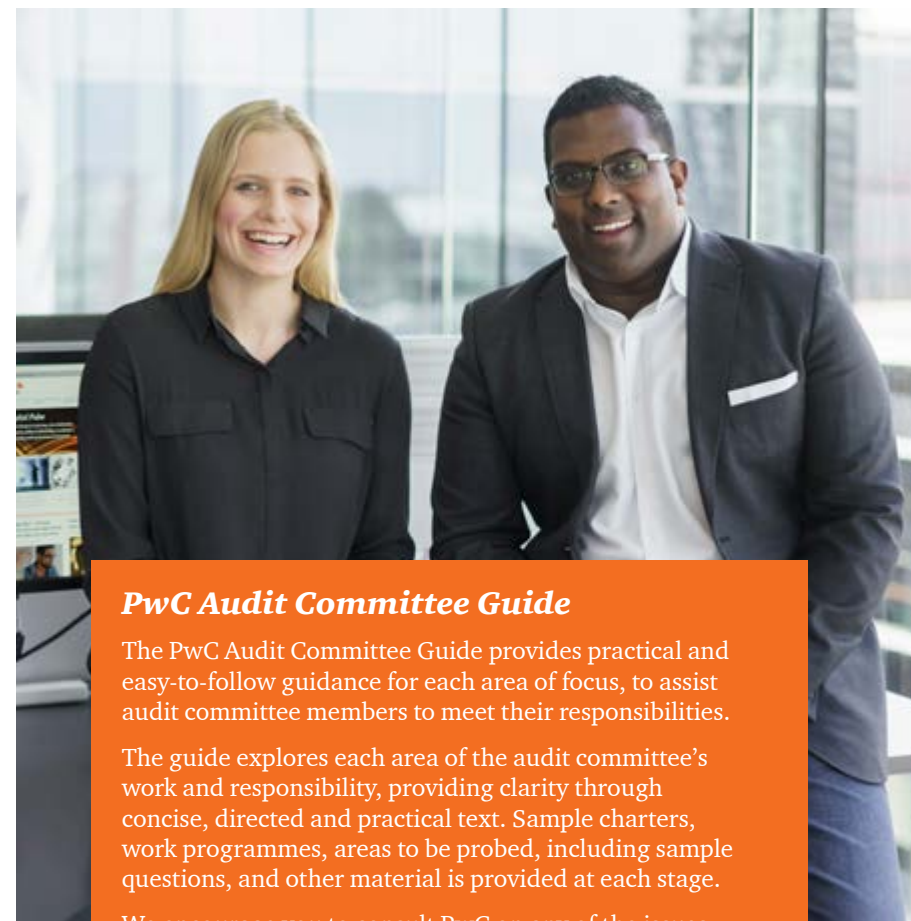


Unless the company has a separate compliance committee, the audit committee usually oversees compliance matters beyond those relating to the integrity of published financial information. Audit committee members therefore need a wider understanding than just the financial reporting process. The audit committee must understand and be familiar with not only management's internal financial controls and its procedures for managing financial risks, but also legal, regulatory and industry standards; internal policies; other stakeholder requirements; and ethical matters. All of these factors can have a potential financial, non-financial or reputational impact.

The reputation of a business is a critical factor in determining its value. More and more boards are devoting resources to ethical programmes and it is common for companies to adopt a formal code of conduct, setting out the board's guidelines for acceptable business practices.

The audit committee is not normally responsible for determining ethical standards. That responsibility should belong to the board as a whole. However, the board and management may consult the audit committee in designing a code or setting guidelines for business behaviour.

An audit committee should be responsible for reviewing and approving the policies, processes and framework for identifying, analysing and addressing complaints (including whistleblowing), and for reviewing material complaints and their resolution. The monitoring of complaints is a valuable mechanism for identifying issues that might have a financial, non-financial or reputational impact, and staff who are aware of possible financial malpractice should have a safe channel through which to report their concerns.



PwC Audit Committee Guide

The PwC Audit Committee Guide provides practical and easy-to-follow guidance for each area of focus, to assist audit committee members to meet their responsibilities.

The guide explores each area of the audit committee's work and responsibility, providing clarity through concise, directed and practical text. Sample charters, work programmes, areas to be probed, including sample questions, and other material is provided at each stage.

We encourage you to consult PwC on any of the issues raised in the guide or on any questions you may have in relation to your role on the audit committee.

Setting up the audit committee

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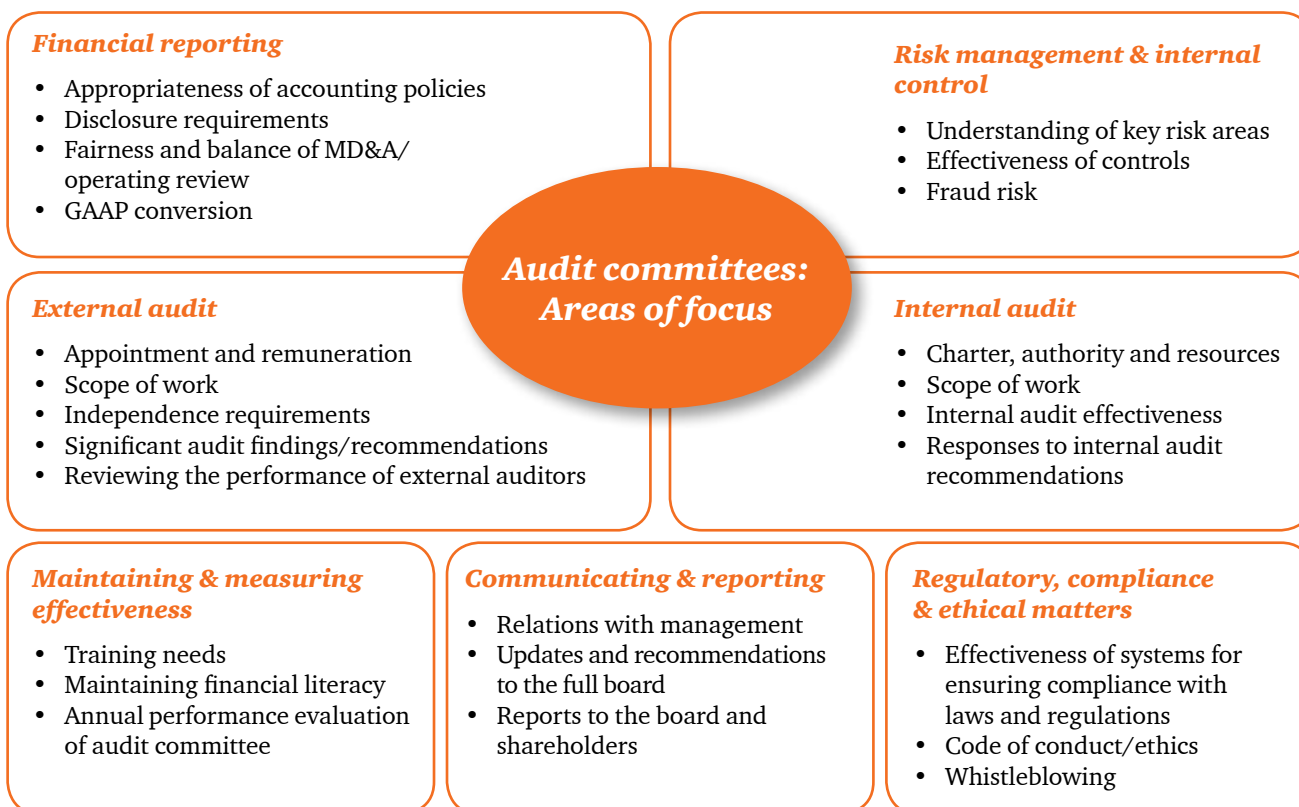
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Setting up the audit committee

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A clearly written charter helps the audit committee, board and others to understand their respective roles and responsibilities, and is an essential starting point.

Having clear membership and selection criteria is a key element of effectiveness, as the audit committee will only be as good as its members. Audit committee members are usually board members and so they will already have qualities relevant to the company and its business. However, for the specific audit committee work, additional skills and attributes are required, such as independence from management, appropriate financial expertise or knowledge, sufficient time and energy for the additional work, and a questioning attitude.

The chair has specific responsibilities in relation to setting agendas and ensuring the effective operation of the audit committee. This is done by ensuring that agenda papers provide concise and clear direction to assist the members' deliberations, and by managing the members' interactions.

This section provides an overview of how to establish an audit committee, its roles and responsibilities, and the skills and expertise required of its members.



1. The charter

A well-written charter, which clearly sets out objectives, roles and responsibilities, composition, structure and membership requirements, is a prerequisite for an effective audit committee. The SC 9 Principles recommends that an audit committee should have a charter, and should make it publicly available.² We suggest that not only should there be a comprehensive charter, but that it also needs to be embraced by the audit committee members. The mere existence of a charter, which does not guide behaviour and activity, will not enhance governance.

Audit committee objectives, roles and responsibilities

A charter will begin with a general statement of objectives, which reflects the specific board responsibilities assumed by the audit committee. The roles and responsibilities section then sets out how these objectives are to be met. This section is often split into specific categories such as risk management, internal control, financial reporting, compliance, external audit and internal audit.

Points to consider

- What is the extent of the committee's responsibilities for risk management, compliance and internal control – is it responsible for the entire risk management system or only financial risks?
- Has the committee assumed any specific responsibilities, for example the assessment and review of the company's governance framework?
- Does the charter provide enough flexibility to allow the committee to operate effectively, while ensuring its roles and responsibilities are clear?
- Does the charter grant the committee the resources and access to people, information and independent advice it needs to meet its obligations?

Structures, procedures and administration

A comprehensive charter also details the audit committee's:

- authority
- organisation – membership, meetings and minutes
- reporting responsibilities
- performance evaluations
- charter review requirements.

An example of an audit committee charter is provided in Appendix A.

Making the most of it

To maximise the benefit of a well-constructed charter, many audit committees:

- use it as the basis for preparing agendas for meetings
- adopt it as the framework for reporting to the board and for evaluating the audit committee's performance
- review it at least annually, with its final form being approved by the board.

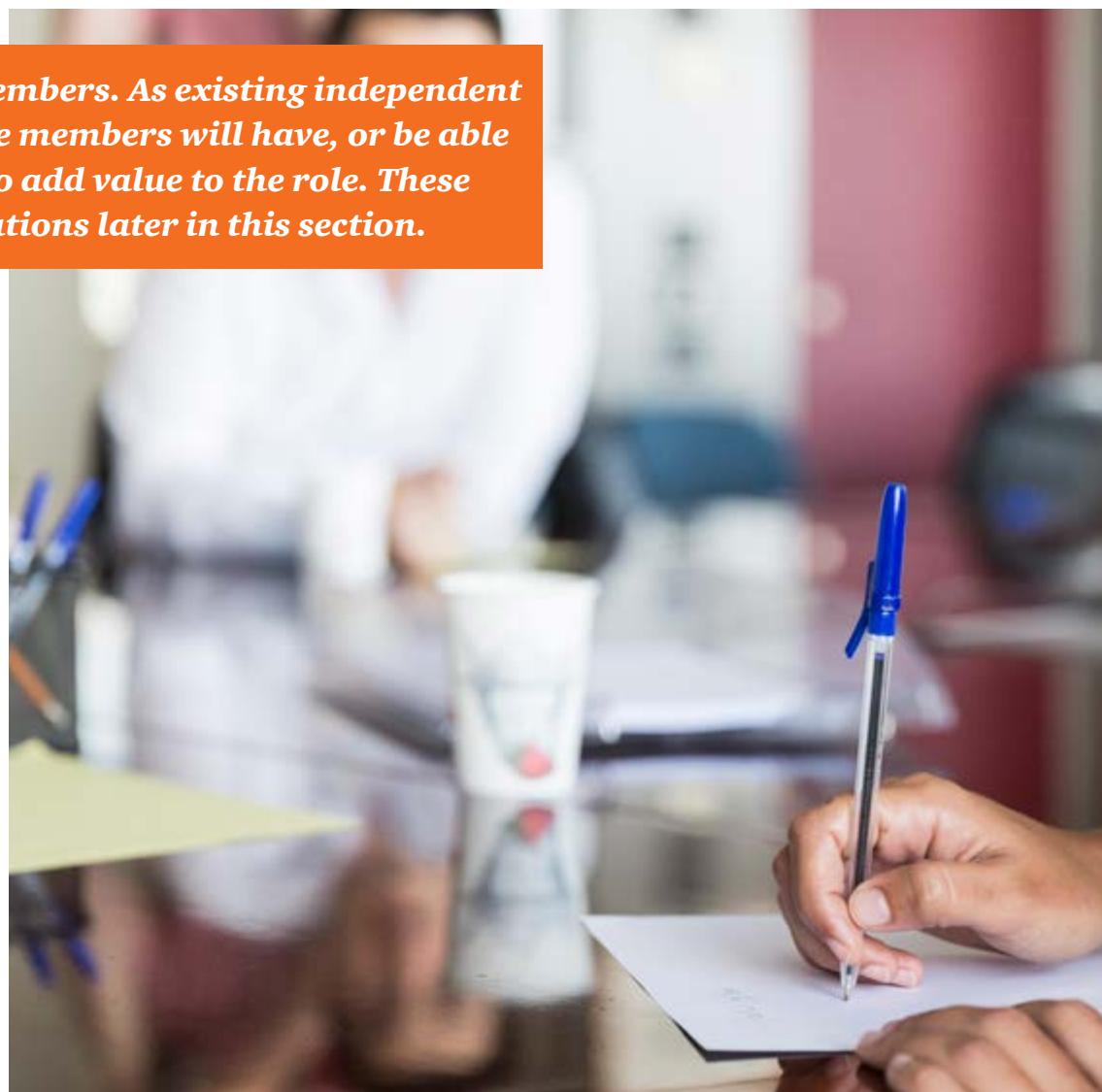
2. Membership

An audit committee is only as good as its members. As existing independent non-executive directors, all audit committee members will have, or be able to attain, the qualities and skills required to add value to the role. These include the qualities set out under Qualifications later in this section.

For some companies, particularly smaller listed companies, there is a concern that audit committee membership adds to costs and the demands placed on management resources. Some worry that audit committees add an unnecessary tier to the management structure and create additional bureaucracy.

However, research shows that small companies can be, and are, flexible about how they compose audit committees to suit their individual circumstances. For example, some comprise non-executives who are not independent according to company definitions. In these cases, a company meets its obligations by obtaining a waiver from the NZX prior to their appointment and disclosing that fact, along with the key details, in its annual report so that the issue is transparent to the shareholders.

A properly established audit committee with appropriate membership will generally add value. The experience and commercial advantages members of an audit committee can bring to a company – particularly those with less sophisticated risk management systems, less robust internal controls or more aggressive accounting policies – outweigh any cost or management resource considerations.



2. Membership

Committee members' expectations

The areas of focus for the audit committee are comparatively wide ranging, and one of the most important matters to address is what is expected of the members. Typical areas of focus for audit committees are set out in the diagram below.

Members are expected to be able to assess information provided to them in all of these areas, and to direct challenging enquiries on key issues. Specific guidance on fulfilling the responsibilities in each of these areas of focus is set out in other sections in the PwC Audit Committee Guide.

Selecting members

The appointment of suitably qualified members is a critical factor in an audit committee's performance.



2. Membership

The board or a nominations committee is usually responsible for selecting and appointing audit committee members. To do this, it must first set selection criteria relating to qualifications and experience.

Qualifications

Each member should be capable of making a valuable contribution to the audit committee. A diverse outlook among members is desirable, because a uniform view can lead to over-emphasis in one direction. Qualities which are valuable for audit committee members include:

- an attitude of mind independent of the company's management
- integrity
- a capacity to dedicate sufficient time and energy
- an understanding of the business, its products and services
- knowledge of the company's risks and controls
- an ability to read or understand basic financial statements, ask pertinent questions about them, and interpret and evaluate answers
- an ability to give direct and honest opinions
- inquisitiveness and independent judgment
- an ability to offer different perspectives and constructive suggestions
- financial literacy.

Newly appointed audit committee members may not initially possess all of these characteristics. It may take six to 12 months to acquire familiarity with the company's operations to the level required for the audit committee role.

The Listing Rules³ requires that at least one member of the audit committee has an accounting or financial background. A member of the Audit Committee will be deemed to have adequate accounting or financial background if he or she is a member of the New Zealand Institute of Chartered Accountants (NZICA), or has held a Chief Financial Officer position at an issuer for a period greater than 24 months, has successfully completed a course approved by the NZX for Audit Committee membership or has the experience and/or qualifications deemed satisfactory by the Board.

Additionally, some members should have an understanding of the industry in which the company operates.

However, the audit committee should not place undue reliance on the skills of any single individual. Ultimately, the personal qualities of the people on an audit committee and the tone of its activities are of paramount importance. It is an individual's analytical skills, tenacity and judgment arising from experience that will make for the best audit committee member – not simply being able to tick the box for detailed criteria. It is the audit committee that takes the responsibility collectively for its activities, not any designated individual.

Independence

The audit committee is responsible for overseeing the financial reporting process. In doing so, it might be necessary to challenge management's judgement or to take positions that might be contrary to those of management. That is why independence from management is an essential quality for audit committee members.

In addition, the emphasis on independence is because there is a belief and a perception that independent directors are better equipped to express their opinions freely, unconstrained by financial ties or their position in the company.

For these reasons, an audit committee composed wholly of independent directors is considered optimal. The IoD recommends that an audit committee should wholly or substantially comprise independent non-executive directors suitably qualified.⁴ In Australia, the ASX CGC recommends a majority of independent directors and encourages companies to move towards an audit committee comprising only independent directors.⁵

3. Rule 3.6.2d, NZX Listing Rules.

4. IoD Principles of Best Practice for New Zealand Directors.

5. Recommendation 4.2 and its commentary and guidance, ASX CGC Principles of Good Corporate Governance and Best Practice Recommendations.

2. Membership

The concept of independence is not easy to define, though many major investors and representative bodies have developed frameworks or guidance for their own purposes. The board will have its own understanding of how ‘independence of directors’ is defined and perceived by the market. It is important that the board’s approach to the independence of its directors and audit committee members, and its independence criteria, be communicated to shareholders.

In addition to the company’s individual criteria, directors and members must satisfy any applicable laws and regulations relating to audit committee independence. For example, in New Zealand, the Listing Rules define an independent director as being one who is not an executive officer and who has no disqualifying relationships. The criteria for disqualifying relationships are described in Appendix B.

However, if a board considers that it is in the best interests of the company and its shareholders, it might decide to appoint a director who has one or more of the relationships perceived to be incompatible with independence. A waiver may be obtained from the NZX prior to their appointment as an independent director, which should then be disclosed to shareholders as the ultimate arbitrators of the company’s best interests.

Financial literacy and expertise

The SC 9 Principles⁶ states that at least one audit committee member should have financial expertise (ie be a chartered accountant or have another recognised form of financial experience). This expertise could have been gained through past employment in finance or accounting, through a professional qualification in accounting, or through any other comparable experience, such as being a senior officer with financial oversight responsibilities or the auditor of a listed company.

The assessment of ‘relevant’ financial experience should be relatively straightforward. For example, a recently retired finance director or the audit partner for a listed group might reasonably be judged to have the required experience in relation to similar sized companies or companies within the same sector.

Conversely, someone who has never had reason to review or query a set of financial statements might reasonably be judged to lack relevant experience.

Not all cases will be so clear-cut. Financial experience can accrue in diverse ways. Regulators, central bankers, chief executive officers, investment bankers, fund managers, treasurers, insolvency practitioners, commercial lawyers, analysts, and public sector managers and trustees, for example, can all be characterised as having financial experience in at least a broad sense, and all will have deep financial expertise in certain matters.

Appendix C contains a checklist of information relevant to assessing financial literacy and expertise.

In Australia, under ASX CGC recommendations, each member of the audit committee should be financially literate – that is, should have the ability to read and understand primary financial statements.

Audit committee members in Australia must give attention to matters such as:

- Generally Accepted Accounting Principles (GAAP) and non-GAAP amounts, key performance indicators and ratios
- complex and sensitive areas or areas of judgement, such as financial instruments; accounting for superannuation and share options; business combinations; and valuation of intangible assets
- in the case of companies with multiple listings, the implications of preparing financial statements under several reporting frameworks
- moving from one reporting framework to another (for example from national GAAP to International Financial Reporting Standards).

An audit committee member needs to be able to challenge management on financial reporting issues at a high level, so an important aspect of the role is to know what questions to ask and understand how to assess responses.

Ideally the audit committee will have more than one person with financial experience, so that responsibility for the financial statements is not seen to fall to one person. The whole of the audit committee, and ultimately the board, is responsible for the financial statements, regardless of whether only some of the members have financial experience.

6. Principle 3, SC Corporate Governance in New Zealand Principles and Guidelines.

2. Membership

Additional considerations for USA registrant companies

For listed companies that are also USA registrants, a similar but separate requirement has been introduced by the SEC. This is set out in Appendix C.

The chair's role

The position of the audit committee chair is pivotal. The chair is the focal point for the audit committee's relations with the board, the chief financial officer and the internal and external auditors. The chair is also responsible for the smooth running of meetings, ensuring that the views of each member are heard and that sufficient time for discussion is devoted to each issue. Most chairs plan the agenda for each meeting with the audit committee secretary.

The board therefore needs to look for someone with strong leadership qualities, and the ability to promote effective working relationships among audit committee members and with others (such as management and external and internal auditors). The IoD considers it desirable that the chair is a chartered accountant or a person well versed in commercial matters.⁷

The roles of chair and financial expert might in some cases be combined in one individual. However, for most audit committees a better balance of skills will be achieved by having these roles performed by different people. In these circumstances, the chair must be properly briefed on the technical aspects to be able to report to the board and shareholders.

Tips for the chair's role:

Be proactive – decide what you want to do, plan and lead.

Get the timetable right to ensure the audit committee sees things in good time.

Get the agenda right to allow members to prepare and to effectively manage meetings.

Know the **strengths and weaknesses** of members.

Ensure the board is well informed – orally as well as by minutes.

Liaise closely with the CFO to ensure you brief each other in good time on relevant issues.

Get to know the external auditor so you can probe effectively, understand its relationship with management, and be alert to concerns.

Make sure **members are kept up to date** on financial reporting, risk management and regulatory developments.

Ensure **internal control matters are fully discussed** with management and auditors, and issues are understood.

Ensure a **direct line to the internal audit function** and understand its scope.

Use the role to encourage **communication with the market**.

Ensure the **audit committee is flexible** – not stuck to routine.

Size of committee

An audit committee should be large enough to represent a balance of views and experience, yet small enough to operate efficiently.

It is generally thought that audit committees of three to six members are the ideal size. The NZX Listing Rules requires that the audit committee consist of no fewer than three members, all non-executive directors and the majority independent directors.⁸

However, the important issue is that the size is appropriate for the company's circumstances, and depends on the nature and extent of the audit committee's responsibilities.

7. IoD Principles of Best Practice for New Zealand Directors.

8. Rule 3.6.2 and rule 3.1, Appendix 16, NZX Listing Rules.

2. Membership

Term of office

The number of years that members serve on an audit committee varies. A common term is three years, with possible reappointment for a second term, but longer terms are also possible. It is rare for audit committee members to rotate on an annual basis, which is why a programme that regularly evaluates the audit committee members' performance is important. (See the Maintaining & measuring effectiveness section.)

When determining the length of time audit committee members may serve, the board will weigh two opposing considerations – continuity and freshness. Rapid turnover can be detrimental to the audit committee's effectiveness, because members need time to familiarise themselves with the company's business and financial reporting structure and understand technical issues. On the other hand, new members bring a fresh perspective. To balance these considerations, the board may wish to consider staggered terms for members.

New members

Most companies use executive selection agencies to screen directors for new positions. In the same way, prospective audit committee members will want to conduct their own 'due diligence' before they accept the role, particularly if they are also new to the board.

Questions prospective board and audit committee members might ask themselves before taking on the role include:

- Can investors understand the company's governance structure?
- Who are the company's principal advisers?
- How does the business make its money?
- Is the company clearly honest and transparent in its dealings with stakeholders?
- Is the audit committee seen as important internally as well as externally?
- How wide is the audit committee's remit (too narrow or too broad)?
- Who is the audit committee chair and how does he or she control meetings?
- Do the other members add value by their skills or experience, and how will I complement these attributes?

Once their appointment is confirmed, it is important to provide new audit committee members with relevant background information. Examples of what this may cover are provided in Appendix D. Although audit committee members will normally also be directors of the board, the information and knowledge they will need to fulfill their audit committee obligations will differ from that necessary for their board functions.

New members have a responsibility to ensure they have an appropriate understanding of the company, including its:

- products and services
- areas of risk
- internal control and financial reporting systems.

They also want to be clear about the requirements and objectives of the audit committee.

For this reason, most induction processes for new audit committee members cover:

- an overview of the business
- the role of the audit committee
- the time commitment expected from members
- an introduction to the company's senior finance, compliance, internal audit and risk management staff.

In addition, to obtain further clarification about the audit committee's requirements and objectives, new members should review the charter, the minutes of prior meetings, and recent reports by the committee to the board.

3. Meetings

Preparing for meetings

It is the chair's role to ensure that meetings are properly planned and run. This means holding regular meetings and ensuring the timetable and agendas are carefully planned and participants are briefed on their responsibilities.

The number of meetings the audit committee holds is influenced by its objectives and scope of activities, and the size and nature of the business. Regular meetings provide the opportunity to review and discuss information on a timely basis. It is helpful to schedule meetings (particularly those at which financial statements are reviewed) well in advance of the corresponding board meeting.

Generally, meetings correspond with major phases of the financial reporting, external audit and internal audit cycles, which often means a minimum of four meetings a year. The audit committee chair should decide the frequency and timing of the committee's meetings.

Papers

In our experience, the reaction of members to the arrival of audit committee papers is typically either "Too much!" or "Too late!". To maximise effectiveness, it is useful to have a detailed written agenda with clear supporting papers highlighting matters for decision. Examples of this are provided in the Communicating & reporting section.

An appropriate timescale for receiving meeting papers is at least three or four working days before the meeting, although most audit committee members prefer a longer period to review the papers.

In the case of the annual financial report, it may be appropriate to schedule two meetings – one about two weeks before the report is released to ensure adequate time to address the significant issues; another just before the release, to review the final numbers.

Minutes of audit committee meetings should be prepared and sent promptly to committee members and to the board of directors (and external and internal auditors where appropriate). These minutes, in addition to direct reports to the board from the audit committee chair, help keep the board informed about audit committee activities.

Time commitment

To fulfill their responsibilities, audit committee members need to dedicate a significant amount of time and energy to committee activities. The number of other directorships they hold might affect the amount of time they can devote to audit committee activities. Boards will consider these aspects when evaluating potential candidates.

It is usually expected that members of the audit committee will attend all audit committee meetings.

3. Meetings

Other participants

Other participants may attend audit committee meetings by invitation. Such participants could include:

- the head of the company's internal audit function
- the heads of risk management and compliance
- the lead partner of the external auditor
- senior management, including the chief financial officer or finance director.

Other attendees should be limited to those who are familiar with or responsible for topics on the agenda, for example the in-house lawyer or external legal counsel. The table below lists some of those who are commonly invited to attend audit committee meetings.

Person/Group	Frequency	Reason
Internal auditor	Each meeting	<ul style="list-style-type: none"> • Take part in a brainstorming session on key risk areas • Discuss matters affecting the financial reporting process, including significant estimates/areas of judgement • Discuss possible override of internal controls and any indications of improper conduct by senior management • Report on the design and effectiveness of key internal controls
External auditor	Each meeting	<ul style="list-style-type: none"> • Take part in a brainstorming session on key risk areas • Discuss matters affecting the financial reporting process, including significant estimates/areas of judgement • Report on key internal controls and wider observations

Person/Group Frequency Reason

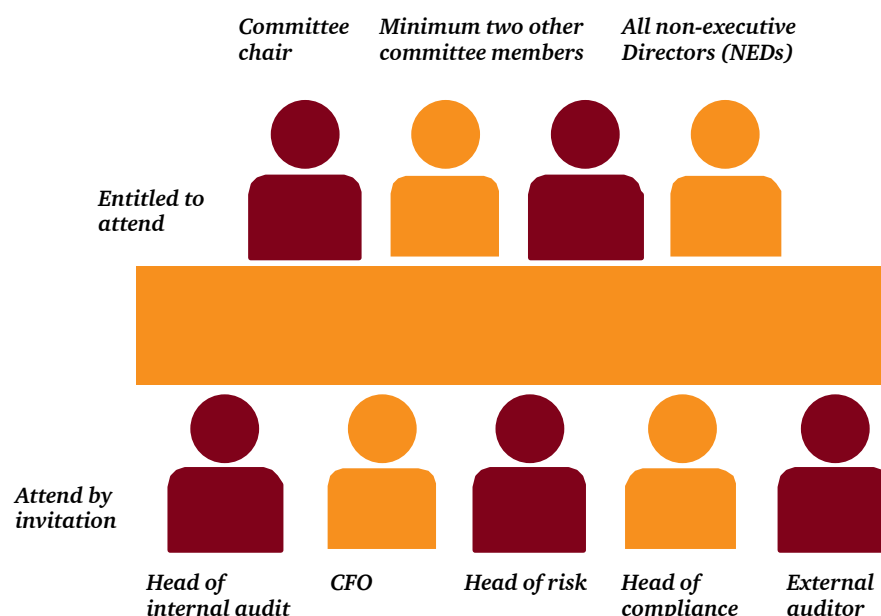
Key employees:	Each meeting	<ul style="list-style-type: none"> • Take part in a brainstorming session on key risk areas • Discuss matters affecting the financial reporting process, including significant estimates/areas of judgement • Key internal controls
– Chief financial officer		
– Risk management/compliance		
Key employees:	Each meeting	<i>Risk Management/Compliance</i>
– General counsel		<ul style="list-style-type: none"> • Provide information on the management of key existing and emerging risks • Provide information on significant compliance issues, including policy, process and culture • Provide information on complaints, including whistleblowing
– Human resources		
– Marketing/sales		
– Business unit leaders		
	Most meetings	<i>Chief financial officer</i>
		<ul style="list-style-type: none"> • Provide information on the financial reporting process, including key financial risks, controls and accounting policies
	Once a year or more if legal issues arise	<i>General counsel</i>
		<ul style="list-style-type: none"> • Advise of any legal breaches or violations of company's code of conduct • Explain any major legal risks facing the entity, which may create pressure to engage in fraud
	Annually	<i>Human resources</i>
		<ul style="list-style-type: none"> • Provide information on management's integrity and the 'tone at the top'

3. Meetings

Person/Group	Frequency	Reason
	Annually	Sales and marketing <ul style="list-style-type: none"> Provide information about policies and controls over selling activities. This information may help reveal pressures to meet revenue targets and causes of possible inappropriate behaviour
	Annually	Business unit leaders <ul style="list-style-type: none"> Discussion about performance-based incentives and management-imposed pressures may provide information about the risk of the potential management override of internal controls.

Where appropriate, the audit committee should arrange separate meetings with management and external and internal auditors. Topics for discussion with management might include the evaluation of the external auditor, accounting and internal audit personnel. Discussions with auditors might include the co-operation the external and internal auditors receive from the company's staff and management. These matters are discussed in more detail in other sections of the PwC Audit Committee Guide.

Audit committee meeting attendees



Support

Audit committee members are not full-time directors or management of the company, and so will require assistance in fulfilling their duties and accessing relevant information. Most audit committees have at least one dedicated administrative or secretarial support person. This person manages paperwork, prepares agendas and minutes in conjunction with the chair, and helps audit committee members access other information they require. Often the company secretary will act as secretary to the audit committee.

Occasionally other resources may be required (for example, when conducting special investigations), such as legal advisers and other specialists.

The audit committee also needs to be supported by the company management and personnel. A role of the board is to make it clear to all directors and staff that they must co-operate fully with the audit committee and supply information as required.

Appendix A: Example of charter

1. Purpose/objectives

The audit committee is appointed by the board of directors (or supervisory board) to assist the board in discharging its oversight responsibilities. The audit committee will oversee the financial reporting process to ensure the balance, transparency and integrity of published financial information.

The audit committee will also review the following:

- the effectiveness of the company's internal control and risk management system
- the effectiveness of the internal audit function
- the independent audit process, including recommending the appointment and assessing the performance of the external auditor
- the company's process for monitoring compliance with laws, regulations, internal standards (including the code of business conduct), policies and expectations of key stakeholders, including customers, employees and society as a whole.

In performing its duties, the audit committee will maintain effective working relationships with the board of directors, management, and external and internal auditors. To perform his or her role effectively, each audit committee member must develop and maintain his or her skills and knowledge, including an understanding of the audit committee's responsibilities and of the company's business, operations and risks.

2. Authority

The board authorises the audit committee, within the scope of its responsibilities, to:

- 2.1 perform activities within the scope of its charter
- 2.2 engage independent counsel and other advisers as it deems necessary to carry out its duties
- 2.3 ensure the attendance of company officers at meetings as appropriate
- 2.4 have unrestricted access to members of management, employees and relevant information

- 2.5 establish procedures for dealing with the concerns of employees regarding accounting, internal control or auditing matters
- 2.6 establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters
- 2.7 be directly responsible for the appointment, compensation, retention and oversight of the work of the external auditor
- 2.8 approve all audit engagement fees and terms as well as reviewing policies for the provision of non-audit services by the external auditor (and, when required, the framework for pre-approval of such services).

3. Organisation

Membership

- 3.1 The board of directors (or shareholders' meeting) will nominate the audit committee members and the chair of the audit committee (who is an independent director).
- 3.2 The audit committee will comprise at least (number) members and (the majority of)/(all) members will be independent non-executive directors of the company.
- 3.3 A quorum of any meeting will be (number) members/(proportion) of members.

Appendix A: Example of charter

- 3.4 Each member should have skills and experience appropriate to the company's business.
- 3.5 At least one member must have accounting or related financial expertise.
- 3.6 Members will be appointed for a (number)-year term of office. Appointments will be staggered and members will be eligible for reappointment.
- 3.7 The secretary of the audit committee will be the company secretary, or such other person as nominated by the board.

Meetings

- 3.8 Only audit committee members are entitled to attend meetings. The audit committee may invite other people (such as the CEO, CFO, CRO, head of internal audit and external audit engagement partner) to its meetings as it considers necessary.
- 3.9 External and internal auditors should be invited to make presentations to the audit committee as appropriate.
- 3.10 Meetings will be held not less than (number) times a year and should correspond with the company's financial reporting cycle.
- 3.11 Special meetings may be convened as required. The secretary will convene a meeting on receipt of a request by the external or internal auditors.
- 3.12 The secretary will circulate the agenda and supporting documentation to the audit committee members within a reasonable time before each meeting.
- 3.13 The secretary will circulate the minutes of meetings to members of the board, members of the committee, and the head of internal audit and the external auditor where appropriate.
- 3.14 As a minimum, the chair of the audit committee (or other committee member) will attend the board meeting at which the financial statements are approved.
- 3.15 Members of the audit committee should attend every meeting of the committee.
- 3.16 The audit committee should meet regularly with in-house legal counsel. A meeting with outside legal counsel should be held if it is considered necessary.

- 3.17 The audit committee will meet with the external auditor at least once a year without management present.

4. Roles and responsibilities

Risk management and internal control

- 4.1 Evaluate whether management is setting the appropriate 'control culture' by communicating the importance of internal control and management of risk.
- 4.2 Ensure that management has appropriate processes for identifying, assessing and responding to risks in a manner that is in accordance with the organisation's risk appetite, and that those processes are operating effectively.
- 4.3 Understand the internal control systems implemented by management for the approval of transactions and the recording and processing of financial data.
- 4.4 Understand the controls and processes implemented by management to ensure that the financial statements derive from the underlying financial systems, comply with relevant standards and requirements, and are subject to appropriate management review.
- 4.5 Evaluate the overall effectiveness of the internal control and risk management frameworks, including the risk of fraud, and consider whether management has implemented recommendations made by the internal and external auditors.
- 4.6 Consider how management is held to account for the security of computer systems and applications, and the contingency plans for processing financial information in the event of a systems breakdown or to protect against computer fraud or misuse.
- 4.7 Participate in the appointment, promotion or dismissal of the head of risk management.
- 4.8 Meet separately with the head of risk management without management personnel being present. Ensure a direct reporting line between the head of risk management and the audit committee is established.

Appendix A: Example of charter

Financial reporting

- 4.9 Gain an understanding of the current areas of greatest financial risk and how these are being managed.
- 4.10 Review significant accounting and reporting issues, including recent professional and regulatory pronouncements, and understand their impact on financial reports.
- 4.11 Oversee the periodic financial reporting process implemented by management and review the interim financial statements, annual financial statements and preliminary announcements before their release.
- 4.12 Review management's process for ensuring that information contained in analyst briefings and press announcements is consistent with published financial information, and is balanced and transparent, particularly regarding GAAP vs non-GAAP data.
- 4.13 Meet with management and the external auditor to review financial statements, key accounting policies and decisions, related party transactions and the results of the audit.
- 4.14 Ensure that significant adjustments, unadjusted differences, disagreements with management and critical accounting policies and practice are discussed with the external auditor.
- 4.15 Review the other sections of the annual report before its release and consider whether the information is understandable and consistent with members' knowledge about the company and its operations, and lacks bias.

Compliance with laws, regulations, internal policies and industry standards

- 4.16 Review the effectiveness of the system for monitoring compliance with laws, regulations, internal policies and industry standards, and the results of management's investigation and follow-up (including disciplinary action) of fraudulent acts or non-compliance.
- 4.17 Obtain regular updates from management and the head of compliance about compliance matters that may have a material impact on the company's financial statements, strategy, operations or reputation.

- 4.18 Be satisfied that all regulatory compliance matters related to the business of the company have been considered in the preparation of the financial statements.
- 4.19 Review the findings of any examinations by the regulators.
- 4.20 Approve/review the policies, processes and framework for identifying, analysing and addressing complaints (including whistleblowing) and review material complaints and their resolution.
- 4.21 Participate in the appointment, promotion or dismissal of the head of compliance and legal counsel.
- 4.22 Meet separately with the head of compliance and legal counsel without management personnel being present.

Working with the external auditor

- 4.23 Review the professional qualification of the external auditor (including background and experience of partner and auditing personnel).
- 4.24 Consider the independence of the external auditor and any potential conflicts of interest.
- 4.25 Review on an annual basis the performance of the external auditor and make recommendations to the board for the appointment, reappointment or termination of the appointment of the external auditor.
- 4.26 Review the external auditor's proposed audit scope and approach for the current year in light of the company's circumstances and changes in regulatory and other requirements.
- 4.27 Discuss with the external auditor any audit problems encountered in the normal course of audit work, including any restriction on audit scope or access to information.
- 4.28 Ensure that significant findings and recommendations made by the external auditor and management's proposed response are received, discussed and acted on appropriately.
- 4.29 Discuss with the external auditor the appropriateness of the accounting policies applied in the company's financial reports and whether they are considered to be aggressive, balanced or conservative.

Appendix A: Example of charter

- 4.30 Meet separately with the external auditor at least once a year to discuss any matters that the audit committee or auditor believes should be discussed privately. Ensure the external auditor has access to the chair of the audit committee when required.
- 4.31 Review policies for the provision of non-audit services by the external auditor and, where applicable, the framework for pre-approval of audit and non-audit services.
- 4.32 Ensure the company has appropriate policies for hiring audit firm personnel for senior positions.

Internal audit

- 4.33 Review the activities, resources and organisational structure of the internal audit function and ensure there are no unjustified restrictions or limitations.
- 4.34 Participate in the appointment, promotion or dismissal of the internal audit head and discuss with the external auditor the standard of work of internal audit staff.
- 4.35 Review the effectiveness of the internal audit function and ensure that it has appropriate standing within the company.
- 4.36 Meet separately with the head of internal audit to discuss matters that the audit committee or internal auditors believe should be discussed privately. Ensure a direct reporting line between the head of internal audit and the audit committee is established.
- 4.37 Ensure that significant findings and recommendations made by the internal auditors and management's proposed response are received, discussed and appropriately acted on.
- 4.38 Review the proposed internal audit plan for the coming year and ensure that it addresses key areas of risk and that there is appropriate co-ordination with the external auditor.

Reporting responsibilities

- 4.39 Regularly update the board about audit committee activities and make appropriate recommendations.
- 4.40 Ensure the board is aware of matters that may significantly affect the financial condition or affairs of the business.
- 4.41 Prepare any reports required by law or listing rules, or requested by the board, such as a report on the audit committee's activities, and duties to be included in the section on corporate governance in the annual report.

Evaluating performance

- 4.42 Evaluate the audit committee's own performance – that of individual members and collectively – on a regular basis.
- 4.43 Assess the achievement of the duties specified in the charter and report the findings to the board.

Review of the audit committee charter

- 4.44 Review the audit committee charter annually and discuss required changes with the board.
- 4.45 Ensure that the charter is approved or re-approved by the board.

Appendix B: Assessing the independence of directors

From the NZX Listing Rules

An independent director is a non-executive director (ie not a member of management) and:

- is not a substantial shareholder⁹ of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company
- they, or an associated person, does not have a relationship with the company or substantial shareholder which is likely to result in the director deriving revenue that is more than 10% of their total annual revenue from the company.

Australia has a more stringent definition for independent director,¹⁰ which has in part been adopted by the RBNZ for registered banks and licenced insurers, and includes the following additional requirements:

- within the last three years has not been employed in an executive capacity by the company or another group member, and there has been a period of at least three years between ceasing such employment and serving on the board
- within the last three years has not been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided
- is not a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer
- has no material contractual relationship with the company or another group member other than as a director of the company
- has not served on the board for a period that could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company
- is free from any interest and any business or other relationship that could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.



9. For this purpose a 'substantial shareholder' is a person with a substantial holding, as defined in section 21 of the Securities Markets Act 1988.

10. Commentary and guidance to Recommendation 2.1, ASX CGC Principles of Good Corporate Governance and Best Practice Recommendations.

Appendix C: Financial expertise

Each case will need to be considered on its merits by the individual committee member and the board. The following checklist may be helpful.

What is ‘relevant financial experience’ likely to include?

Generally:

- Feel comfortable reviewing a set of financial statements
- Know the questions to ask and understand how to assess the answers
- Be prepared to keep financial experience up to date
- Know enough to keep members and the company out of trouble
- Have a broad understanding of GAAP and NZ IFRS and their application
- Understand the financial matters being explained to the audit committee
- Have the confidence to ask supplementary questions until properly satisfied
- Recognise when a set of financial statements doesn’t ‘feel right’
- Understand internal controls and procedures for financial reporting
- Have an appreciation of an investor’s viewpoint.

In individual cases:

- Understand how the financial statements are put together
- Understand the subjective areas and areas where judgement is required
- Understand what alternative accounting treatments could have been followed
- Understand the basic tests of quality of earnings and financial position; for example, comparing earnings with cash flow.

Serving on audit committees alone may provide the necessary financial experience. However, if an individual is a member of only one audit committee, it is possible that his or her experience may become static. It is particularly important to keep skills up to date through updates and training.

However, training and updates are not as important as an individual being capable of asking the right questions, being tenacious and challenging appropriately.

SEC definition of financial expertise

The SEC requires companies that are USA registrants to disclose whether or not, and if not the reasons why, at least one audit committee member is a financial expert¹¹.

The SEC defines a financial expert as a person who has the following attributes:

- an understanding of generally accepted accounting principles and financial statements
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves
- experience preparing, auditing, analysing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities
- an understanding of internal controls and procedures for financial reporting
- an understanding of audit committee functions.

11. Section 407, Sarbanes-Oxley Act 2002.

Appendix C: Financial expertise

In addition, the person must have acquired such attributes through any one or more of the following:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in one or more positions involving the performance of similar functions
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions

- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements
- other relevant experience.

Current US auditing proposals require the auditor to consider the audit committee's level of financial expertise.



Appendix D: Orientation of new committee members

New members will need background information on many areas, including:

The company

- Products and services
- Foreign and domestic operations
- Key areas of risk and how they are managed
- Financial and operational controls, and planned modifications
- Types of budget and management reports
- Key accounting policies and reasons for their use
- Key areas of concern about the financial position and reported value of individual assets and liabilities
- Statutory reporting and exchange listing requirements to which the company is subject
- Litigation and contingencies facing the company
- Annual and interim earnings trends
- The company's code of conduct and business behaviour.

Management

- The background and qualifications of senior executives and financial management
- An organisation chart of reporting lines and responsibilities
- The basis on which senior management is remunerated.

The audit committee

- The audit committee's charter – its role in overseeing company policies, financial reporting and other special areas
- The nature and timing of reports prepared by management for the audit committee
- Company staff available to support the audit committee
- External advisers available to support the audit committee.

Internal auditors

- The responsibilities of the internal audit function
- The number of internal auditors and their qualifications and experience
- The audit committee's relationship with the internal audit department
- The types of reports the audit committee receives from the internal audit department
- The current year's internal audit plan.

External auditor

- A copy of the current year's external audit engagement letter
- The scope of the external audit, including the current year audit plan
- The audit committee's relationship with the external auditor
- The types and timing of reports issued by the external auditor
- Company policy on engaging the auditor to provide audit and non-audit services.

Financial reporting: Reviewing financial information

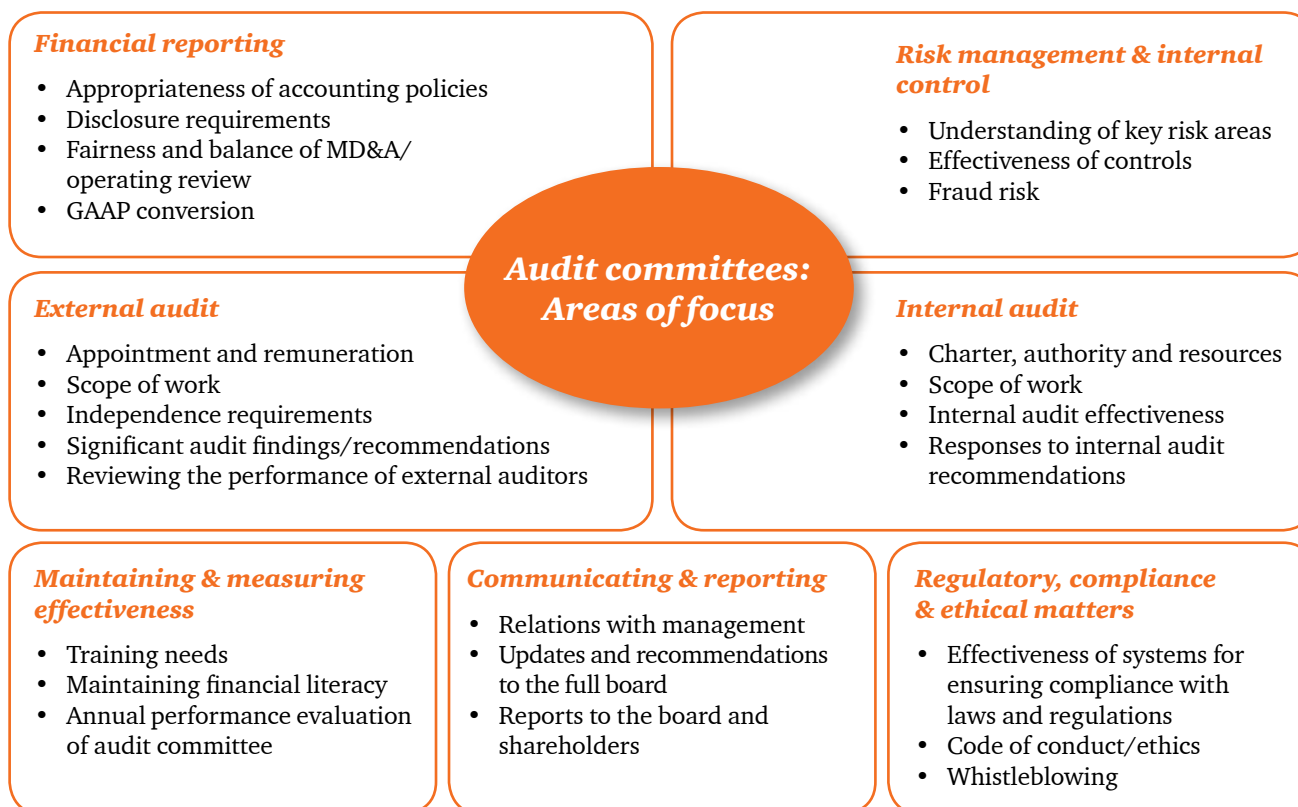
In the wake of recent corporate reporting failures stakeholders, the investor community and the regulator are sharpening their focus on director's responsibilities and how effectively these responsibilities are discharged.

Whilst directors' responsibilities cannot be delegated, audit committees have an essential role to play in the governance of an organisation and ensuring the integrity and transparency of corporate reporting.

The PwC Audit Committee Guide is designed to help members of the audit committee work through the maze of director's responsibilities in a practical manner.

Financial reporting: Reviewing financial information

Thousands of pages on corporate governance have been issued. However, regulations seldom provide helpful guidance on how the Audit Committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be focused? This guide is designed to help audit committees answer these questions.



The guide consists of:

- Introduction
- Setting up the audit committee
- Financial reporting: Reviewing financial information
- Risk management & internal control
- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Regulatory, compliance & ethical matters
- Compliance frameworks
- Materiality in audits

We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.

Financial reporting: Reviewing financial information

The audit committee plays a key role in reviewing financial information on behalf of the board.

The SC 9 Principles recommends that the CEO, the CFO and at least one other director of publicly owned entities should certify in the financial reports that these comply with generally accepted accounting standards and present a true and fair view of the financial affairs of the company. While company management is responsible for preparing the financial statements, overall responsibility for the content sits with the board.



The audit committee plays a key role in reviewing financial information, on behalf of the board, before it is published. To fulfil this role it is important that audit committee members have a good understanding of financial accounting and its application to the business. This can be gained through previous experience in financial accounting or through training. Knowledge and experience of relevant accounting standards is a great advantage, and audit committee members also need to ensure they are up to date with changes in regulations and standards.

When reviewing financial statements or other documents, the audit committee will make use of the knowledge gained from considering internal control, risk management and compliance activities, and from discussing matters with the

internal and external auditors. This knowledge is a vital element in aiding understanding and ensuring that the information fairly presents the company's activities and strategy.

This section focuses on financial reports, but the audit committee will also review other financial information to be presented by the company, such as media releases concerning profit announcements, and documents in connection with acquisitions or other price-sensitive information. The general advice in this section is relevant to any such financial information.

1. The accounting framework

It is important to be familiar with the accounting framework the company uses for financial reporting. In most cases this will be the New Zealand accounting standards and associated interpretations approved for use in New Zealand.

As far as for-profit entities are concerned, the New Zealand accounting standards are consistent with International Financial Reporting Standards (IFRS), except for some additional disclosure requirements. As a consequence, for-profit entities will generally be able to state that they have complied with IFRS as well as the New Zealand accounting standards, reducing the need for Generally Accepted Accounting Principles (GAAP) reconciliations.¹² The External Reporting Board has decided that standards for public benefit entities should in future be based on International Public Sector Accounting Standards rather than IFRS.

Where companies raise capital on foreign markets that do not accept IFRS-compliant reports, they may have to report in accordance with more than one GAAP, or provide a reconciliation from one GAAP to another.



¹² For-profit entities will not comply with IFRS if they have taken advantage of the differential reporting framework. There are also specific provisions in the New Zealand accounting standards for not-for-profit and public sector entities, which may not always be compliant with IFRS.

2. Annual financial reports

The role of the audit committee is to review the annual financial report, including the appropriateness of accounting policies and disclosure requirements, and to assess whether these are complete and consistent with the information that is known to the audit committee. As audit committee members need time to conduct their review, a final draft, including supporting commentary by management, will be required at least three or four days in advance of any meeting. Discussions with management and the external auditor about the reports, either together or in separate meetings, are essential.

The annual financial report consists of:

Financial statements (statement of comprehensive income or separate income statement and statement of comprehensive income; statement of financial position (balance sheet); statement of changes in equity; and statement of cash flows)

Notes to the financial statements



2. Annual financial reports

Key aspects to consider include¹³:

What to ask	What to ask	What to look for in response
How did management select and apply critical accounting policies, judgements and estimates?	Management	<ul style="list-style-type: none"> Has management articulated the critical policies and estimates? Are they consistent with your knowledge from other audit committee work and your work on the board? Do the judgements reflect the company's strategies?
What is the quality of earnings sensitivities?	Management	<ul style="list-style-type: none"> Are the matters raised key areas for the company? Are the responses consistent with the audit committee's knowledge of the company?
Were there any internal control issues in relation to the production of the financial statements?	Management/ external auditor/ internal auditors	<ul style="list-style-type: none"> What impact could these issues have? How were they dealt with?
What alternative accounting policies have been applied by peer-group companies?	Management/ external auditor	<ul style="list-style-type: none"> Is the company in line with peers?
What is the impact of business risks and sensitivities on financial statements?	Management	<ul style="list-style-type: none"> Are sensitivities understood and communicated?

13. Also see Appendix A, Reviewing financial reports: Sample questions.

14. See Appendix B, Fraud indicators.

What to ask	What to ask	What to look for in response
What are the implications of expected changes in accounting policies due to new accounting standards and/or interpretations?	Management/ external auditor	<ul style="list-style-type: none"> Will the financial statements look significantly different? Are there any capital management issues?
What is the impact of the company's financing structure on current and future profitability, and how is it dealt with in the company's financial reports?	Management	<ul style="list-style-type: none"> Have financing-related risks been appropriately identified and disclosed?
How useful and relevant is the presentation of other disclosures, including 'going concern' issues?	Management/ external auditor	<ul style="list-style-type: none"> Do the disclosures make sense? Are disclosures consistent in content and tone with audit committee members' knowledge of the company's activities? What were the major issues for the company during the year and are these reflected in the reports?
Have the board made disclosures in accordance with s211 of the Companies Act 1993?	Management	<ul style="list-style-type: none"> Was the process for making this disclosure robust? Did the CEO or CFO identify any matters of concern before they signed?
Are any indicators of fraud present? ¹⁴	Management/ external auditor	<ul style="list-style-type: none"> Have these been addressed by management? Has the impact been assessed?

2. Annual financial reports

Many audit committees insist on management providing explanations of significant fluctuations in financial results from year to year, as well as variations between actual results and the budget or forecast results. Understanding these reports is vital.

In addition, particular attention is usually given to complex or unusual transactions and to areas of subjectivity, for example those areas where different assumptions could have a significant effect on the financial statements.

Tip:

Examples of areas where different assumptions could have a significant effect on the financial statements include business combinations, special-purpose entities, off-balance-sheet transactions, classification and de-recognition of financial instruments, derivatives and hedging, valuation and impairment of assets, restructuring charges, warranty obligations, environmental liabilities and litigation provisions.

A key role for the audit committee is to make an overall assessment of whether the financial report gives a true and fair view. 'True and fair' is not defined in legislation or standards and is used to indicate that the totality of information provided reflects the substance of the business's activity and position during the period.

However consideration should also be given to the accessibility of information in the annual report. Current global initiatives advocate the streamlining of the annual report with two broad areas of focus emerging: Improving the transparency and connectivity within the annual report; and removing the clutter - that is, immaterial, boilerplate and duplicate information.¹⁵

¹⁵ PwC Streamlining the annual report.



3. Review of operations and activities /MD&A¹⁶/ operating review

The company may present other information in the annual report in addition to the financial report. A practice statement¹⁷ has been issued by the International Accounting Standards Board, which provides guidelines to the users of the financial report to assess:

- operations
- financial position
- business strategies and prospects for future years.

The practice statement is not an IFRS or New Zealand IFRS and so companies do not need to comply with the practice statement to comply with IFRS or New Zealand IFRS. However this guidance is a useful reference point for audit committees to check the fairness and balance of the matters reported.

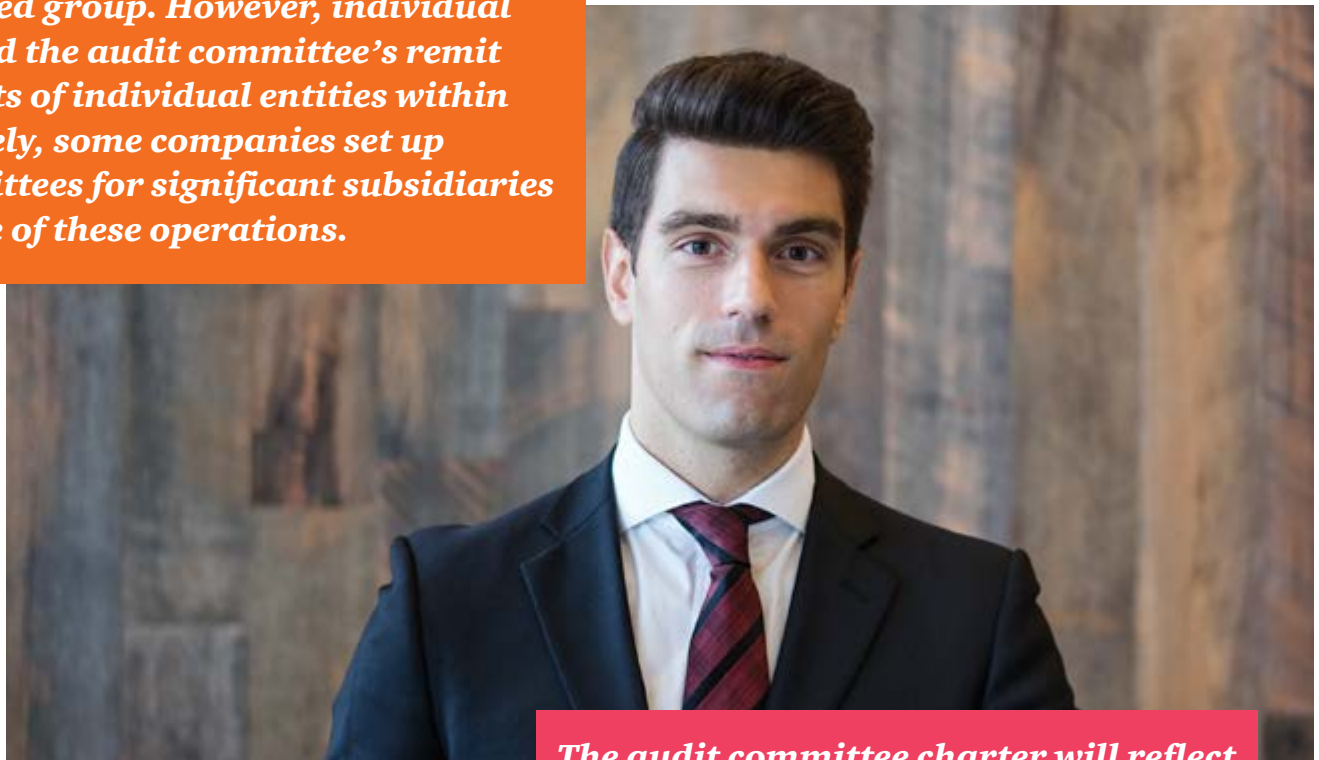


16. MD&A means management discussion and analysis, a term used mainly in US reporting. In New Zealand, MD&A usually refers to the chair's report and CEO report, both of which are usually provided within Annual Reports.

17. IFRS Practice Statement, Management Commentary: A framework for presentation.

4. Financial reports of subsidiaries

The audit committee is primarily concerned with public reporting, and hence information relating to the parent consolidated group. However, individual companies may extend the audit committee's remit to the financial reports of individual entities within the group. Alternatively, some companies set up separate audit committees for significant subsidiaries due to the importance of these operations.



The audit committee charter will reflect the roles and responsibilities of the audit committee in this regard.

5. Other published financial information

Other financial information published by companies is scrutinised by the investment community, and the price of a company's stock is significantly affected by investors' reactions to results announcements. These are often press releases or preliminary results announcements. Although it may increase the audit committee's burden of work, there are significant benefits in reviewing interim information and preliminary announcements, including:

- improved ability to identify and direct attention to significant issues on a timely basis
- establishing a regular flow of information from management to the audit committee, improving committee members' understanding of the company's business
- the opportunity for the audit committee to engage in discussions with the external auditor, particularly on matters of accounting policy treatment, at an early stage.



The benefits might be further enhanced if the audit committee has input into the material used for analyst and institutional investor presentations. Where routine financial information is produced on a regular basis – such as returns to regulators and financial forecasts – it will be useful to establish protocols with management for its review and release. Audit committees who undertake this role note that they concentrate on whether there is an appropriate process for the information's preparation, but do not review every document that is filed or published.

The major role for the audit committee is to consider whether the material is biased or unbalanced. The market is seeking honest commentary on all significant news, whether good, bad or neutral. In addition, the FMA has provided its views on when non-GAAP performance measures should or should not be used which will need to be considered by audit committee members. An audit committee member needs to be able to consider, from a shareholder's perspective, whether the information being proposed provides a clear and fair understanding of the company's operations and position for the period. Ultimately, increased oversight by the audit committee will strengthen the financial reporting process and further protect investors' interests.

Appendix A – Reviewing financial reports: Sample questions

Following are examples of questions to guide the audit committee in its review. These questions should not be viewed as a “tick the box” exercise; the focus should be on ensuring the financial statements “tell the story” of the financial performance and position of the company. While this might appear burdensome, it is worth remembering that most transactions are straightforward. Hence the audit committee will be focusing on non-routine aspects, and, through its internal control responsibilities, will be aware of key risk areas and the strength of the company’s internal control processes.

In addition, the audit committee’s meetings with the external auditor throughout the period will assist in directing and assessing relevant questions.

Audit committee members might find it useful to ask the CEO and/or CFO to work through these questions before an audit committee meeting, and to brief members on their views. For significant businesses or business segments, it is often also useful to ask management to attend the audit committee meeting in which the results are being discussed.

The audit committee can then concentrate on challenging and testing management’s views at the meeting.



Appendix A – Reviewing financial reports: Sample questions

Sample questions

Issue	Comment
A. Financial reporting process	
• What are the current areas of greatest financial risk, and how are they being managed?	
• Are accounting systems (including controls over disclosure and financial reporting processes) adequate and appropriate?	
• What significant recommendations have been made to management (by external and/or internal auditors) for improvements to the reporting process? How did management respond?	
• Are there significant areas that still require attention?	
• What are the procedures for making profit and cash flow projections?	
• What evidence has management used to satisfy itself that the company is a going concern (ie that it will continue to operate for the foreseeable future)? Has a going concern board paper been prepared?	
B. Accounting policies	
• Does the financial report contain a clear and unambiguous reference to the accounting framework adopted?	
• Are accounting policies appropriate and compliant with the reporting framework?	
• Are the assumptions underlying them still valid?	
• Are accounting policies disclosed for all significant items or transactions?	
• Is management comfortable that the accounting policies are appropriate under the circumstances?	

Issue	Comment
• Did any accounting policies change this year?	
• If so, why, and what were the effects of the changes?	
• Were all alternatives considered in selecting the most appropriate accounting policy?	
• What effects would new or proposed changes in GAAP or other regulations have on the financial statements?	
• Has the impact of approved but not yet mandatory changes been disclosed, or have the changes been adopted early?	
• Were there disagreements between management and the auditors on accounting policies or principles?	
• Were these issues satisfactorily resolved?	
• How do the company's policies compare with industry norms?	
• What are the overall impressions of the conservativeness or aggressiveness of the accounting policies adopted and the underlying estimates?	
• Are intangibles appropriately accounted for?	
• If there are intangible assets with an indefinite useful life, is this appropriate and supportable?	
• Has key management personnel compensation (remuneration of directors and executives) been measured in accordance with applicable accounting standards?	
• Are there any other related-party transactions (including directors' relationships) that require disclosure?	

Appendix A – Reviewing financial reports: Sample questions

Issue	Comment
<ul style="list-style-type: none"> Have you determined who the chief operating decision maker is? Is the information disclosed in the segment note consistent with the information reported to the board, executive committee or other chief operating decision makers? Has it been reconciled back to the information disclosed in the financial statements, where necessary? Is the information consistent with information reported elsewhere in the annual report (eg the directors' report, the review of operations, chair's report, or management discussion and analysis)? 	
<ul style="list-style-type: none"> Has the company capitalised any expenses? If yes, what type of expenses are capitalised and is management satisfied that the capitalisation is in accordance with applicable accounting standards? 	

Issue	Comment
C. Financial statements	
<ul style="list-style-type: none"> Are there significant fluctuations in account balances in current and prior periods? What caused them? What significant accruals or adjusting entries were made as part of the year-end accounting process? Were there any prior-period adjustments or changes in estimates? What were the circumstances? Do they need to be disclosed? Were any significant transactions completed during the year that are not evident from the financial statements? How were they accounted for? Did any of these transactions involve related parties? Were any significant issues raised by management, the company's legal counsel or outside legal counsel concerning litigation, contingencies, claims or assessments? How are such matters reflected in the financial statements? How do the reported results compare to budgets and the audit committee's expectations? How do the results affect the provisions of loan agreements and covenants? Have FMA letters on prior year disclosure issues been addressed satisfactorily? Overall, are the financial statements a true and fair reflection of the operations and position of the company for the period? 	

Appendix A – Reviewing financial reports: Sample questions

Issue	Comment
Review of statement of comprehensive income	
• Does the company present a single statement of comprehensive income, or a separate income statement and statement of comprehensive income?	
• Are items correctly classified and presented either in profit or loss or in other comprehensive income?	
• Are the revenue recognition policies appropriate and do they cover all material sources of revenue?	
• Is the revenue policy, including cut-off, appropriate and properly applied?	
• Is the accounting for disposals – including calculation of profit, categorisation of discontinued operations, and appropriate assessment of timing – relevant and supportable?	
• Are any items separately presented as ‘individually significant items’?	
• If yes, what type of items are they and is a separate presentation appropriate under New Zealand accounting standards (or another relevant reporting framework)?	
• Have expense items been consistently classified either on a functional basis (eg costs of goods sold, distribution and administration expenses) or by nature (eg raw materials, employee benefits, depreciation)?	
• Have employee share and option schemes been appropriately recognised as expenses?	

Issue	Comment
Review of balance sheet	
• Where there have been any acquisitions of subsidiaries or businesses, have all assets and liabilities of the acquired entity (including intangible assets and contingent liabilities) been identified and recognised at their fair value and the residual recognised as goodwill?	
• Was there any doubt as to which company was the acquirer in the transaction?	
• If there are any classes of assets carried at fair value, are the valuations up to date?	
• Are key assumptions and methodologies appropriately disclosed where valuation techniques are used?	
• How has management satisfied itself regarding the value of assets and impairments?	
• Have indicators for impairment been considered for all assets and/or cash generating units?	
• Has an impairment calculation been performed for goodwill and indefinite life intangible assets regardless of whether there is an indication of impairment?	
• Has goodwill been allocated to the lowest level at which it is monitored (not larger than an operating segment)?	
• Is management satisfied that assumptions used in the impairment test (discount rates, exchange rates, prices etc) are appropriate? Have these been disclosed appropriately?	

Appendix A – Reviewing financial reports: Sample questions

Issue	Comment
<ul style="list-style-type: none"> Is the average age of accounts receivable and other collectability issues consistent with previous years and with expectations? Is the impairment provision calculated based on conditions at the balance date without taking into account future expectations? (A provision can only be recognised if there is objective evidence that a debt was impaired at the reporting date.) 	
<ul style="list-style-type: none"> Are inventories appropriately carried at the lower of cost and net realisable value? 	
<ul style="list-style-type: none"> Was the company involved in establishing a special-purpose entity as sponsor or creator but did not consolidate this entity? 	
<ul style="list-style-type: none"> Does the company have any investments in which it holds more than 50% or 20% of the voting rights but management has concluded that there is no control or significant influence over this investment? If yes, how has management justified this decision? 	
<ul style="list-style-type: none"> Have any financial assets been de-recognised during the financial year? If yes, on what grounds? 	
<ul style="list-style-type: none"> Where the company uses hedge accounting, are the conditions in the accounting standard satisfied, including hedge effectiveness, formal designation and documentation? Have existing leasing arrangements been reviewed to assess whether they are onerous (a provision is required)? 	

Issue	Comment
<ul style="list-style-type: none"> Has the company entered into any arrangement that conveys the right to use an asset without being included in the legal form of a lease (eg outsourcing arrangements, purchase of network capacity or take-or-pay contracts)? If yes, has management considered whether the arrangement contains a lease (must be separately accounted for)? 	
<ul style="list-style-type: none"> Have financial instruments issued during the year been appropriately classified either as a debt or equity instrument or both (compound financial instrument), depending on the terms and conditions? 	
<ul style="list-style-type: none"> Are there any long-term financing arrangements due to be settled within 12 months from the reporting date but which are still presented as non-current? If yes at balance date, does the company have the unconditional right to defer settlement for at least 12 months and was the company committed to an agreement to refinance before the reporting date. 	
<ul style="list-style-type: none"> Has there been a default or breach of covenants in relation to any of the borrowings during the year, such that the borrowing became repayable on demand? If yes, was the breach remedied or the loan re-negotiated before the reporting date, or is the loan presented as current? 	
<ul style="list-style-type: none"> Have the current and deferred tax balances been reviewed by a person familiar with the tax position of the company and the tax laws in the relevant jurisdiction? 	

Appendix A – Reviewing financial reports: Sample questions

Issue	Comment
<ul style="list-style-type: none"> Are any significant items in dispute, or are there open tax years? If yes, how have these been measured and accounted for? Are the uncertain tax positions disclosed in the notes to the financial statements? Where a deferred tax asset is recognised for some, but not all of the carried-forward tax losses, on what basis did management decide how much to recognise? Have any significant events occurred after the reporting date and, if yes, are these adequately disclosed? Do the disclosures meet the requirements of each jurisdiction in which the financial statements may be filed? Do balance sheet provisions follow accounting standards in relation to justification, timing, utilisation and release? Is the audit committee aware of any commitments or contingent events which are not reflected in the financial report? 	
Review of statement of changes in equity	
<ul style="list-style-type: none"> Does the statement of changes in equity include all mandatory disclosures, including separate columns for each category of equity? 	

Issue	Comment
Review of statement of cash flows	
<ul style="list-style-type: none"> Was the statement of cash flows prepared on a basis that is consistent with previous years? Does the classification of cash flows between operating, investing and financing activities reflect your understanding of activity during the period? Are the financing arrangements as disclosed likely to have an impact on company stakeholders which needs to be managed? 	
Disclosures in the notes to the financial statements	
<ul style="list-style-type: none"> Are there appropriate disclosures regarding going concern issues? Does the financial report explain the key sources of estimation uncertainty and significant judgements made by management in applying the accounting policies? Is there adequate disclosure of financial risks and the company's management of them? Do the financial instrument disclosures appropriately and clearly explain their nature? Are all material off-balance-sheet transactions, arrangements and obligations (including contingent obligations) appropriately accounted for and disclosed? Are other relationships of the company with unconsolidated entities or other persons appropriately disclosed? Are there any significant or unusual amounts due from officers or employees? Have all fees paid to auditors been disclosed appropriately? 	

Appendix A – Reviewing financial reports: Sample questions

D. Transparency

Issue	Comment
<ul style="list-style-type: none"> Do the financial statements “tell the story” of the financial performance and position of the company? Are the financial statements logically structured and easy for a shareholder to read and understand? Have all disclosures been reviewed critically to ensure their inclusion is material? 	
<ul style="list-style-type: none"> Is the management commentary consistent with the financial statements? Is it balanced, comprehensive and understandable? 	
<ul style="list-style-type: none"> What significant changes took place during the year in the markets in which the company operates? Is this reflected in the management commentary? Is the funding and liquidity position of the company adequately explained? 	
<ul style="list-style-type: none"> Overall, does the annual report (the financial statements, operating review and other parts of the annual report together) give a transparent view of the company’s performance? 	
<ul style="list-style-type: none"> Are references to non-GAAP amounts or measures appropriate and fully explained? Are non-GAAP amounts presented no more prominently than GAAP information? Are they consistent with prior reporting periods? 	
<ul style="list-style-type: none"> From a review of the financial statements, is there any indication of possible deficiencies in internal control or fraud and error? 	
<ul style="list-style-type: none"> Are any situations developing that do not require accounting recognition or disclosure this year, but might next year if conditions do not improve? 	

Issue	Comment
<ul style="list-style-type: none"> Are the proposed corporate governance disclosures in relation to the audit committee appropriate and comprehensive? Are they consistent with the SC 9 Principles?¹⁸ 	
<ul style="list-style-type: none"> Have NZX requirements, including continuous disclosure and financial reporting disclosures, been met? 	
<ul style="list-style-type: none"> Are there any FMA notifications or communications? 	



18. SC Corporate Governance in New Zealand Principles and Guidelines.

Appendix A – Reviewing financial reports: Sample questions

E. Other matters

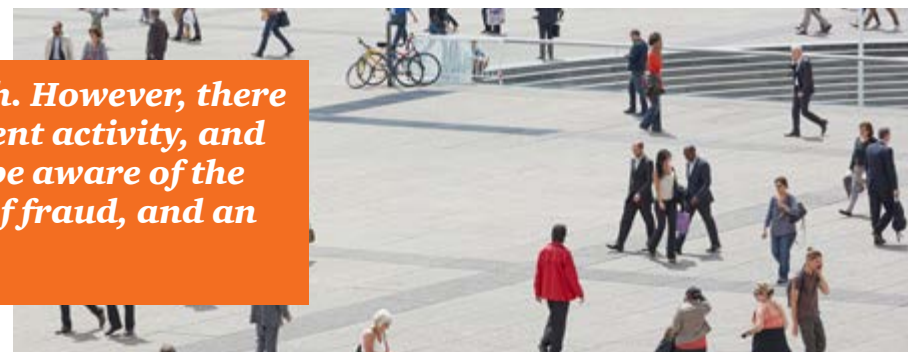
Issue	Comment
• Have any other FMA pronouncements or guidance materials relevant to the company been considered?	
• Is the company also preparing concise reports?	
• Has the relevant information been derived from the full, audited financial statements?	
• Has the audit committee seen the text for the other information in the annual report, for example the corporate governance statement and review of operations?	
• Is this other text consistent with the audit committee's understanding of activities?	
• Have dividend payments been made in compliance with the solvency-based rules in the Companies Act 1993, and the company's constitution (where applicable)?	
• If applicable, should the company's constitution be updated to be consistent with the Companies Act 1993 requirements?	

F. Questions to ask the external auditor about the financial statements

Issue	Comment
• Did the actual scope of the audit differ from pre-audit plans?	
• Did management restrict or limit the scope of the audit in any way?	
• Did management co-operate during the course of the audit and was the auditor provided with all the information and explanations required without hesitation?	
• Was there any difficulty obtaining written representations from the board of directors or executive management?	
• Were any significant adjustments to the financial statements made as a result of the audit?	
• Are there any unrecorded adjustments resulting from the audit?	
• What are the most significant areas of subjectivity in the accounts?	
• Would you consider the accounting policies prudent or aggressive?	
• Has management resisted significant areas of disclosure?	
• If you had prepared these financial statements yourself, what would you have done differently and why?	

Appendix B: Fraud indicators

Fraud is deceit and by its very nature is difficult to unearth. However, there are circumstances that may encourage or protect fraudulent activity, and if these exist at the company, the audit committee should be aware of the risk. There are also some indicators that may be a result of fraud, and an audit committee can be alert to these signs.



Circumstances that may encourage or protect fraudulent activity

- Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations)
- Inadequate record keeping for assets susceptible to misappropriation
- Lack of an appropriate segregation of duties
- Poor physical safeguards over cash, investments, inventory or fixed assets
- Lack of mandatory holidays for employees performing key control functions
- A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity
- A high degree of competition or market saturation, accompanied by declining margins
- A declining industry with increasing business failures and a significant reduction in customer demand
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence
- a significant component of remuneration at risk.

Indicators that may be a result of fraudulent activity

- Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers
- Limitation in audit scope imposed by management
- Identification of important matters not previously disclosed by management
- Aggressive application of accounting principles
- Conflicting or unsatisfactory evidence provided by management or employees
- Information provided unwillingly or after an unreasonable delay
- Seriously incomplete or inadequate accounting records
- Evidence of an unduly lavish lifestyle for officers or employees
- Inability to generate cash flows from operations while reporting earnings and earnings growth
- Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgements or uncertainties, or that are subject to potential significant change in the short term, in a way that might have a financially disruptive effect on the entity. For example:
 - i. The ultimate collectability of receivables
 - ii. The timing of revenue recognition

Appendix B: Fraud indicators

- iii. The realisability of financial instruments based on highly subjective valuation of collateral or difficult-to-assess repayment sources
- iv. A significant deferral of costs
- Significant related-party transactions that are not in the ordinary course of business
- Significant, unusual or highly complex transactions (especially those close to the end of the period) that pose difficult questions concerning substance over form
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry
- Unusually high dependence on debt; a marginal ability to meet debt repayment requirements; or debt covenants that are difficult to maintain
- Unrealistically aggressive sales or profitability incentive programmes
- Motivation for management to engage in fraudulent financial reporting, for example:
 - i. A significant portion of management's compensation is represented by bonuses, share options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow
 - ii. Management commits – to analysts, creditors and other third parties – to achieving what appear to be unduly aggressive or clearly unrealistic forecasts
- Failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might be:
 - i. Management does not effectively communicate and support the entity's values or ethics, or communicates inappropriate values or ethics
 - ii. Management is dominated by a single person or a small group, without compensating controls such as effective oversight by those charged with governance
 - iii. Management sets unduly aggressive financial targets and expectations for operating personnel
 - iv. Management continues to employ ineffective accounting, information technology or internal audit staff
- High turnover of management, legal advisers or board members
- A strained relationship between management and the current or former auditor
- A history of contraventions of the Companies Act 1993, Financial Reporting Act 1993 or other legislation, or claims against the entity or its management alleging fraud or violations of securities laws.



Risk management & internal control

In the wake of recent corporate reporting failures stakeholders, the investor community and the regulator are sharpening their focus on director's responsibilities and how effectively these responsibilities are discharged.

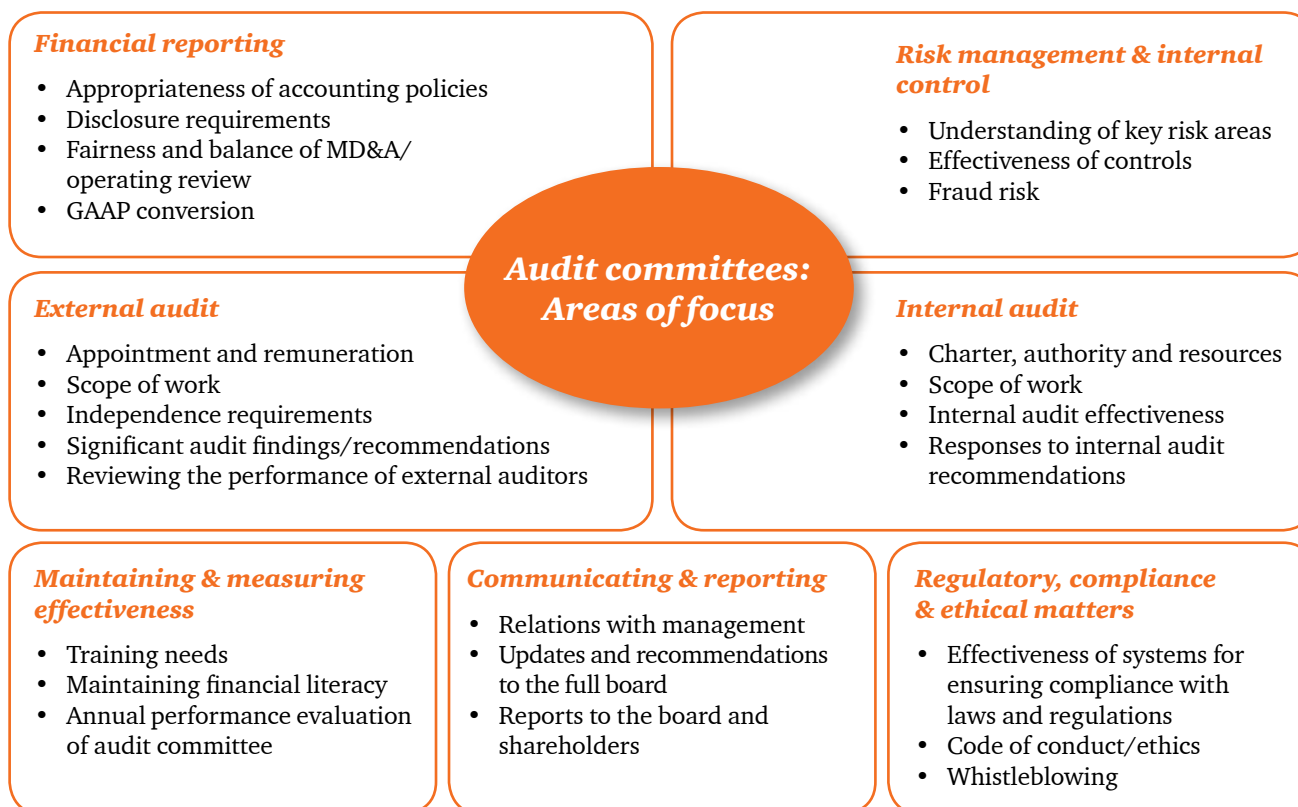
Whilst directors' responsibilities cannot be delegated, audit committees have an essential role to play in the governance of an organisation and ensuring the integrity and transparency of corporate reporting.

The PwC Audit Committee Guide is designed to help members of the audit committee work through the maze of director's responsibilities in a practical manner.



Risk management & internal control

Thousands of pages on corporate governance have been issued. However, regulations seldom provide helpful guidance on how the Audit Committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be focused? This guide is designed to help audit committees answer these questions.



The guide consists of:

- Introduction
- Setting up the audit committee
- Financial reporting: Reviewing financial information
- Risk management & internal control
- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Regulatory, compliance & ethical matters
- Compliance frameworks
- Materiality in audits

We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.

1. Understanding risk management and internal control

Risks are uncertain future events – both positive and negative – that have the potential to affect the achievement of a company's goals and objectives. A common feature of successful companies is the ability to navigate the many risks and uncertainties they face in the pursuit of shareholder value.

Those companies successfully use strategies that help them:

- cost-effectively protect their exposure to events that have the potential to destroy shareholder value
- identify and seize opportunities to increase shareholder value through prudent risk-taking and a consideration of the balance between risk, growth and returns
- effectively control activities and processes towards the achievement of company objectives.

One of the factors that can help a company achieve these objectives is an effectively functioning risk management and internal control framework.

An effective framework

The three most commonly used sources of guidance on the elements of an effective risk management and internal control framework are the:

- Australia/New Zealand Standard on Risk Management (AS/NZS 4360) and accompanying handbooks
- Enterprise Risk Management Conceptual Framework (published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)).
- Internal Control – Integrated Framework (also published by COSO).

All three sources provide a useful description of many risk management and internal control concepts, and are a useful point of reference when considering a company's risk management and internal control framework.

However, they are necessarily conceptual in nature, and require considerable judgement, interpretation and customisation before being successfully applied within a company.

For example, COSO's Enterprise Risk Management Conceptual Framework (which encompasses internal control) describes enterprise risk management as:

“...a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

The framework identifies eight interrelated components, which, integrated with existing management processes, help an organisation achieve strategic, operational, compliance and reporting objectives.

1. Understanding risk management and internal control

The eight COSO risk management components

Internal environment – Management sets a philosophy regarding risk and establishes a risk appetite. The internal environment sets the basis for how risk and control are viewed and addressed by an entity's people. The core of any business is its people – their individual attributes, including integrity, ethical values and competence – and the environment in which they operate.

Objective setting – Objectives must exist before management can identify events affecting their achievement. Enterprise risk management ensures that management has in place a process to set objectives, and that the chosen objectives support and align with the entity's mission and that they are consistent with its risk appetite.

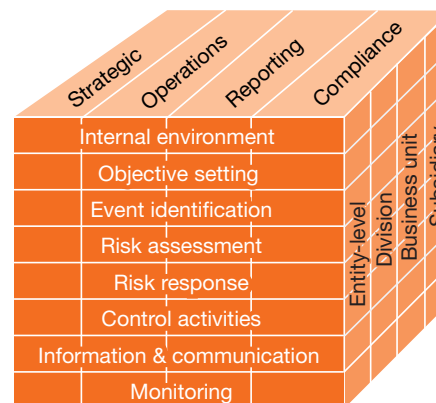
Event identification – Potential events that might have an impact on the entity must be identified. Event identification involves identifying potential events from internal or external sources that affect the achievement of objectives. It includes distinguishing between events that represent risks, those representing opportunities and those that may be both. Opportunities are channelled back to management's strategy or objective-setting processes.

Risk assessment – Identified risks are analysed to form a basis for determining how they should be managed. Risks are associated with objectives that may be affected. Risks are assessed on an inherent and a residual basis, with the assessment considering risk likelihood and impact.

Risk response – Personnel identify and evaluate possible responses to risks, which include avoiding, accepting, reducing and sharing risk. Management selects a set of actions to align risks with the entity's risk tolerances and risk appetite.

Control activities – Policies and procedures are established and executed to help ensure the risk responses management selects are effectively carried out.

Information and communication – Relevant information is identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities. Information is needed at all levels of an entity for identifying, assessing and responding to risk. Effective communication also occurs in a broader sense, flowing down, across and up the entity. Personnel receive clear communications regarding their role and responsibilities.



Monitoring – The entirety of enterprise risk management is monitored, and modifications made as necessary. In this way, it can react dynamically, changing as conditions warrant. Monitoring is accomplished through ongoing management activities, separate evaluations of enterprise risk management, or a combination of the two.

The design of a risk management and internal control framework must address how each organisation makes decisions in key areas such as strategy, investment and financial management. What works well in one industry may not necessarily be effective in another, and individual companies will often have quite legitimate differences of approach according to factors such as:

- industry
- company size
- organisational model (ie centralised vs decentralised)
- governance structures in place within the company
- organisational culture and management operating style
- existing business planning, investment decision-making and performance monitoring processes.

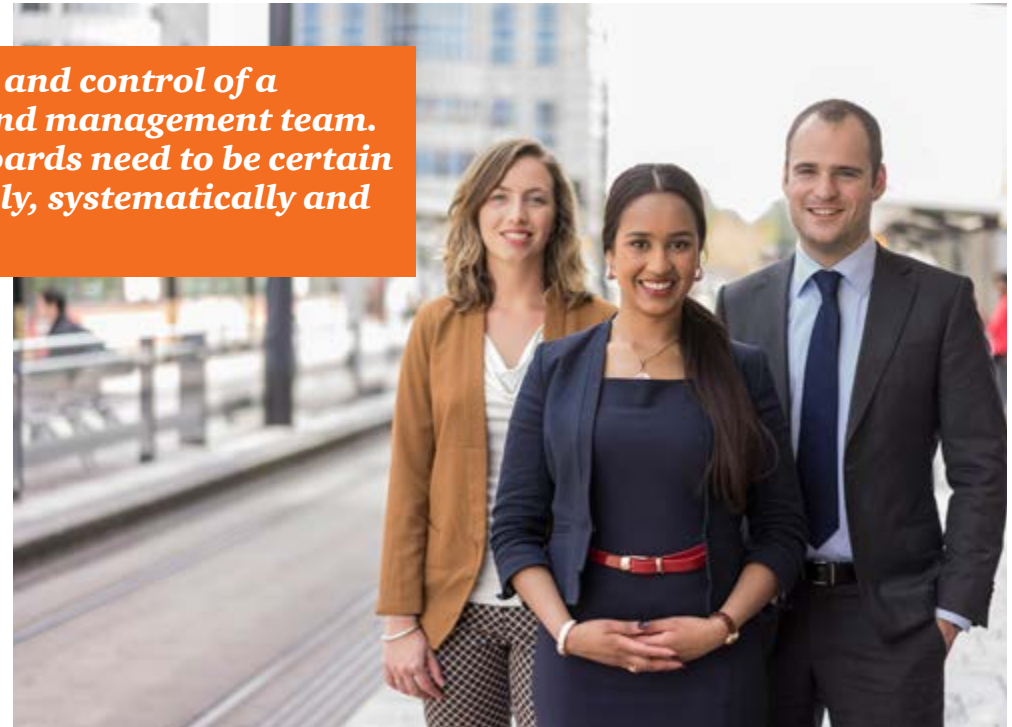
2. Responsibilities of the board and the audit committee

Responsibility for the effective management of risk, and control of a company's operations, lies with a company's CEO and management team. To fulfil their oversight responsibilities, however, boards need to be certain that those responsibilities are carried out proactively, systematically and effectively.

The board's responsibilities with respect to risk management and internal control can be summarised as follows:

1. Establish a 'tone at the top' that promotes a risk-aware culture
2. Agree with management the company's risk appetite
3. Be informed about the company's risk profile as well as the measures that management is taking in relation to significant risks and uncertainties
4. Ensure that the company has appropriate processes for identifying, assessing and responding to risks in accordance with the organisation's risk appetite, and that those processes are operating effectively
5. Ensure that the company's activities are effectively controlled so that management's risk responses and policies are carried out as planned towards the achievement of strategic, operational, compliance and reporting objectives.

While establishing an appropriate 'tone at the top', agreeing on the company's risk appetite and monitoring the strategic risks facing the company are responsibilities that will typically remain with the board, many of the other responsibilities with respect to risk management and internal control are often delegated to the audit committee (and in some cases to a separate risk management committee).



2. Responsibilities of the board and the audit committee

The audit committee's responsibilities and how to meet them

Audit committee responsibility	Points to consider
To be informed about the company's risk profile	<ul style="list-style-type: none"> Does management have a structured process for periodically identifying, assessing and reporting its risk profile and associated management activities to the audit committee? If so, is the audit committee satisfied that process provides a complete picture of the company's risk profile? Does the audit committee charter describe the types of risks it is required to monitor and which management will report on? In many cases this list will include: <ul style="list-style-type: none"> risks associated with the breakdown in key business processes (in particular, financial reporting and financial management processes) fraud-related risks risks of non-compliance with key laws and regulations business continuity and disaster preparedness. Does the audit committee's programme of meetings monitor the evolution of significant risks and management's action plans?
Oversight that risk-taking is in accordance with the company's risk appetite	<ul style="list-style-type: none"> Does the audit committee understand the key components of the company's risk management framework? What processes, accountabilities and influencers of organisational behaviour are key to the way the organisation manages risk? How does the audit committee obtain assurance that those components are functioning as intended? Is it provided with key performance indicators (KPIs) for the operation of the framework? What processes help to ensure that management decision making incorporates a sufficient consideration of risk and uncertainty, and how does the audit committee obtain assurance that management is operating effectively? How does the audit committee obtain assurance that the information it receives is complete, reliable and accurate? How does the audit committee form a view as to how the culture of the organisation influences the management of risk and uncertainty? What information does the audit committee have about risk events that have occurred and are within its sphere of authority?
Oversight of the company's state of internal control	<ul style="list-style-type: none"> To what extent does the audit committee understand what the key business processes are and where tight internal control is required? Does the audit committee receive reliable information on any incidents of fraud or major control breakdowns? Does management make any representations to the audit committee about the effectiveness of internal control in key business processes? To what extent has management made sufficient enquiries to support these representations? Does the audit committee receive sufficient independent feedback on the operation of key controls from the company's internal and external auditors? How does the audit committee monitor and follow up management's implementation of any corrective actions for control weaknesses?

3. Applying ASX Corporate Governance Council Principle 7

Within Australia, ASX-listed companies are required to consider and publicly state the extent to which they have chosen to adopt the recommendations of Principle 7: Recognise and manage risk of the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations. The recommendations outlined in Principle 7 are:

Recommendation 7.1

Companies should establish policies for the oversight and management of material business risks and disclose a summary of those policies.

Recommendation 7.2

The board should require management to design and implement the risk management and internal control system used to manage the company's material business risks and report to it on whether those risks are being managed effectively. The board should disclose that management has reported to it as to the effectiveness of the company's management of its material business risks.

Recommendation 7.3

The board should disclose whether it has received assurance from the chief executive officer (or equivalent) and the chief financial officer (or equivalent) that the declaration provided in accordance with section 295A of the Corporations Act 2001 is founded on a sound system of risk management and internal control and that the system is operating effectively in all material respects in relation to financial reporting risks.

Recommendation 7.4

Companies should provide the information indicated in the guide to reporting on Principle 7.

While the ASX has intentionally not prescribed the way companies should meet these guidelines, guidance has been developed by the G100 (the Group of 100, representing Australia's senior finance executives) in its publication Guide to Compliance with ASX Principle 7 'Recognise and manage risk'.

3. Applying ASX Corporate Governance Council Principle 7

Applying the Principle 7 recommendations

The following table sets out some matters for the audit committee to consider in relation to the Principle 7 recommendations.

What to ask	Who to ask	What to look for in response
Recommendation 7.1 – Risk management policy		
Do we have a risk policy and is it publicly available on our website?	Company secretary	<p>The policy describes the following elements:</p> <ul style="list-style-type: none"> the roles and responsibilities of the board, audit committee, management and the internal audit function the key elements of the company's risk management system the nature of risks that the company's risk management system focuses on a requirement that the board review, at least annually, management's implementation of the risk management system the frequency with which the audit committee must review the policy.
Recommendation 7.2 – Chief executive and chief financial officer's statement to the board		
What is the scope of the statement and does it satisfy the audit committee's expectations?	CEO/CFO	<p>The majority of companies have chosen to limit the CEO/CFO statement to the effectiveness of internal control over the financial reporting process.</p> <p>However, in some companies the audit committee has asked that management (often broader than just the CEO/CFO) comments on the effectiveness of risk management, internal compliance and control in additional areas (eg legislative compliance, OH&S).</p> <p>The audit committee should ensure that it understands and is comfortable with the scope of the sign-off provided.</p>
What is the breadth of operations covered by the statement?	CEO/CFO	<p>Does it cover the operation of controls in all subsidiaries, material joint ventures and material associates (including outsourced service providers)?</p> <p>Does it cover the operation of controls during the full year as opposed to a point in time such as the financial year-end?</p>
What steps have the CEO/CFO taken to support their statement? Has their evaluation been sufficiently robust?	CEO/CFO	<p>Is the statement supported by a systematic and comprehensive evaluation process which included:</p> <ul style="list-style-type: none"> a consideration of risk management, internal compliance and control against an established set of criteria such as those of the COSO framework a consideration of the effectiveness of the design of internal controls remediation of weaknesses identified testing of the operating effectiveness of key controls? <p>Is there evidence that the CEO and CFO have actively reviewed and understood the results of the evaluation rather than passively accepting a recommendation provided by staff?</p> <p>How do the results of the evaluation compare with the findings of internal and external audit during the year?</p> <p>Have material weaknesses been identified elsewhere that have not been identified by the CEO/CFO in their statement?</p>

3. Applying ASX Corporate Governance Council Principle 7

<i>What to ask</i>	<i>Who to ask</i>	<i>What to look for in response</i>
Recommendation 7.3 – Management		
What is the scope of the statement and does it satisfy the audit committee's expectations?	Management	<p>The majority of companies have chosen to limit management's statement to the effectiveness of internal control over the financial reporting process only.</p> <p>The audit committee should ensure that it understands and is comfortable with the scope of the sign-off provided.</p> <p>Is the statement supported by a systematic and comprehensive evaluation process which included:</p> <ul style="list-style-type: none"> • a consideration of risk management, internal compliance and control against an established set of criteria such as those of the COSO framework • a consideration of the effectiveness of the design of internal controls • remediation of weaknesses identified • testing of the operating effectiveness of key controls?
What is the breadth of operations covered by the statement?	Management	<p>Does it cover the operation of controls in all subsidiaries, material joint ventures and material associates (including outsourced service providers)?</p> <p>Does it cover the operation of controls during the full year as opposed to a point in time such as the financial year-end?</p>
Recommendation 7.4 – Public disclosure		
Has the company disclosed any departures from the recommendations of Principle 7 in the corporate governance section of its annual report?	Company secretary	<p>Where the company has made a conscious decision to not adopt one of the recommendations under Principle 7, has it clearly stated its reasons in its annual report?</p> <p>If the CEO/CFO statement identifies one or a number of material weaknesses in internal control, this represents a departure from Recommendation 7.2 and should be disclosed in the annual report.</p>
In the annual report, how has the company described its system of risk management, internal compliance and control?	Company secretary	<p>Is the description of the system of risk management, internal compliance and control consistent with the scope of the statement provided by the CEO and CFO?</p> <p>If it covers a broader group of risks than does the statement, is there a possibility that there will be an expectation gap on the part of readers?</p>
Has the company placed a copy of its risk policy in the corporate governance section of its website?	Company secretary	Confirmation that the risk policy is on the corporate governance section of the website.



Working with the external auditor

In the wake of recent corporate reporting failures stakeholders, the investor community and the regulator are sharpening their focus on director's responsibilities and how effectively these responsibilities are discharged.

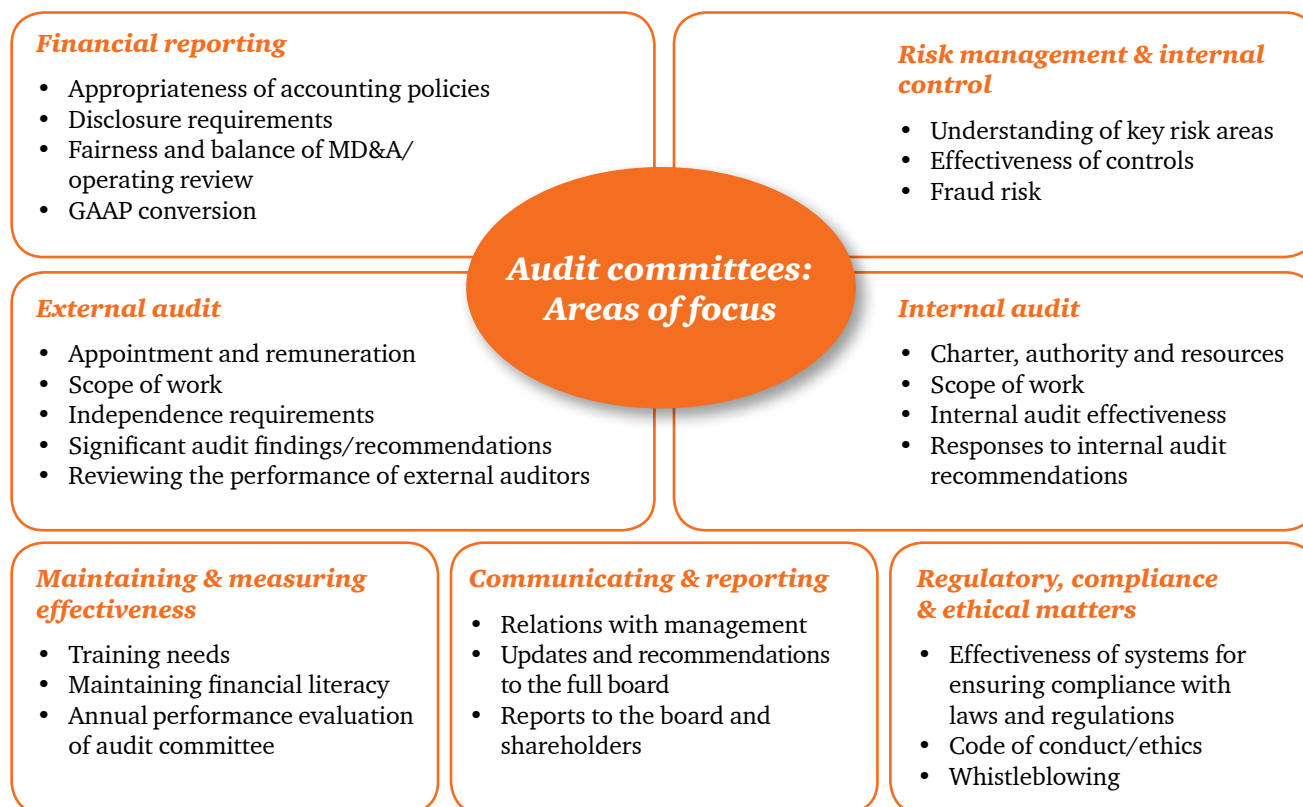
Whilst directors' responsibilities cannot be delegated, audit committees have an essential role to play in the governance of an organisation and ensuring the integrity and transparency of corporate reporting.

The PwC Audit Committee Guide is designed to help members of the audit committee work through the maze of director's responsibilities in a practical manner.



Working with the external auditor

Thousands of pages on corporate governance have been issued. However, regulations seldom provide helpful guidance on how the Audit Committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be focused? This guide is designed to help audit committees answer these questions.



The guide consists of:

- Introduction
- Setting up the audit committee
- Financial reporting: Reviewing financial information
- Risk management & internal control
- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Regulatory, compliance & ethical matters
- Compliance frameworks
- Materiality in audits

We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.

Working with the external auditor

The audit committee has become the primary focus for the company's relationship with the external auditor.



The role of the audit committee involves making recommendations to the board about the appointment of the auditor, agreeing audit fees, reviewing the scope of external audit work, and holding private meetings with the auditor to discuss its findings. It also includes reviewing, with the external auditor, the external auditor's independence.

The objective of an external audit of financial statements is to determine whether, in the auditor's opinion, the statements present fairly in all material respects – that is, they show a true and fair view in all material respects of the company's financial position, results of operations, and cash flows, in conformity with GAAP.

This covers a range of matters, many of which are a part of the audit committee's responsibilities. Hence, regular communication with the external auditor can be extremely valuable in assisting the audit committee's work.

Broadly, discussions with the external auditor can cover four key areas, which range from specifics about the auditor and its relationship with the company, to discussion about the industry, business and control environment of the company. These areas can be summarised as follows:

- service approach (the auditor's qualifications, including independence, to perform the work, and its approach to the audit)
- audit plan (the key risks identified by the auditor in relation to the financial statements and the company's controls, and the resulting audit plan and response to the risks)
- financial reporting (accounting policies, disclosures and observations about the overall quality of financial reporting)
- governance matters (matters noted by the auditor in the course of its work that it believes should be brought to the audit committee's attention).

These areas are discussed further in this section.

Working with the external auditor

Service approach

- Review last year's external auditor's performance – audit team, services and fees
- Discuss audit proposition – service approach/strategy, terms and fees
- Review auditor's independence and experience of audit team, including understanding the auditor's own performance evaluation processes.

Audit plan

- Understand the audit plan
- Understand from the auditor what to expect – services, timing and reporting requirements
- Review the experience of the audit team
- Consider how key risk areas will be addressed during the audit.

Timing of communication

It is usual to hold regular discussions with the external auditor, not just when the annual audit is completed. Ideally, the audit committee will meet at least three times during the year, to coincide with the external reporting and audit cycles. Discussion with the auditor at each meeting, on different aspects of its work or the audit committee's duties, can be helpful. In addition, most audit committees meet privately with the external auditor at least once a year to ensure free and open communication, and others also ensure they have a private conversation about the half-year report.

Financial reporting

- Review the audited financial statements
- Discuss key audit findings – significant accounting policies/audit judgements/financial reporting quality
- Discuss any disagreements that occurred with management
- Meet separately with the external auditor.

Governance matters

- Be aware of difficulties encountered in performing the audit – restrictions on access to information/management
- Be informed of deficiencies in internal control/fraud/illegal acts
- Be updated on matters affecting the auditor's independence, including rotation plans for succession of the key audit partner.

International Standard on Auditing 260 includes specific requirements for communication between the external auditor and the audit committee. It flags matters that the external auditor should ordinarily report on or discuss with the audit committee. These requirements are incorporated in the guidance contained in this section, which emphasises the importance of regular communication.

1. Appointment and remuneration

The Companies Act 1993 requires all companies to appoint an auditor, unless certain criteria are met.¹⁹ From 1 July 2012, all issuers will be required to appoint a licensed auditor or registered audit firm to conduct the audit.²⁰ Given the value that a good working relationship can bring to the audit committee and the company, the appointment of the external auditor warrants careful consideration.

Matters to consider in relation to the external auditor include the following.

What to ask

The audit firm and its people

- Does the audit firm offer high-quality service in all of the key geographical areas in which we operate?
- Does the audit firm employ dedicated industry specialists able to identify issues important to our business, thus providing a value-added service?
- Does the audit firm have access to tax, corporate finance and systems specialists able to be channelled effectively to our company where required?
- Are the personnel on the proposed audit team appropriately experienced, qualified and skilled?
- Do the personnel on the proposed audit team exhibit high professional standards and personal integrity?
- Does the audit firm exhibit styles and values compatible with those of our company?

Audit approach

- Will the audit approach be customised for the specific attributes of our company, incorporating the views and concerns of management and directors?
- Will the audit firm advise the audit committee of the audit plan and scope at a mutually agreed time?

What to look for in response

- Does the firm operate in all our offshore and overseas locations? If not, how will it cover the audit of these countries?
- What experience does the auditor have in our industry? What specialists will it use, and does this seem appropriate?
- Will the audit firm be able to respond to the audit committee's needs and requirements in relation to understanding the central risk management environment?
- Are the people being proposed for the audit team experienced in audit and/or the industry?
- Do the audit team members give confidence that we will receive a quality audit?
- Do the audit committee members feel they will be able to work productively with the audit team?

- An audit is a judgement based on knowledge of the company and its operations. Does the audit approach reflect this?
- What does the audit partner propose discussing with the audit committee? When are meetings proposed to be held?

19. Paragraph 196, Companies Act 1993 and Section 19, Financial Reporting Act 1993.

20. Paragraphs 8 and 9, Auditor Regulation Act 2011.

1. Appointment and remuneration

What to ask

Does the audit firm have effective means of reporting to and communicating with the audit committee and senior management on the identification and resolution of accounting and disclosure issues, recommendations on internal control, and other opportunities for improvement?

Quality and service delivery

Will the audit firm be able to satisfy key service performance standards such as response times, deliverables, staff continuity and communication protocols?

Does the auditor have an internal process to measure client satisfaction?

Will the audit firm be able to provide clear and regular communication to appropriate staff members of our company?

Does the audit firm have appropriate resources at its disposal to be able to co-ordinate and deliver a range of other services within the mandate of the audit?

Is the audit firm able to provide comprehensive and timely guidance on technical developments and industry trends?

Does the proposed fee for the audit represent fair compensation for a comprehensive and high-quality audit?

Has the auditor shown evidence that it is prepared to make tough calls on audit matters, including potential disagreements with management?

Other matters

Can the auditor demonstrate that the independence and objectivity of the audit firm will be maintained, considering the types of additional non-audit services that may be provided and the projected fees?

What to look for in response

What are the audit team's proposals for informing the audit committee if a matter of serious concern, such as management fraud, is uncovered?

Has the auditor proposed specific measurable service standards? How will the audit committee be able to monitor this?

Who from our company is involved in this process?

Who is the auditor proposing to deal with at the company other than the CFO?

If the audit committee requires additional work in, for example, fraud analysis, will the audit team be able to assist?

To whom and when is the audit team proposing to provide updates?

Does the fee reflect the amount of work proposed and at a commercial rate?

Understand what additional work the auditor would perform if the fee was higher to evaluate whether that work seems appropriate to be left from the programme.

Is the level of experience required to undertake the agreed audit plan reflected in the cost?

What stand has the auditor previously made in sensitive areas?

Can the auditor provide relevant information to confirm its independence, including plans for rotating the audit partner? (Also see the independence checklist in Appendix B.)

Audit committees lead the process of appointing an auditor to work with management, and, once a decision has been made, make a recommendation to the full board, which then appoints the auditor subject to shareholder approval.

If tendering for a change of external auditor, a number of formalities need to be undertaken. In addition to any commercial tender process there are matters a proposed new auditor must undertake before accepting an appointment. Therefore the timing and management of any change needs to be considered and discussed with the auditor.

2. Scope of audit work

The purpose of the statutory audit is to form an opinion on whether the information presented in the financial report, taken as a whole, reflects the financial position of the company at a given date. Extensive background work is required to produce this opinion, including:

- understanding the company's activities
- considering any significant economic and industry issues that might have affected the business during the period
- identifying and assessing risks associated with the major items reported in the financial report
- understanding how management has managed the risks identified and how the reported results were prepared.

The audit committee should ask the auditor to provide its views on matters relevant to the conduct of the audit, for example, the effectiveness of the company's systems, management of fraud risks, or the quality of the reporting process. Audit committees may request additional comfort in areas over and above the scope of the statutory audit. If this is the case, the scope of this work is discussed and agreed with the external auditor at the beginning of the audit process.

Based on its knowledge of the company and risks related to the financial statements, the external auditor prepares a detailed audit plan. The audit committee's review of the proposed plan and approach enables it to understand what it can expect from the external audit.



2. Scope of audit work

Questions the audit committee might ask the external auditor about the plan include:

- What are the objectives of your audit?
- What are our company's financial reporting requirements (including the time within which the company is to report)?
- Which risk areas do you plan to emphasise in your audit? Why?
- To what extent will you assess our company's system of internal controls?
- How will any recent actions by our company – such as mergers and acquisitions, restructurings, changes of business strategy and changes in financing arrangements – affect your audit?
- To what extent do you plan to rely on the work of the internal auditors?
- Which company locations will you visit this year? How do you determine which locations to visit and when?
- Which subsidiaries will you audit? What steps do you take regarding those not audited?
- If other auditing firms are involved, how will you satisfy yourself that their work is acceptable and that they are independent? Do you intend to refer to them in your report?
- Is the audit fee sufficient to undertake the level of work proposed?

Governance

The auditor may have views about the company's governance structure and processes. Many audit committees invite the external auditor to comment on:

- the way in which the audit committee has operated and responded to significant issues
- the composition and range of audit committee and board member experience
- company and board responsiveness to recommendations and requests
- the effectiveness of governance processes from the auditor's perspective
- the role and working of the internal audit function.

Tip:

Audit committees commonly ask the external auditor to inform them of major resolved and unresolved issues encountered during the audit and of any restrictions senior management imposes on the scope of the audit.

3. Independence requirements

External auditors must act with objectivity. This is a fundamental principle of the audit profession, which requires its members to observe ethical rules designed to safeguard auditors' independence. NZICA has issued a code of ethics that sets out potential threats to independence and safeguards to mitigate those threats.

Although the audit committee's primary focus is the effectiveness of the audit, it is also important to consider the effect on objectivity of any relationships or other services the external auditor has with, or provides to, the company or its management. The audit committee will need to determine to its own satisfaction that the auditor's independence has not been compromised.

The rules in some countries require the audit committee to review and make recommendations on company policy about engaging the auditor to perform other services. For SEC registrants, there is also a requirement that audit committees must pre-approve all services – both audit and non-audit – performed by the external auditor.

The SC 9 Principles²¹ requires the board to ensure the quality and independence of the external audit process.

In Australia, requirements for the audit committee's consideration of auditor independence are set out in the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations and in the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004. A summary of the requirements is set out on the following page.



21. Principle 7, SC Corporate Governance in New Zealand Principles and Guidance.

3. Independence requirements

Australian independence requirements

Information to be publicly available:

- Procedures for the selection and appointment of external auditors (ASX CGC, Principle 4)
- Procedures for the rotation of external audit engagement partners (ASX CGC, Principle 4).

Information to be reported to the board:

- Procedures for selection and appointment of external auditors and rotation of engagement partners (ASX CGC, Principle 4)
- Recommendations for the appointment or removal of an auditor (ASX CGC, Principle 4)
- Assessment of the performance and independence of the external auditor and whether the audit committee is satisfied about independence having regard to the provision of non-audit services (ASX CGC, Principle 4).

Information to be included in the directors' report in the annual report:

- A copy of the external auditor's independence declaration (CA298(1c))²²
- The name of each person who:
 - i. is an officer of the company at any time during the year AND
 - ii. was a partner in an audit firm ... that is an auditor of the company for the year AND
 - iii. was such a partner ... at the time when the audit firm ... undertook an audit of the company (CA300(ca)).
- For listed companies only: if the audit engagement partner has been auditing the company for more than five successive financial years (CA300(11A))
- For listed companies only: amounts paid for non-audit services, including a statement that the directors are satisfied that the provision of these services is compatible with the auditor's independence and reasons why (CA300(11B)).²³

²² The auditor must provide a written declaration that to the best of its knowledge and belief there have been no contraventions of the auditor independence requirements of the Act or professional codes of conduct.

²³ The audit committee must provide the board with written advice to this effect.

Factors to consider

There are several factors to consider when assessing the external auditor's independence.

Most important is to discuss independence issues. The auditor will be able to inform the audit committee of the broad range of safeguards it uses to protect its independence, such as the regular rotation of the engagement partner, use of review partners, and internal quality inspection programmes. These discussions can also cover a range of questions that the audit committee members and other directors will need to be comfortable about before making an annual report statement. For example:

- the level of fees and other services compared to comparable companies or situations
- safeguards of the auditor and of the client in relation to independence matters
- an assurance over systems to ensure compliance with legal requirements.

Other services

The company may engage the audit firm for a variety of special services if these services do not pose an unacceptable threat to independence, or breach independence restrictions. Using people who know the company and its culture, and who can apply this knowledge in providing other services, can have significant advantages. And the increased knowledge the auditor gains from performing these services can in turn contribute to the quality of the audit. However, audit committee members still need to act in the best interests of the company and ensure that the services supplied represent value for shareholders.

If the audit committee can be satisfied in these respects, the company should be free to engage the firm it considers best equipped to perform a particular task.

4. Significant audit findings and recommendations

Throughout the audit, and as agreed to in the audit plan, the audit committee, management and external auditor will meet to review the financial statements and results of the audit and any half-year review. The intention of these regular meetings is to encourage open and frank dialogue between the audit committee and external auditor, and with management, although there may be some meetings to which management is not invited.

As well as meeting the audit committee for discussions, the auditor will normally also prepare reports relating to the annual audit of financial statements (and sometimes the half-year review). These may be delivered at different times of the year, as work progresses. The reports may take different forms – a written report covering all relevant matters, a series of papers to be discussed in a meeting, a presentation, or an oral report. Their content will vary depending on circumstances. The content may include the items listed on the following page.



4. Significant audit findings and recommendations

<i>What to discuss</i>	<i>Who to ask</i>	<i>What to look for in response/How to follow up</i>
The general approach and scope of the audit, including any expected limitations or additional requirements.	External auditor	Link to agreed audit plan and deliverables. Check that management is not hindering progress.
The selection of, or changes in, significant accounting policies and practices that have or could have a material effect on the financial statements.	External auditor/ management	Does the selection make sense in light of the company's expectations and strategies?
The auditor's judgements about the quality, not just acceptability, of the company's financial accounting principles.	External auditor	This could include issues such as the transparency of the company's financial disclosures and degree of aggressiveness or conservatism of its accounting policies and underlying estimates, areas of greatest judgement and most sensitive accounting policies and underlying estimates.
The auditor's insight into those areas of greatest importance in coming to a view as to the truth and fairness of the financial report as a whole.		
The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that must be disclosed in financial statements.	External auditor/ management	Is this properly disclosed?
Audit adjustments, whether or not recorded by the entity, that have or could have a significant effect on the financial statements.	External auditor	Amount and significance of impact. What does this say about management's ability and/or integrity?
Material uncertainties about events and conditions that may cast doubt on the entity's ability to continue as a going concern.	External auditor/ management	How is this being disclosed, and what impact does it have on market perceptions?
Disagreements with management about matters that individually or in aggregate could be significant to the financial statements or the auditors' report.	External auditor	These communications include consideration of whether the matter has been resolved and the significance of the matter.
Expected modifications to the auditors' report.	External auditor	Understand why these modifications are necessary and why they arose.
Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management.	External auditor	
Any other matters agreed in the terms of the audit engagement.	External auditor	For example, review of preliminary results, fraud investigation.
Other information in the annual report.	External auditor	Understand the auditor's limited responsibility in this area and what was done.

For more detail about financial reporting discussions and questions, refer to the Financial reporting: Reviewing financial statements section.

5. Reviewing the performance of the external auditor

Most audit committee charters suggest a regular (generally annual) review of the performance of the external auditor.

Matters to consider when assessing the performance of the external auditor are broadly:

- the audit firm's professional capabilities, resources and personnel assigned to the audit
- the audit approach
- the audit team's knowledge of the company's industry
- the geographic coverage of the audit
- the audit firm's availability and its communications with the audit committee
- the audit firm's commitment and ability to stand firm on tough decisions.

An assessment of the auditor's performance will be most effective if there is openness between the committee and the auditor. For that reason, expectations and performance criteria will need to be understood by both parties. A checklist that can help the audit committee with this assessment is provided in Appendix A.

The audit committee's charter will usually require the committee to be involved in any decision to remove the external auditor. Matters to consider in such a case are whether the proposed removal is based on substantial grounds and not, for example, merely because the external auditor took positions on accounting issues contrary to management's preferences.

If the audit committee has concerns about the quality of service, the first step is to discuss those concerns with the partner in charge of the external audit. Open and candid discussions between the parties can lead to a constructive resolution of matters of concern.



Appendix A: Evaluating the performance of the external auditor

Good practice	Is good practice being followed? Yes/No/NA	Follow-up steps necessary
Firm qualities		
The audit firm exhibits strength and depth in all key geographies and industries in which the company operates.		
The audit firm has a transparent and rigorous process for dealing with difficult accounting and auditing issues.		
The audit firm has a well-considered process for establishing independence and this is communicated fully, appropriately and promptly to the audit committee.		
Team member qualities		
Members of the audit team are dedicated industry specialists able to identify important issues in the business and provide a value-added service.		
Team continuity and succession planning are actively managed and discussed with the company.		
Members of the audit team exhibit style and values compatible with working with company personnel.		
Members of the audit team are appropriately experienced, qualified and skilled.		
Members of the audit team demonstrate strength of character in carrying out their audit work.		
Members of the audit team exhibit high professional standards and personal integrity.		
Team technical skills and knowledge transfer		
Lead partners and key personnel are visible at the company and deliver practical advice to senior management, the audit committee and the board.		

Appendix A: Evaluating the performance of the external auditor

<i>Good practice</i>	<i>Is good practice being followed?</i> <i>Yes/No/NA</i>	<i>Follow-up steps necessary</i>
The advice provided by the auditor on regulatory/industry developments and implications is timely, technically robust and commercially sound.		
<i>Audit approach and deliverables</i>		
The audit approach is customised to incorporate the risks of the company and the views and concerns of management, the audit committee and the board.		
The audit timetable is efficient and well planned.		
Reporting and communication with the audit committee, board and management provides identification and resolution of accounting and disclosure issues, recommendations on internal control, commentary on the organisation's financial reporting, and other opportunities for improvement with an appropriate level of benchmarking against best practice.		
The audit approach adds value by explaining the impact of audit findings and results of the auditor's risk assessments.		
Audit requests are responded to and resolved in a timely manner, with agreed-on deadlines met.		
Key service performance standards are satisfied, including response times, deliverables, staff continuity, communication protocols.		
The audit firm is able to co-ordinate and deliver a range of other services as circumstances require.		
Feedback on service quality is actively sought at all levels, and issues swiftly rectified where required.		

Appendix A: Evaluating the performance of the external auditor

Good practice	Is good practice being followed? Yes/No/NA	Follow-up steps necessary
Access to tax, corporate finance and systems specialists is channelled effectively by the lead partner where required.		
Clear and regular communication is provided by the auditor to the audit committee and staff members of the company where appropriate.		
The audit committee and board are satisfied that the audit firm has met expectations, delivered results and provided overall value relative to fees. Reference is made to management and key staff opinions and reasons.		
Fees		
A clear analysis of fees is delivered annually.		
The fee for the audit represents fair compensation for a comprehensive and high-quality audit.		

Appendix B: Assessing the independence of the external auditor

These questions, and discussions arising from them, are designed to assist audit committees form a view about the independence of the external auditor.

Questions to consider

Has the issue been satisfactorily addressed?

Have you received from, and discussed with, your auditor a declaration of independence covering professional and regulatory matters?

If not, ask the auditor for such a declaration, and discuss.

Y / N

Management liaison

Has the audit committee met with the auditor on a regular basis without management present?

If not, set up a process to allow regular meetings without management present.

Y / N

Are you satisfied that management has not placed undue pressure on the auditor?

If not, discuss with the auditor and ensure there are direct communication channels for the auditor and audit committee.

Y / N

'Undue pressure' is real or implied pressure on the auditor to act as management wishes rather than in an objective manner.

Have any disagreements between the auditor and management been discussed and resolved?

If you are unsure, ask management and the auditor separately to explain the nature and extent of all disagreements.

Y / N

There may be real or implied pressure on the auditor, particularly if management has 'shopped around', to accept management's application of an accounting principle or reduce the level of audit work.

Are you satisfied that if there is any actual or threatened litigation between the auditor and the company, it will not affect independence?

If not, consider the nature and source of the litigation.

Y / N

Appendix B: Assessing the independence of the external auditor

Questions to consider

Has the issue been satisfactorily addressed?

Litigation may impact objectivity, for example if it arises from previous audit work.

Relationships

Are the tenures of the audit signing partner and the quality review/concurring partner in line with rotation requirements?	If not, discuss with the audit signing partner options for a change.	Y / N
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Are you satisfied that none of the employment or family relationships of the company's directors and officers, or of the auditor, affect audit independence?	If not, ask management for a list of relationships (including former audit firm staff employed in senior company positions), and ask the company directors and the auditor for confirmation that all such relationships are disclosed.	Y / N
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Have you received confirmation that significant gifts or hospitality have not been provided to or from the auditor?	If not, identify the nature and extent of the items and consider the implications in light of other company and auditor safeguards.	Y / N
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Services	Ask management to provide you with an analysis of services and fees, covering all group companies.	
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Are additional services provided by the auditor in accordance with board policy and negotiated at arm's length in a transparent process?	If not, consider the analysis and the particular circumstances, including the company's internal approval processes and auditor safeguards, and discuss with the auditor.	Y / N
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'Other services' may give the impression of additional financial benefit being linked to the audit (also consider contingent fees).

Is the nature of other services consistent with the auditor's independence?	If you are unsure, consider the analysis and the particular circumstances, including the company's internal approval processes and auditor safeguards, and discuss with the auditor and management.	Y / N
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Certain services that place the auditor in the position of acting in a management capacity, being responsible for material in the financial statements, or having a mutual or conflicting interest are not considered permissible.

Is the ratio of total fees for other services to total audit fee appropriate to the company's circumstances for the period?	If you are unsure, consider the analysis and the particular circumstances, including the company's internal approval processes and auditor safeguards, and discuss with the auditor and management.	Y / N
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A high ratio may give an impression that audit independence is being compromised.

Appendix B: Assessing the independence of the external auditor

Questions to consider

Has the issue been satisfactorily addressed?

Audit scope and fee

Is the audit committee responsible for, and does it have significant involvement in, determining the audit scope and plan and audit fee?

If not, discuss with the auditor at a private meeting and ensure future audit committee involvement.

Y / N

Is the audit fee commensurate with the scope of the audit?

If not, discuss with the auditor at a private meeting and obtain a full understanding of the circumstances and implications.

Y / N

An unreasonable budget may restrict or reduce necessary audit work. This is particularly relevant when there is a change of auditor.

Are all audit fees paid as due?

If not, ask management to explain the delay, then help to resolve it.

Y / N



Understanding internal audit

In the wake of recent corporate reporting failures stakeholders, the investor community and the regulator are sharpening their focus on director's responsibilities and how effectively these responsibilities are discharged.

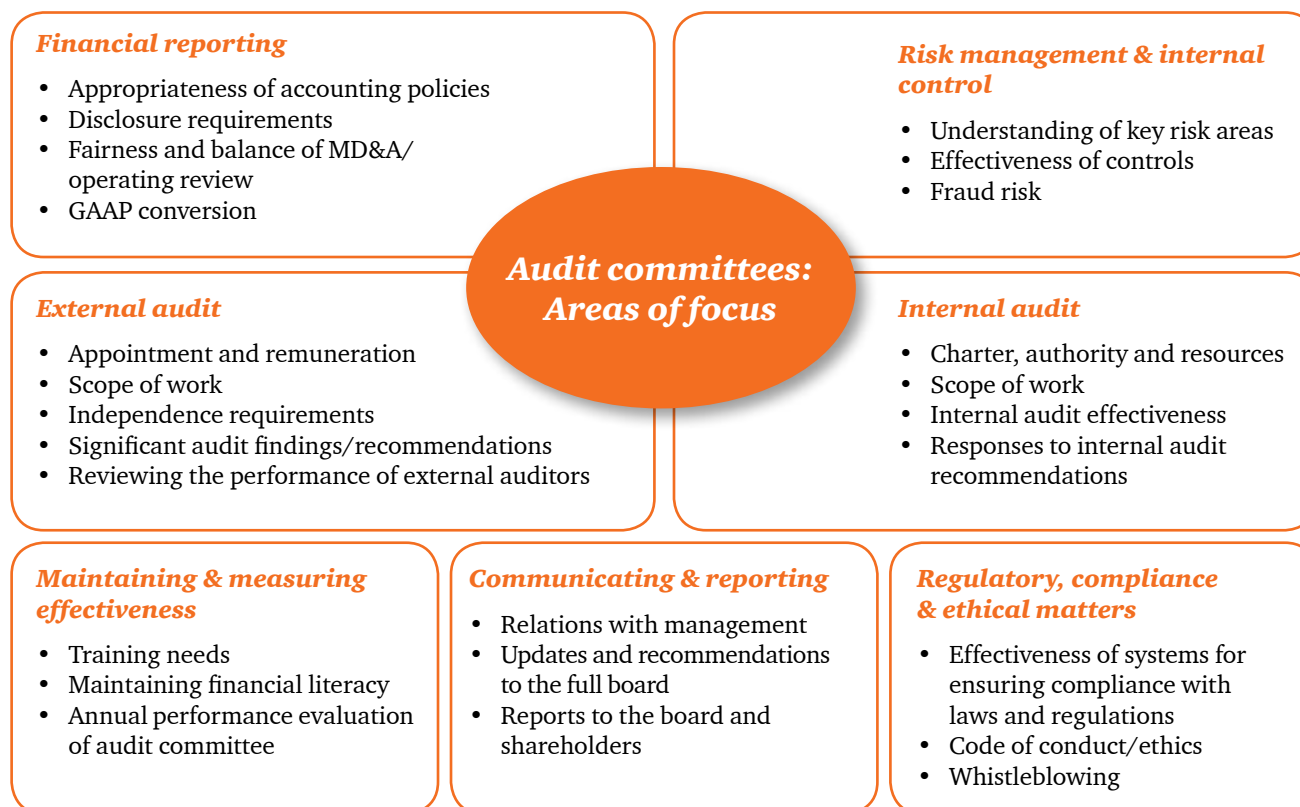
Whilst directors' responsibilities cannot be delegated, audit committees have an essential role to play in the governance of an organisation and ensuring the integrity and transparency of corporate reporting.

The PwC Audit Committee Guide is designed to help members of the audit committee work through the maze of director's responsibilities in a practical manner.



Understanding internal audit

Thousands of pages on corporate governance have been issued. However, regulations seldom provide helpful guidance on how the Audit Committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be focused? This guide is designed to help audit committees answer these questions.



The guide consists of:

- Introduction
- Setting up the audit committee
- Financial reporting: Reviewing financial information
- Risk management & internal control
- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Regulatory, compliance & ethical matters
- Compliance frameworks
- Materiality in audits

We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.

Understanding internal audit

A strong, positive relationship with internal audit can give audit committee members an insight into control elements relevant to their work.

Companies and boards are responsible for the risks a business faces and the controls it has adopted to mitigate those risks. An internal audit function is intended to provide assurance to the board and management about the way the company is managing risks and controls as they relate to the organisation's business objectives.

The Institute of Internal Auditors – (IIA) defines internal auditing as “an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”



1. Internal audit and the audit committee

The internal audit function can be an important source of information and advice for the audit committee. It is therefore imperative that there be a strong relationship between them.

Many audit committees report they find value in ensuring there is an open line of communication between the committee and the internal audit function. Some companies require the head of internal audit to report directly to the audit committee, rather than to management and this represents best practice. Others keep the management line of reporting, but require the head of internal audit to meet with the audit committee (or chair) regularly, including, at times, without management present.

The audit committee chair and the head of internal audit should have regular contact outside audit committee meetings. This ensures that the head of internal audit can talk directly to a non-executive about operational or management issues that may arise. The audit committee should also encourage a positive relationship between internal audit and the external auditor, to ensure a productive working relationship between them.

If a company does not have an internal audit function, it is a responsibility of the audit committee to consider, in conjunction with the board or senior management, whether such a function would benefit the company.



2. Charter and authority

Ensuring the internal audit charter clearly articulates the internal audit department's responsibilities and meets the companies needs will help maximise the effectiveness of the internal audit function.

To be effective, an internal audit department must have the support of management and the board. This means not only that management and the board must provide the right resources, time and authority, but also that internal audit must have a comprehensive mandate in the form of a charter. The charter and authority, in turn, can provide the audit committee with a clear understanding of internal audit activities, functions and organisational structure.

An internal audit charter sets out the roles, responsibilities, authority and reporting requirements of the internal audit function. The charter will vary from company to company. An example of an internal audit charter is provided in Appendix A to this section.

The role of internal audit will depend on the individual company's requirements. The audit committee needs to consider whether the charter sets out the internal audit responsibilities clearly and whether these meet the company's needs. When evaluating the charter, the audit committee should consider the following:

- Does the charter clearly articulate the internal auditor's mandate will perform and as agreed by the audit committee?
- Does internal audit have appropriate authority to undertake its responsibilities?
- Does the charter outline the reporting lines of the internal audit department? If so, are these sufficient to meet the needs of audit committee members?
- Does the charter require the head of internal audit to meet regularly with the audit committee without management present, or does it provide direct access to the audit committee chair?
- What relationship will internal audit have with other assurance providers?
- When was the charter last reviewed and updated? Has it kept pace with the company's activities and changes to the compliance/regulatory environment?
- Does the charter outline the standards under which internal audit will operate? For example, the IIA Standards for the Professional Practice of Internal Auditing (IIA Professional Standards).



3. Resourcing

The audit committee can play an important role in focusing attention on the adequacy of the internal audit department's resources.

Skills

The audit committee should consider the internal audit department's size and skill set in the context of the business environment in which the company operates. For example, important attributes could include computer and systems experience, treasury experience and foreign language skills.

Also important are the personal qualities of the internal audit staff and how they interact with the company.

The need for good relationships between the internal auditor and the management and staff of the company has to be balanced with the need to remain impartial and maintain a professional scepticism in the internal auditor's role as business partner. The audit committee will require the internal audit function to 'call it as they see it', and to make the committee aware of key control breakdowns and actions to correct them. As this may involve explicit or implicit criticism of management, internal audit staff will need the right mix of technical and 'soft skills' training to enhance their effectiveness.

In New Zealand, the introduction of the new financial markets regulator, the small market and the lure of overseas opportunities may place pressure on the ability of organisations to hire suitable internal audit staff who have these skill sets.



3. Resourcing

Head of internal audit

These constraints and pressures place additional emphasis on the quality of the head of internal audit. This person will need to be a strong individual, able to balance demands and challenges and to manage staff effectively. Given this profile, the audit committee should take responsibility for reviewing or approving the appointment, replacement or dismissal of the head of internal audit.

Outsourcing

Due to the complexities of running an internal audit function, some companies choose to outsource the activity. Outsourcing the internal audit function is a popular option because it:

- provides access to a wider range of skills than small, traditional departments can support
- provides a solution to the difficulties faced by companies of all sizes in retaining specialist auditors
- provides a window to better practice methods that smaller departments cannot access
- can increase internal audit's independence from operational management.

External experts

Where necessary, the internal audit function will need to employ other skills; for example treasury supply chain and IT expertise. In these instances the internal audit department might engage experts, either from within or outside the organisation. Where external experts are required regularly, large internal audit departments are increasingly choosing to develop strategic alliances with external providers. These alliances give the department access to experts who understand their industry and organisation, as well as access to best practice internal audit knowledge and specialist skills from one provider.

If this is considered a suitable approach, the internal audit function will need to have the authority to implement it. Usually the audit committee will approve – or, at a minimum, review – such alliances.

Assessing the resourcing of internal audit

Typical questions to ask concerning resourcing include those set out below.

Key questions	Who to ask	Response to look for
Do you have sufficient resources to complete the internal audit plan?	Head of internal audit	Yes. If the answer is no, determine what plans are in place to achieve and maintain appropriate resourcing.
How many vacancies exist? (Also consider how long any vacancies have remained unfilled.)		
What is the mix of resources in internal audit? (ie in-house vs external staff/experts)	Head of internal audit	Appropriate mix to deliver best result. The mix of resources is clearly linked to the charter and responsibilities and has been properly costed.
What training programme does the internal audit department have?	Head of internal audit	Necessary training to maintain qualifications and 'soft skills' and to keep up to date on emerging trends.
Is there a succession plan for the head of internal audit?	Head of internal audit, CEO and CFO	Yes – and there is an appropriate programme in place to prepare potential future leaders.

4. Internal audit's scope of work

The scope of work of an internal audit department varies significantly depending on its mandate, the industry within which it operates, the skills of the staff and the existence of other assurance providers in the organisation.

The scope of work of an internal audit department varies significantly depending on its mandate, the industry within which it operates, the skills of the staff and the existence of other assurance providers in the organisation. The scope of work may include:

- financial controls assurance
- operational auditing (eg reviews of areas other than finance such as logistics or production planning)
- monitoring of risk management implementation
- IT controls assurance
- project management assurance
- special investigative and ad hoc reviews (eg investigations of suspected fraud).

Assessing internal audit's scope of work

There are some general factors that are relevant to the work of an internal audit function. These can be used as pointers when assessing the scope of work.

1. Balanced relationship with management

Internal auditors should not allow management to inappropriately influence the scope of reviews and internal audit findings, and should challenge management 'bullies'. Ensuring that the scope of the audit is clearly defined and properly communicated to all concerned is a major step towards transparent outcomes.



4. Internal audit's scope of work

2. End-to-end audits

End-to-end auditing may be needed where a process crosses over business units, thereby splitting management responsibilities. Walk-throughs and flowcharts are important techniques for examining the entire process chain and ensuring that important controls do not 'fall between the cracks'. When performing end-to-end audits, the scope should include the facility for these techniques, as well as checks of both manual and automated controls.

3. Devil in the detail

The current heightened risk environment arising due to cost cutting, the impact of the depressed economy in New Zealand and significant challenges faced by companies means there is little room for budget-driven shortcuts. Businesses should be prepared for internal auditors to test internal controls in detail. Appropriate documentation and sampling standards should be consistently employed throughout the internal audit department.

4. Areas selected for attention

Internal auditors should not ignore remote or niche parts of the business because of their relative size. Areas where performance appears too good to be true or is outside expectations should be a particular focus of tests. An adequate risk assessment process should be undertaken to ensure that the internal audit plan is properly focused on the key risks affecting the organisation.

5. Fraud prevention and incident management strategies

Auditing fraud risks requires specialist skills and a tailored approach. Typical tools that should be used by internal auditors include data mining and analysis tools, and specially built computer-assisted audit tools (CAATs). These tools aid the accurate analysis and detection of unusual activity. Such tools can also create efficiencies as they can interrogate large amounts of data faster than manual testing methods.

Fraud and related incidents occur in most organisations and internal audit should be involved in managing such incidents. Internal audit should consider whether specialists are required to conduct or assist in the investigation. Such specialist assistance can include interviewers, forensic data specialists, lawyers and other experts.

Organisations should also have an incident management plan detailing the actions that need to be taken should a fraud incident occur. This plan should cover details such as legal and HR consultation, the engagement of specialists, communication protocols and reporting processes. When overseeing the scope of work of internal audit, the audit committee will need to bear these matters in mind. Typical questions that will help assess these matters include those set out in the following table.

Key questions	Who to ask	Response to look for
What percentage of the audit plan is dedicated to financial assurance reviews, operational reviews etc?	Head of internal audit	An adequate explanation concerning the key focus areas for internal audit, including a comparison to previous years and consideration of niche or high-performing areas.
How does this compare to previous years?		
How did you develop the plan and prioritise the audits?	Head of internal audit, CEO and CFO	A clear explanation of the risk assessment process used to develop the plan, as well as evidence of adequate, but not domineering, involvement of management.
What involvement did management have?		
How have you integrated the organisation's risk management framework and key risks into the internal audit plan?	Head of internal audit, CEO and CFO	A clear explanation that the risks identified in implementing the risk management framework – including direct links to the organisation's key risks and risk management policy – have been incorporated into the planning process.

4. Internal audit's scope of work

<i>Key questions</i>	<i>Who to ask</i>	<i>Response to look for</i>
Which risks identified as part of implementing the risk management framework are not addressed by internal audit? Are they addressed by other assurance providers? If not, why not?	Head of internal audit, CEO	Identification of those risks not addressed by any assurance group, and the reasons why not.
What are the top five reviews of your assessment process that did not make it into this year's plan?	Head of internal audit	A discussion of those reviews that 'just' missed out on this year's plan. There may be justification for conducting these reviews and re-prioritising.
Have you been involved in any ad hoc or special investigative reviews since we last met? If so, what impact will this have on the internal audit plan?	Head of internal audit	A discussion about the reasons for, who requested, and the impact on the internal audit plan of, any ad hoc assignments. The process for approving these assignments should be discussed. Generally the audit committee should be at least aware of these in advance.
Were any frauds identified during the period under review? If so, was the internal audit function promptly advised and involved in any investigation?	Head of internal audit	Evidence that there is a system for identifying frauds (see the Regulatory, compliance & ethical matters section), that internal audit activity was within a reasonable time of the fraud being reported, and that all reports were fully investigated, regardless of size.



5. Responses to internal audit recommendations

Many audit committees follow up on how the internal audit function's recommendations have been dealt with by management. This provides them with an insight into the role and effectiveness of the internal audit function and also some understanding of management's attitude to internal audit.

Any recommendations or agreed actions not implemented by management should be reported to the audit committee, especially where there is a risk of exposure. Reasons for any actions being resolved and revised resolution dates should also be reported. If the reasons provided are unacceptable, requests for further information from management should be made.

Following are some sample questions to ask the internal audit head regarding previously reported internal audit findings.

Key questions	Response to look for
In the reports you are presenting at this audit committee meeting, has management agreed to all findings reported?	Yes. If the answer is no, appropriate reasons are required.
Are management's proposed resolution dates appropriate to address the risks in a timely manner?	Yes. Timeframes to action findings should be commensurate with the risk/exposure of the finding.
How long has it taken for you to finalise each of the reports presented?	An explanation for any undue delays. The time it takes to finalise a report is often a sign of pushback from management.
In your professional opinion, are management's reasons for not actioning findings by their resolution date appropriate?	Yes. If the answer is no, the findings in question should be discussed and a revised deadline for action/follow-up agreed.
What process do you undertake to confirm that agreed actions have been implemented?	Internal audit cannot physically verify all previous findings. At a minimum, the next visit/audit scope should include the follow-up of previous findings.

6. Internal audit effectiveness

To ensure the internal audit department maintains high performance, it is important that the audit committee regularly assesses the department's effectiveness. The IIA Professional Standards require that an independent or external assessment of the internal audit function be performed at least once every five years, and an internal assessment once a year.

In the meantime, the audit committee can contribute to maintaining the quality of performance by determining whether the internal audit function:

- is satisfying the values of the key stakeholders (ie audit committee, executive management, operational management)
- has maintained its objectivity
- is adequately trained (the company should provide a supportive atmosphere where internal auditors can receive continuing professional education)
- keeps up with current issues and technology; for example, where a company has significant computerised operations or is heavily dependent on electronic commerce, internal auditors should have the necessary skills to understand the internal control implications
- has appropriate qualifications in both professional training and practical experience (the company should encourage internal auditors to become members of professional associations and to seek professional certification where appropriate)
- is appropriately funded within the organisation.



6. Internal audit effectiveness

Some questions to ask include the following.

<i>Key questions</i>	<i>Who to ask</i>	<i>Response to look for</i>
Has internal audit ever undergone an external assessment? If yes, how long ago, and how are we tracking actions to address findings?	Head of internal audit	The timing and results/actions from the last external assessment (at least every five years).
Does internal audit perform annual self-assessments? If so, how are actions tracked and reported?	Head of internal audit	The timing and results/actions from the last self-assessment (yearly is best practice).
Is the internal audit charter and/or mandate appropriate? Has it kept pace with the company's activities and information and control systems?	Head of internal audit, CEO and CFO	Yes, the internal audit function has an appropriate charter that is followed and is sufficiently flexible to allow it to address changing risks.
What standards and guidance does the internal audit function follow?	Head of internal audit	Institute of Internal Auditors. Other relevant standards issued by relevant authorities.
Does internal audit assess areas significant to the key operational and financial risks faced by the business?	CEO and CFO	Yes. If not, why not? Is the function not sufficiently risk focused?

<i>Key questions</i>	<i>Who to ask</i>	<i>Response to look for</i>
Does the company act on recommendations from internal audit and monitor the changes made?	Head of internal audit	Yes. This should be supported by reporting to the audit committee on clearance of previously reported findings.
Do the internal auditors have an effective working relationship with the external auditor and with company personnel involved in risk management processes?	Head of internal audit, external auditor and chief risk officer	Yes. Evidence would be a link from the internal audit plan to the risk profile, and external audit being able to rely on internal audit's work.

Appendix B is an example of a questionnaire that can be used when evaluating the effectiveness of the internal audit function. It may be useful to have the head of internal audit and CEO/CFO fill this out separately and compare the results.

Benchmarking

Another approach to evaluation is to commission a benchmarking exercise. This involves an independent review of the internal audit department's activities, which is used as the basis for benchmarking those activities against those of comparable internal audit departments. Such reviews can improve the effectiveness of the internal audit department by identifying actions to ensure future needs are met.

Benchmarking exercises should be both quantitative and qualitative. As no two organisations are the same, recommendations should be tailored to the needs of the organisation.

6. Internal audit effectiveness

General questions for the head of internal audit

As a member of an audit committee, it is important that you understand fully the operation of your internal audit department, especially if you are relying on the department to provide you with assurance over the controls within the organisation. Questions to ask your internal audit head are set out in the table below.

Key questions	Response to look for
What co-operation do you receive from both corporate and operational management?	Good co-operation at all times. However, differences of opinion will always surface. These should be explained so the committee can assess the stance of each party and how they work together. Serious differences of opinion need to be resolved.
Have you experienced any circumstances where management was less than co-operative?	Examples will help to clarify the issues and the working relationship.
Have any of your requests for information been denied?	No. Internal audit should have the ability to review all information it requests. The charter should also reinforce this. If concerns are expressed, the audit committee should consider their impact and how they can be resolved.
In your opinion, where is our organisation exposed (be it financial, reputational, operational etc)?	A clear explanation demonstrating a good understanding of the risks, and providing comfort that these are being addressed through internal audit or some other assurance process (if appropriate).
Is addressing this exposure part of your internal audit plan?	

Key questions

Have you been inappropriately pressured to alter or re-prioritise findings from your work?

Response to look for

The only changes made to reports should be to ensure factual accuracy. Internal audit must ensure that all key risk exposures it detects during internal audits are reported to the audit committee.

If there are concerns about undue pressure, the committee will need to discuss with the head of internal audit from whom these pressures are coming and how the head of internal audit thinks they can be resolved.



Appendix A: Example of an internal audit charter

The internal audit function may cover a range of activities. This example illustrates one option only.

1 Purpose of the charter

- 1.1 The internal audit charter provides the functional and organisational framework within which internal audit operates. This document sets out the nature, role, status, authority and responsibility of internal audit.
- 1.2 This document should be read in conjunction with the audit committee charter.

2 Mission and objective of internal audit

- 2.1 Internal audit's mission is to provide independent, objective assurance to the audit committee on the state of risks and internal controls, providing management with recommendations to enhance controls.
- 2.2 Its secondary objective is to assist the CEO and senior management in the effective discharge of their responsibilities to the board in the areas of risk management and internal control, by providing independent appraisals of the adequacy and effectiveness of the risk management and internal control systems. In performing this role, internal audit may also provide assistance to the board in the discharge of its responsibilities.
- 2.3 The risk management and internal control systems encompass all policies, processes, practices and procedures established by management or the board, to provide reasonable assurance²⁴ that:
 - established corporate and business strategies and objectives are achieved
 - risk exposure is identified and adequately monitored and managed
 - resources are acquired economically, adequately protected and managed efficiently and effectively, throughout the course of business
 - significant financial, managerial and operating information is accurate, relevant, timely and reliable

- there is an adequate level of compliance with policies, standards, procedures, and applicable laws and regulations.

In addition, a review might highlight opportunities for improving management control, profitability and the identification of the company's risk profile. These findings will be communicated to the appropriate level of management through the normal reporting process.

3 Independence

- 3.1 Internal audit must be, and must be seen to be, independent of the activities and processes it appraises, to ensure it can perform its duties in an objective manner and can provide impartial advice to management and the board.
- 3.2 Audit staff have no line responsibility or authority over any of the activities or operations they review and (except in the rarest of circumstances as approved by the CEO and/or audit committee) are not authorised to:
 - perform any operational duties for the organisation except within internal audit
 - initiate or approve accounting transactions external to internal audit
 - direct the activities of any employee not employed by internal audit
 - engage in any other activity that could compromise their objectivity.
- 3.3 It is the responsibility of internal audit staff to communicate to the CEO and audit committee any perceived or potential conflicts that may compromise the objectivity or independence of internal audit.

²⁴ Any review or evaluation of a system of controls will never provide absolute assurance. Procedures that are adequate at the time of the review may become inadequate due to changed conditions or because the degree of compliance subsequently deteriorates. Accordingly, audit assessments can provide no assurance that breaches of a system of control or loss (whether through fraud, misappropriation or other failure) will not occur in the future.

Appendix A: Example of an internal audit charter

4 Authority and accountability

- 4.1 The head of internal audit reports to the audit committee, which approves and advises the board on the appointment or dismissal of the head of internal audit.
- 4.2 The head of internal audit is responsible for setting the overall direction of internal audit activities and reports, for administrative purposes, to the CFO, CEO and/or company secretary. Internal audit reports to the audit committee regarding its responsibility to:
 - seek approval of the proposed direction for internal audit (ie strategy)
 - discuss and set objectives, scope, timing and resourcing of internal audit activity (ie annual plan)
 - regularly advise of progress against plan and of any significant matters affecting the achievement of the annual work programme
 - report on key risk and internal control issues arising from internal audit activity.
- 4.3 Internal audit has direct access to the chair of the audit committee and vice versa.

5 Access

- 5.1 The activities of internal audit are performed in relation to the parent company and its controlled entities. However, internal audit may also perform review work in relation to, or provide advice or information to, other related entities of the parent company. For example, joint venture arrangements may be subject to internal audit review.
- 5.2 Internal audit has full, free and unrestricted access to all records, documentation and physical property as may be required to fulfil its responsibilities. In particular, internal audit has access to the strategies, policies and priorities established by the board and senior management.
- 5.3 Internal audit also has the authority to seek any information it requires to fulfil its responsibilities from any officer, employee, consultant or contractor related to the company.

- 5.4 Company employees are expected to make themselves available and provide such information and explanations as are required for the conduct of internal audit work.

6 Coverage and reporting

- 6.1 Internal audit work will normally include, but is not restricted to, the following types of activity:
 - Risk management and control monitoring, review and advisory services
 - Risk-based business process reviews
 - Ad hoc special project requests from management or the board/audit committee
 - Special investigative reviews of frauds
 - Financial, operational, procedural and compliance reviews (including Sarbanes-Oxley-related controls work if applicable)
 - Information systems reviews.
- 6.2 Allocation of internal audit resources is based on an annual plan that takes into account:
 - qualitative risk assessments of operations performed in consultation with management
 - organisation strategy and business objectives
 - any special tasks or projects requested by management or the audit committee/board, having regard to internal audit's primary responsibilities
 - discussion with and input from management
 - discussion with and input from the company's external auditor.

Appendix A: Example of an internal audit charter

- 6.3 Some examples of the factors considered in assessing risk exposure are:
- the adequacy of risk management practices within the company generally
 - the extent of compliance with, relevance of and financial effect of established policies, plans, procedures, laws and regulations
 - the extent to which resources and interests are accounted for and safeguarded from losses of all kinds, such as inefficient administration, poor value for money, or fraud
 - the suitability, reliability and integrity of financial and other management information and the means used to identify, measure, classify and report such information
 - the security and integrity of information systems, including systems under development, to ensure that controls over data processing and associated operational procedures offer adequate protection against error, fraud and loss
 - the follow-up actions taken by management to remedy previously identified significant risk and internal control exposures.
- 6.4 The plan is developed in conjunction with management and senior corporate executives. It is approved by the audit committee.
- 6.5 Internal audit management or the audit committee may make alterations to the annual plan. These changes require the approval of internal audit and the relevant executive manager, with notification to the chair of the audit committee. Alterations to the plan will be tabled at the next available audit committee meeting.
- 6.6 Before a review is started, a terms of reference (TOR) will be agreed with internal audit and the relevant management team. This TOR is the scope document that forms the basis for a detailed work programme.
- 6.7 An internal audit report will be issued for every review performed. There may be instances where a memorandum is issued by internal audit in place of a report (for example, reviews undertaken to address specific operational problems or issues, or minor matters for management attention).
All reports issued will contain, as a minimum:
- the scope of the review
 - relevant administrative information (for example, title of the review, area under review, reviewer, date of the review)
 - a grading of the issues/findings raised (ie significant, important, minor)
 - a summary of the control issues/findings that arose during the review, together with appropriate recommendations and agreed management actions.
- 6.8 All reports will be discussed with management before the report is issued. These management discussions include discussions with:
- operational line managers (ie the internal audit project sponsor)
 - general and executive general managers
 - chief operating officer and/or CFO
 - managing director/CEO.
- 6.9 A summary report will be provided to the audit committee at each quarterly meeting. Complete details of all significant findings will be reported to the audit committee.
- 6.10 Internal audit will also maintain a register of issues/findings raised during audit reviews. The resolution of these will be monitored and, if required, reviews may be scheduled to follow up on the closure of issues.
- 6.11 The status of issues/findings previously reported to the audit committee will be reported at each audit committee meeting.

Appendix A: Example of an internal audit charter

7 Relationship with related assurance functions and the external auditor

- 7.1 To achieve cost-effective and efficient coverage, internal audit needs to liaise regularly with the external auditor, including:
- meeting to discuss and co-ordinate work, to minimise duplication of effort
 - providing copies of all reports arising from internal audit activity
 - providing access to all internal audit working papers and documentation that may assist the external auditor in carrying out its duties.
- 7.2 It is the sole responsibility of the external auditor to determine the extent to which it can rely on the reports, working papers and other documentation for its external audit or other purposes.
- 7.3 Internal audit will consider the work performed by the other assurance functions when planning for each review.

8 Operating standards

- 8.1 Internal audit staff are expected to promote the highest possible professional standards and service levels. In doing so, they will have regard to:
- internal audit procedures and standards
 - the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors
 - any other standards relevant to the maintenance of their professional standing.

- 8.2 In addition, internal audit staff are expected to:

- have a broad knowledge of operations
- remain informed about significant issues affecting or likely to affect those operations, and be responsive to changing organisational needs
- maintain their technical competence and build on their professional qualifications and skills through continuing education, which may include membership and participation in professional bodies; participation in research projects; and attendance at relevant conferences, seminars, external courses and in-house training programmes
- exercise honesty, objectivity and discipline in performing their duties and responsibilities
- maintain a healthy level of 'professional scepticism'
- maintain their independence
- be prudent in the use of information acquired in the course of their duties and, where necessary, preserve the confidentiality of such information
- maintain a constructive relationship with other staff encountered in the course of their duties.

9 Review of charter

- 9.1 The internal audit charter is reviewed at least annually by internal audit to ensure it remains consistent with its strategy and objectives. The outcomes of this annual review should be reported to the audit committee.
- 9.2 Any significant proposed changes are approved at the audit committee meeting.
- 9.3 Any review of this charter should take into consideration the impact of any service agreement with a third party for the provision of technical audit services.

Appendix B: Checklist for evaluating the effectiveness of internal audit

This short-form evaluation checklist is illustrative only. Each entity should tailor its evaluation to best meet its own criteria for internal audit effectiveness. The audit committee can complete this checklist based on discussions with internal audit and management, or it may require internal audit and management to complete the questionnaire separately, with the audit committee then assessing the results.

Internal audit performance criterion	Yes	No	Not sure	Comments
1. Is the internal audit department efficient and effective in performing its responsibilities? (Also refer to No 18).				
2. Given the internal audit plan and scope of work, are the resources appropriate?				
3. Is the internal audit department objective? How does it ensure this objectivity?				
4. Do internal audit staff have sufficient technical knowledge to perform their duties?				
5. Is there a formal training programme in place for the department?				
6. Are IT auditors available to consider risks and related controls associated with operating systems?				
7. Was the staff turnover level for the current year in accordance with expectations?				

Internal audit performance criterion	Yes	No	Not sure	Comments
8. Was the internal audit plan delivered within the agreed budget, with a concentration on high risks and areas of sensitivity?				
9. Was the entire annual internal audit plan completed?				
10. Is the internal audit planning process appropriate?				
11. Were established and documented criteria used to prioritise the annual and long-term audit plans?				
12. Does planning include written audit plans and programmes?				
13. Are reporting responsibilities (ie how often, to whom, format) formally documented?				
14. Are audit reports issued promptly?				
15. Is sufficient detail included in the audit reports?				

Appendix B: Checklist for evaluating the effectiveness of internal audit

Internal audit performance criterion	Yes	No	Not sure	Comments
16. Are recommendations/agreed actions completed in accordance with agreed timeframes?				
17. Does the scope of work include both operational and financial auditing?				
18. Does the head of internal audit consider efficiency and effectiveness improvements to the department?				
19. Is outsourcing of any internal audit services in place or planned?				
20. Does the internal audit team have a periodic peer review? If so, what were the results of the latest review?				
21. Has the charter been evaluated to determine whether it is still appropriate?				





Maintaining & measuring effectiveness

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- Financial reporting: Reviewing financial information
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- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Regulatory, compliance & ethical matters
- Compliance frameworks
- Materiality in audits

We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.

Maintaining & measuring effectiveness

As with all elements of the corporate reporting chain, accountability is important for effective operation.

The work of the audit committee can be detailed and members need to ensure their knowledge and awareness remains up to date (particularly where financial accounting standards and wider reporting and regulatory issues are concerned). This may involve educational or training sessions for audit committee members, in addition to other meetings.

The audit committee should regularly evaluate its performance against the responsibilities set out in its charter. This assessment can take place on an individual basis and/or collectively. It is usual for the results of the evaluation to be reported to the board as well as being used by the audit committee for improvement.

This section provides an overview of what audit committees need to be aware of in maintaining and measuring their effectiveness.



1. The need for training

Audit committee members are senior members of the board, and as such bring considerable business and practical experience to their work. However, their work on the audit committee may bring some members into areas with which they have had little previous experience. Even those who do have the relevant experience generally find that regular updates or reminders are useful.

Many audit committees therefore establish a training programme as part of their work. Training sessions may focus on any number of matters considered relevant by the audit committee, such as:

- accounting and financial reporting updates
- specific accounting issues (eg financial instruments, tax consolidation, business combinations, impairment testing)
- regulatory updates
- fraud/anti-money laundering
- risk management and internal control design (eg COSO)
- treasury operations and controls
- corporate governance
- industry updates
- inspections of company operations.

Training can be formal, for example on specific topics or tailored by external providers specifically for the organisation, or more informal, in the form of (for example) conferences, business networking activities or reading.



2. Maintaining financial literacy

A key area of audit committee responsibility is financial reporting. It is therefore important for audit committee members to understand how financial reporting works. As set out in the Setting up the audit committee section, New Zealand audit committees should wholly or substantially comprise suitably qualified directors and are required to have at least one member that has an accounting or financial background. A stronger requirement exists in Australia, where each member is required to be financially literate – that is, should be able to read and understand financial statements.

This is not a one-off state of affairs, but an area of knowledge that must be continually updated. It may be that a training programme will be sufficient for members to maintain their financial literacy. If no training programme is in place, the minimum requirement would be an annual discussion with the external auditor on financial reporting developments.



3. Evaluating performance

Corporate governance principles emphasise the need for boards and board committees to demonstrate a high level of professionalism. This is reflected in recommendations not only for more training, but also for evaluating performance on a regular basis.

Evaluation can be in the form of reviewing the performance of individual audit committee members and of assessing the effectiveness of the audit committee as a whole.

Individual performance evaluations

While the performance of the audit committee is a collective issue, it is important in terms of accountability that the audit committee (or board) chair periodically reviews the performance of each audit committee member.

This review will consider an individual's:

- business knowledge
- specific areas of expertise
- objectivity and independence
- understanding of the duties and responsibilities of the audit committee
- willingness to devote time to preparing for meetings
- attendance at and contribution to meetings.

Commonly a review of an individual's performance will include a self-assessment or some means of independent or facilitated review. It is important to stress that it is the individual's performance as part of the committee that is being assessed.

Assessing the audit committee as a whole

To assess its effectiveness, the audit committee should periodically (for example, annually) review what it has accomplished and whether it has fulfilled its responsibilities.

One way an audit committee can assess itself is by evaluating its activities against its charter. As the audit committee is reviewing itself as a whole, an exercise supervised by an outside facilitator is likely to be beneficial. An external facilitator will not only be emotionally detached, but will approach the matter without bias or preconceptions. In addition, an outside view allows for different perspectives to be discussed and considered. At the end of the review process, the audit committee chair usually discusses the results of the evaluation with the board.

Among topics to consider are the composition of the audit committee, conduct of meetings, activities, and relationships with auditors and management.

The views of the external auditor can be helpful to the audit committee in assessing the committee's performance.

Some audit committees also take advantage of opportunities to benchmark their organisational procedures and activities with audit committees in similar companies. Conferences and seminars provide opportunities to network and learn from the experience of others.

A suggested audit committee work programme and self-assessment guide is provided in Appendix A to this section.

Finally, any process for evaluating performance may fail unless an action plan is implemented to respond to areas identified for improvement.

Appendix A: Self-assessment guide and work plan for audit committees

Does your committee measure up?

Audit committees can use this guide to determine how effectively they are meeting their responsibilities. It also contains a work plan which can be completed each year. The references in the first column relate to the sample audit committee charter presented in Appendix A of the Setting up the audit committee booklet.

Self-assessment guide

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/NA	Follow-up steps necessary
Authority				
2.1	Obtained board authority to perform activities within its terms of reference.	Board		
2.4	Has had unrestricted access to members of management, employees and relevant information.	Management		
2.5, 2.6	Has authority to establish procedures to deal with concerns of employees and complaints received by the company regarding accounting, internal control and auditing matters.	Board		

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/NA	Follow-up steps necessary
2.7, 2.8	Has received board authority to be responsible for appointment, compensation, retention and oversight of the work of the external auditor as well as approval of non-audit services.	Board		
Organisation: Membership				
–	The board has reviewed the mix of experience and skills of audit committee members to maintain an appropriate balance.	Board/chair of audit committee		
3.1	The board or a nominating committee of the board has appointed any changes in audit committee members.	Board		
3.2	The size of the audit committee is appropriate to the organisation.	Board		
3.3	Most/all audit committee members are independent non-executive directors according to the regulatory/securities exchange requirements.	Board		

Appendix A: Self-assessment guide and work plan for audit committees

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/ NA	Follow-up steps necessary
3.4, 3.5	The experience and qualifications of audit committee members are compatible with the duties of the audit committee, including the ability to understand financial statements. At least one of the members has accounting or related financial expertise.	Board/chair of committee		
3.6	Members serve an appropriate term of office.	Board		
Organisation: Meetings				
3.8, 3.9	Only audit committee members are entitled to attend meetings. Senior management and external and internal auditors are invited to attend meetings as necessary.	Committee secretary		
3.10, 3.11	The audit committee met regularly, with special meetings called as circumstances warranted. (At least three or four meetings each year is desirable.)	Committee secretary		
3.12	Meeting agendas and supporting papers were prepared and distributed far enough in advance to enable audit committee members to prepare for meetings.	Committee secretary		
–	Audit committee papers were clear and concise, using standard templates and relevant KPIs and other indicators.	Committee secretary		

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/ NA	Follow-up steps necessary
3.13	Minutes of meetings were circulated promptly to members of the board, audit committee and external and internal auditors where appropriate.	Committee secretary		
3.14	The chair or another audit committee member attended the board meeting at which the financial statements were approved.	Board/chair of audit committee		
3.15	Members of the audit committee attended every meeting.	Board		
3.16	The audit committee met with in-house legal counsel on a regular basis.	Board		
–	New audit committee members were provided with sufficient background information and training to meet their responsibilities effectively.	Chair of audit committee/ committee secretary/ management		
–	The audit committee had adequate resources to discharge its responsibilities.	Board		
–	The audit committee has an effective working relationship with management	Committee/ management		

Appendix A: Self-assessment guide and work plan for audit committees

Work plan

The following part of the guide can be used as an annual work plan.

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/NA	Follow-up steps necessary
Internal control				
4.1	Has evaluated the 'control culture' established by management.	Management		
4.2	Has ensured that management has appropriate processes for identifying, assessing and responding to risks in line with the organisation's risk appetite, and that those processes are operating effectively.	Management		
4.3, 4.4	Has taken active steps to understand the control systems implemented by management for approving transactions, recording data, and compliance of the financial statements with relevant standards and requirements.	Management		
4.5	Has considered the overall effectiveness of the internal control and risk management frameworks and has considered whether management has implemented recommendations made by external and internal auditors.	Management /internal audit/ external auditor		

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/NA	Follow-up steps necessary
4.6	Has considered how management has reviewed the adequacy of controls over electronic data processing and computer security.	Management /IT department		
4.7	Has participated in the appointment, promotion or dismissal of the head of risk management, if applicable.	Head of risk management		
4.8	Has met separately with the head of risk management without management personnel being present.	Head of risk management		
Financial reporting				
4.9	Has reviewed the areas of greatest financial risk and how management is dealing with them.	Management /treasury		
4.10	Has reviewed significant accounting and reporting issues and understood their likely impact on the financial statements.	Management /external auditor		

Appendix A: Self-assessment guide and work plan for audit committees

Work plan

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/ NA	Follow-up steps necessary
4.11	Has overseen the periodic financial reporting process and reviewed the interim financial statements, annual financial statements and preliminary announcements before their release.	Management /external auditor		
4.12	Has reviewed the management process for ensuring that the information contained in analyst briefings and press announcements was consistent with published financial information.	Management		
4.13	Has met with management and the external auditor to review the financial statements and results of the audit.	Management /external auditor		
4.14	Has ensured that significant adjustments, unadjusted differences, disagreements with management and critical accounting policies have been discussed with the external auditor.	External auditor		

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/ NA	Follow-up steps necessary
4.15	Has considered whether the narrative information included in other sections of the annual report is understandable and consistent with the information in the financial statements.	Management /external auditor		
–	Has read the representation letters given by management to the external auditor and considered any specific representations contained in them.	External auditor		
Compliance				
4.16	Has reviewed the effectiveness of the compliance framework.	Head of compliance/ management		
4.17, 4.18	Has reviewed updates regarding compliance matters that may affect the company's financial statements, strategy, operations or reputation.	Head of compliance/ legal counsel/ management		
4.19	Has reviewed the findings of any examinations by regulators.	Head of compliance/ legal counsel		

Appendix A: Self-assessment guide and work plan for audit committees

Work plan

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/ NA	Follow-up steps necessary	Ref to charter	Practice	Also involved	Is it being followed? Yes/No/ NA	Follow-up steps necessary
4.20	Has reviewed/approved the policies, processes and framework for identifying, analysing and addressing complaints (including whistleblowing) and reviewed material complaints and their resolution.	Head of compliance/ whistleblower protection officer			4.26	Has reviewed the external auditor's proposed audit scope and approach. Has enquired into reasons for subsequent changes to the audit plan.	External auditor		
4.21	Has taken part in the appointment, promotion or dismissal of the head of compliance and legal counsel, if applicable.	Head of compliance/ legal counsel			4.27	Has discussed any audit problems, including restrictions on the scope of the audit, or denials of access to requested information.	External auditor		
4.22	Has met separately with the head of compliance and legal counsel without management present.	Head of compliance/ legal counsel			4.28	Has reviewed the external auditor's reports to management and ensured that management responded to the findings.	External auditor/ management		
External audit					4.29	Has discussed the appropriateness of accounting policies with the external auditor.	External auditor		
4.23, 4.25	Has reviewed the qualifications, performance and compensation of the external auditor and made recommendations concerning appointments to the board.	External auditor			4.30, 3.17	Has met separately with the external auditor at least once a year and ensured the auditor had access to the chair.	External auditor		
4.24	Has considered the independence of the external auditor and any conflicts of interest that may arise.	External auditor			4.31	Has reviewed policies for the approval of non-audit services and made recommendations.	External auditor		

Appendix A: Self-assessment guide and work plan for audit committees

Work plan

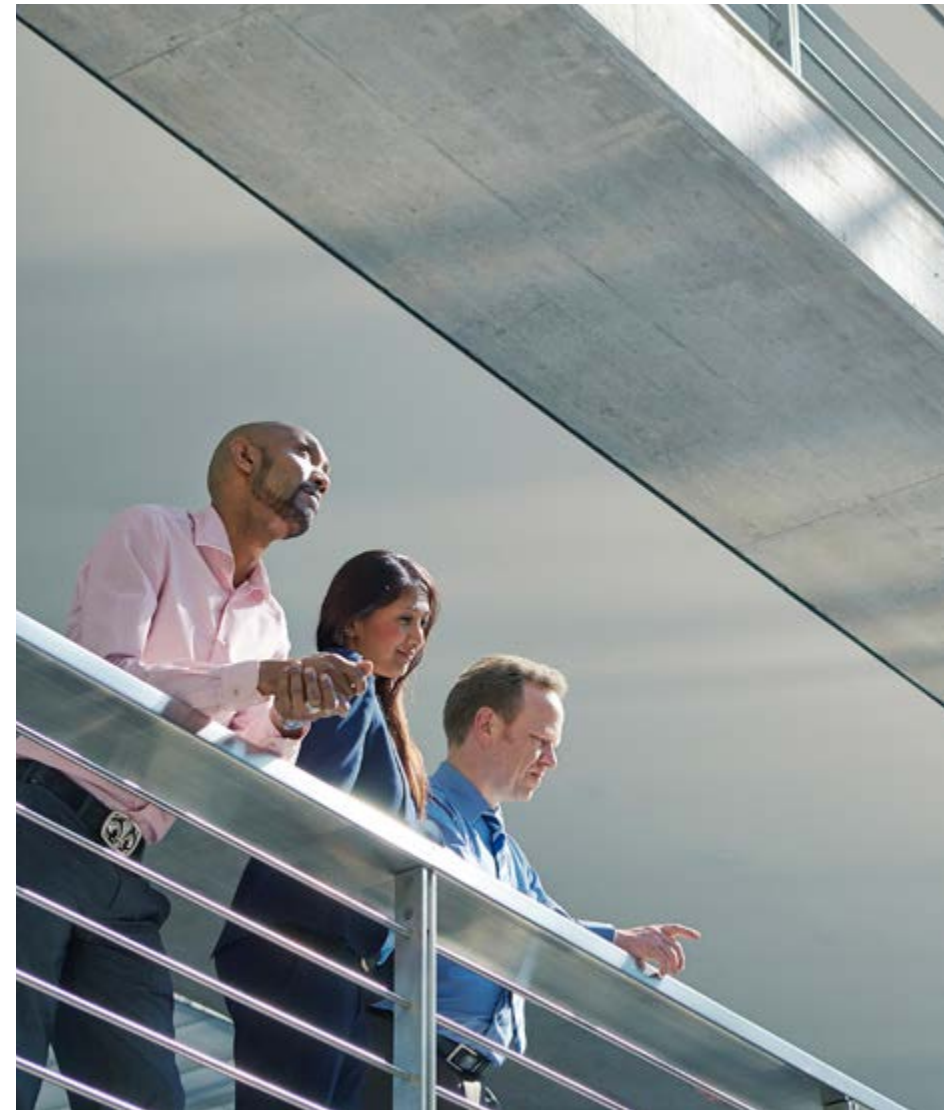
Ref to charter	Practice	Also involved	Is it being followed? Yes/No/ NA	Follow-up steps necessary
4.32	Has ensured that the company has appropriate policies for hiring audit firm personnel for senior positions.	Management		
–	Has enquired about any planned reliance on the work of internal audit by the external auditor.	External auditor/ internal audit		
–	Has enquired about the extent to which audit and accounting firms other than the principal auditor are used, and understood the reasons for using them.	Management		
Internal audit				
4.33	Has reviewed the activities, resources and structure of internal audit and approved the internal audit charter.	Internal audit		
4.34	Has reviewed and approved the appointment, replacement or dismissal of the head of internal audit, if applicable.	Internal audit/ management /external audit		
4.35	Has reviewed the effectiveness of the internal audit function.	Internal audit/ management /external audit		

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/ NA	Follow-up steps necessary
4.36	Has met privately, on a regular basis, with the head of internal audit.	Internal audit		
4.37	Has reviewed significant findings resulting from internal audit and ensured that management responded in a timely manner.	Internal audit/ management		
4.38	Has reviewed the internal audit plan with the head of internal audit, particularly with regard to involvement in control systems and the financial reporting process.	Internal audit		
–	Has reviewed the staffing, training and budget of the internal audit function.	Internal audit/ management		
The committee's own reporting responsibilities				
4.39, 4.40	Has reported audit committee activities to the board regularly and made the board aware of matters that may have a significant impact on the business.	Board		
4.41	Has ensured that any reports on audit committee activities required by law and listing rules have been prepared.	Head of compliance/ legal counsel/ management		

Appendix A: Self-assessment guide and work plan for audit committees

Work plan

Ref to charter	Practice	Also involved	Is it being followed? Yes/No/NA	Follow-up steps necessary
Evaluating performance				
4.42	Has periodically assessed the performance of individual members and audit committee as a whole.	Chair of audit committee		
–	Has ensured that members are devoting sufficient time and energy to the affairs of the company.	Chair of audit committee		
4.43	Has assessed the achievement of the duties specified in the charter and reported to the board.	Board		
Charter				
4.44	Has reviewed the audit committee charter annually and discussed proposed changes with the board.	Board		
4.45	Has ensured the charter is approved/re-approved by the board.	Board		



Communicating & reporting

In the wake of recent corporate reporting failures stakeholders, the investor community and the regulator are sharpening their focus on director's responsibilities and how effectively these responsibilities are discharged.

Whilst directors' responsibilities cannot be delegated, audit committees have an essential role to play in the governance of an organisation and ensuring the integrity and transparency of corporate reporting.

The PwC Audit Committee Guide is designed to help members of the audit committee work through the maze of director's responsibilities in a practical manner.



Communicating & reporting

Thousands of pages on corporate governance have been issued. However, regulations seldom provide helpful guidance on how the Audit Committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be focused? This guide is designed to help audit committees answer these questions.



The guide consists of:

- Introduction
- Setting up the audit committee
- Financial reporting: Reviewing financial information
- Risk management & internal control
- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Regulatory, compliance & ethical matters
- Compliance frameworks
- Materiality in audits

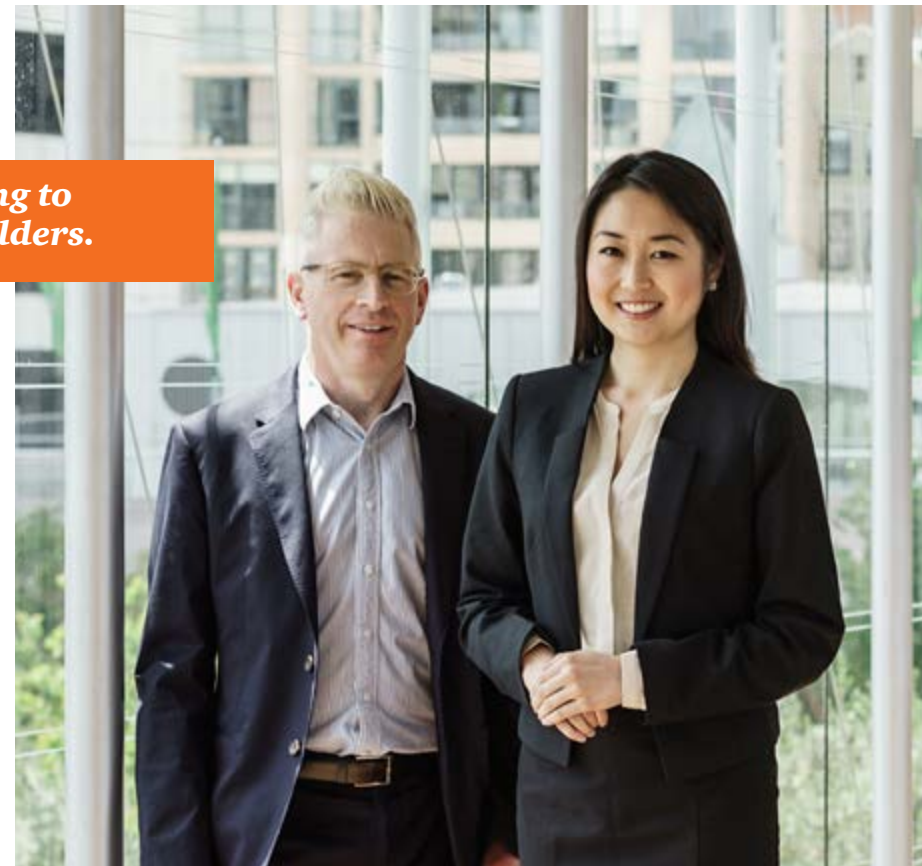
We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.

Communicating & reporting

The audit committee plays an important role in talking to management, the board, the auditor and the shareholders.

The audit committee works under delegated authority from the main board of directors and provides an important link between the board, management and the auditor. This link will only be effective if communication with these groups is effective.

In addition, the audit committee might have responsibilities to report to shareholders, overseas head offices or other stakeholders.



1. Communicating with management

Obtaining information

To contribute constructively to the business, audit committee members must have a good understanding of the company's operations. Regular and meaningful dialogue with management will help to maintain this understanding. Matters on which the audit committee might obtain regular briefings from management include:

Areas for discussion	Specific matters to consider
Strategy	<ul style="list-style-type: none"> • Management's assessment of the business risks the company faces and its planned response to those risks • Current issues affecting the company's industry (for example, regulatory issues or information about the competitive environment) • The effect new tax laws or other regulations may have on the company.
Measures of success	<ul style="list-style-type: none"> • The main financial and non-financial KPIs used to manage and monitor performance against strategies • KPIs that will be reported on (to the board and/or externally) • How KPI results are aligned to remuneration incentive schemes.²⁵

Areas for discussion	Specific matters to consider
Operational matters	<ul style="list-style-type: none"> • The adequacy of the internal control environment, and the continued operation of key controls • The legal environment, including the status of any pending lawsuits or administrative proceedings, and the status of product and environmental liability and warranty reserves • Treasury activities, including cash management, hedging, foreign currency transactions and use of new or unusual financial instruments • The company's foreign operations, including locations, and local controls over financial reporting • Insurance cover for directors and senior officers • Procedures for setting remuneration policies and reviewing senior officers' expenses.
Performance/trends	<ul style="list-style-type: none"> • Achievement of targets for operational and financial KPIs, as well as performance against benchmarks and underlying trends.

25. The board's remuneration committee looks at remuneration schemes in detail. The audit committee, however, needs to be aware of the impact of the financial results on remuneration and vice versa.

1. Communicating with management

Challenging information

As well as receiving information from management, effective oversight requires the audit committee to have significant interaction with management about its reports, which includes asking difficult questions and obtaining reasonable answers.

Constructive challenge is a difficult balance to achieve, especially as senior management are in the role specifically because of their decision-making and leadership abilities. Questions may include (depending on the circumstances):

What to ask	Who to ask	Response to look for
What other matters did you consider when coming to this recommendation/decision?	CEO/CFO/ project manager/ management	Has management considered other options? Are there any other possibilities that have not been covered?
What alternatives did you reject?	CEO/CFO/ project manager/ management	Are the reasons for rejection clear and understandable? Are they linked to achieving a strategy?
What is your assessment of the downside/risks of this decision?	CEO/CFO/ project manager/ management	Is the full picture being provided? Does the assessment appear honest and complete? How are risks being mitigated?
What are our competitors doing in this regard?	CEO/CFO/ project manager/ management	Are the companies chosen real competitors in this particular circumstance? Are the companies chosen for comparison in the same market/field/area/country? Is there any external evidence to support this response?

Assessing the CFO

The audit committee may be charged, through its charter, with providing the board with an assessment of the CFO.

This produces another challenge to establishing an effective working relationship with management. The behaviour and reactions of the CFO may be influenced by the knowledge that the audit committee members will be formally assessing his or her performance at year end.

Audit committees that undertake this responsibility note the importance of open dialogue with the CFO throughout the year, and a clear understanding of what the CFO is being assessed against (for example agreed KPIs, clear-cut objectives). Audit committee members have also found it helpful to discuss performance assessment with other directors, such as those on the nominations or remuneration committees, to establish a consistent approach.

Format of information

Establishing a constructive working relationship with management often requires substantial and ongoing work. Management is the primary source of information for the audit committee, but as the audit committee has different priorities to those of management, management's presentation of material might not always be in the most useful format for the audit committee. While it would be best if papers did not need to be created especially for the audit committee, in practice some tailoring will be required to ensure best use is made of limited audit committee time. An example of how papers can be tailored for audit committee use is provided in Appendix A to this section.

The chair and committee secretary can take a key role in this regard, by stipulating the format of information to be received by the audit committee. Matters to consider in relation to the content of papers and reports include the following:

- Papers should be concise and should be standalone documents, highlighting issues and key matters relevant to the issue (such as alternatives and options).
- The purpose of the papers should be clearly stated (eg information, update, for decision, for discussion) and should be linked to the charter or terms of reference.

1. Communicating with management

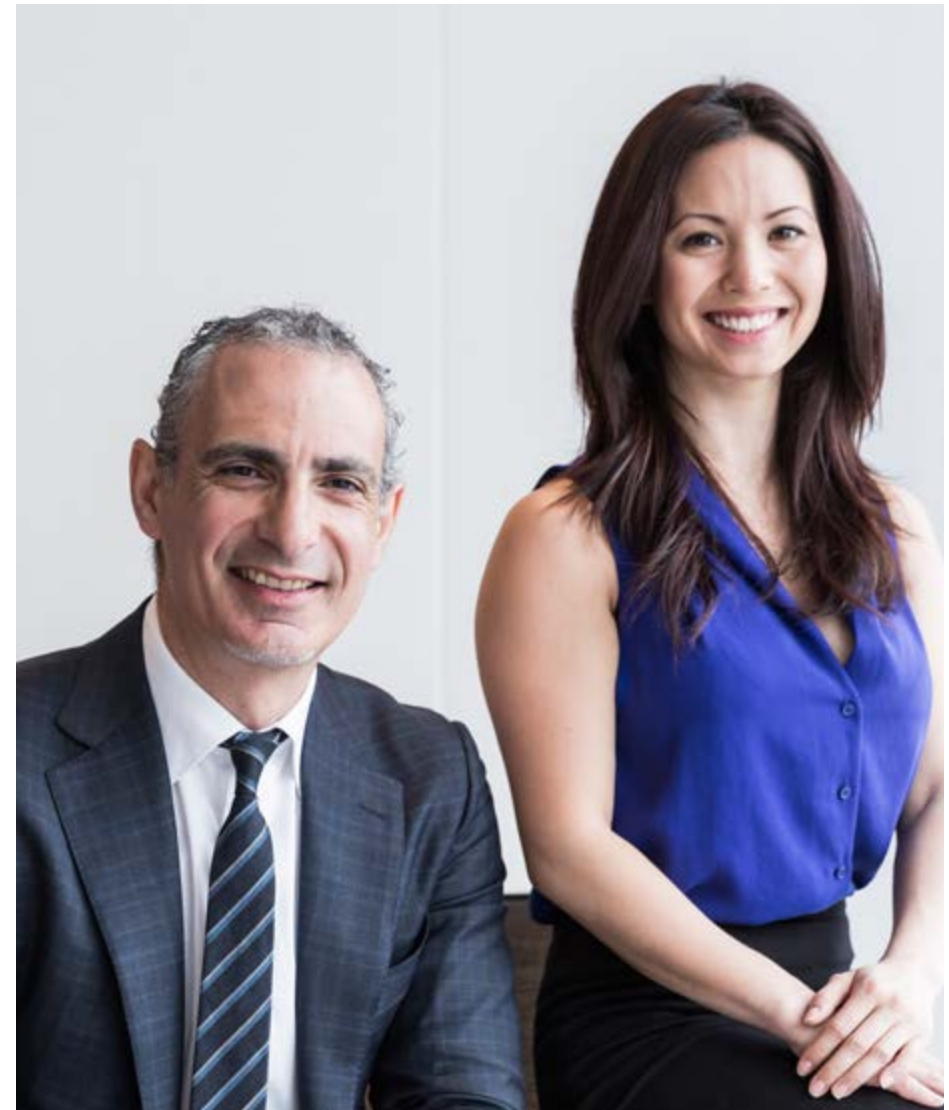
- Templates can be useful to ensure the papers meet the audit committee's requirements.
- Presentations can be as valuable as written reports.
- KPIs and other indicators must be defined and used consistently, and be relevant to the audit committee and board's work.
- Sensitive and confidential papers need to be kept secure.

It can be helpful if the committee secretary sees all papers before they are circulated, to ensure they meet the audit committee members' needs. Some committee secretaries find it effective to maintain files of large documents, such as relevant standards or training information, to which audit committee members can refer, rather than copying every paper to every member. If this approach is used, audit committee members need to be aware of the contents of the files and access arrangements.

All audit committee members report the importance of papers being distributed well in advance of meetings to allow time for proper consideration.

Tip:

If worded well, the recommendations in the audit committee papers can form the basis of the minutes of the meeting, reducing preparation time.



2. Reports to the board

The frequency, formality and level of detail of audit committee reports to the full board varies, depending on the individual company's size and circumstances. Some guidelines based on general practice follow.

As a minimum, there is an annual report to the board. The IoD encourages audit committees to make recommendations to the board for approval, rather than being empowered to make decisions on the boards behalf.²⁶ The IoD Principles also highlight the importance of a system of reporting the work of the audit committee to the board, keeping them informed and giving them opportunities to question and comment on all aspects before they are finalised. Using the audit committee's charter as a guide when preparing a report should ensure that all relevant matters are included. Any additional matters – for example, if the board has asked the audit committee to undertake and report on a wider review of internal control – will also be included.

Most audit committees, however, report to the board at each board meeting, either through the chair of the audit committee or by more formal means.

Reporting is usually done through an oral presentation, although boards often prefer some written material to assist their understanding.

Some companies table the minutes of each audit committee meeting at board meetings. A danger of this approach is that important matters for board attention may not be highlighted unless separately tabled.

As well as a summary of activities for the period, regular reports include recommendations for board approval. If the recommendations require substantive action by the board, written information is more valuable. In these cases, time will need to be scheduled both at the board meeting and afterwards to ensure that board members can consider the proposals and take appropriate action.

It is important that all audit committee members take responsibility for the audit committee's work, even if the chair or another member is appointed as the spokesperson at board meetings.



Tip:

Getting the papers and information flow right at the audit committee level will help in communicating with the board. As audit committee members are normally board members as well, the papers should be appropriately geared to senior director level.

²⁶ IoD Principles of Best Practice for New Zealand Directors

3. Reports to shareholders and others

An increasing number of countries require the audit committee to report to shareholders on behalf of the board. In New Zealand, the full board maintains responsibility for reporting and communicating with shareholders. Therefore, although reference to the audit committee and its activities is required, it is the board that makes the disclosures to maintain the integrity of corporate lines of communication.

Reporting through the annual report

NZX Listing Rule 10.5.5(h) requires annual reports to include a statement of any corporate governance policies, practices and processes adopted or followed by the company. This requirement is supported by the SC's 9 Principles, which recommends that companies report in on how they have achieved each Principle. The SC's 9 Principles also recommends that the audit committee charter is made publicly available. Most companies publish this on their website.

For Australian listed companies, the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations requires disclosure in the annual report of:

- the names and qualifications of members
- the number of meetings and attendees at each meeting
- information about the alternative structure if a company does not follow any of the best practice recommendations (Principle 4).

In addition, the audit committee charter must be made publicly available.

Presentation at the annual general meeting

It is increasingly recognised that the activities of the audit committee are of direct relevance to shareholders, and so communication with shareholders is essential. Some companies highlight this by asking the audit committee chair (in addition to the board chair) to comment on the committee's activities at the annual general meeting.

Opening the channels of communication to shareholders underlines the growing belief that audit committees should play a more active role in encouraging greater transparency of the financial information reported to the market.

When reporting to shareholders, it is helpful to explain the audit committee's role and responsibilities before discussing any other matters. Other points that will make the presentation more effective include:

- keeping answers to shareholders' questions factual
- referring questions to the company chair if they are outside the remit of the audit committee.

Other reporting responsibilities

Some audit committees might be responsible to overseas head offices or boards, or have specific reporting responsibilities in addition to those to external shareholders. Although this reporting may take many different forms, general principles of communication will help ensure reports are effective. For example:

- understand the objectives of the people to whom you are reporting
- ensure the information is provided in a format that meets their requirements
- ensure the information is fair and balanced.

In addition, the company may consider reporting to other stakeholders such as employees, creditors or customers. The audit committee may or may not be involved in these communications. If the audit committee is asked to oversee the process or contribute to the communication, the principles listed above will be helpful.

An example of matters that might be considered for external reporting is presented in Appendix B to this section.

Appendix A: Sample layout for committee papers

Note: Text included for example purposes only

Purpose	FOR/DECISION
Charter reference:	4.7 Review significant accounting and reporting issues, including recent professional and regulatory pronouncements, and understand their impact on financial reports.
Issue:	<p>At each reporting date, management performs an assessment of non-current assets to determine if there is any indication that the assets may be impaired. If there is any indication that an asset or group of assets may be impaired, accounting standards require the recoverable amount to be calculated. Where the recoverable amount is less than the carrying amount an impairment loss will be recognised.</p> <p>Management has identified indicators of impairment for Property A and has calculated the recoverable amount for impairment testing purposes. The recoverable amount was found to be \$X lower than the carrying amount of the property.</p>
Recommendation (if appropriate):	We recommend that the audit committee approves recognition of an impairment loss of \$X for Property A.
Key relevant matters:	<p>The recoverable amount of Property A using the value in use methodology is \$C, which is \$X below the current carrying value.</p> <p>Key assumptions used in the calculation of the recoverable amount are:</p> <ul style="list-style-type: none"> • discount rate of x% • rental growth rate of y% • expected vacancy rate of z%.
Impact on KPIs:	If the audit committee resolves that an impairment of \$X be recognised for Property A; net profit and EBITDA will be negatively impacted by \$X and EPS will decline by X cents per share.

Note: Text included for example purposes only

Alternative options:	The alternative is to use the fair value less cost to sell methodology to determine the recoverable amount. However, in light of current market volatility there is uncertainty in determining the fair value of Property A. Accordingly, such an approach may not be reliable.
Prepared by:	CFO
Date:	DD/MM/YY



Appendix B: Example of matters for external reporting

The following represents the matters shareholders may wish to know in relation to the audit committee. Those items marked † are required to be disclosed under ASX and legislative requirements. In New Zealand, the NZX requires companies to disclose the members of the audit committee in their annual report and the SC 9 Principles recommends making the audit committee charter publicly available, however there are no further mandatory requirements.

1 Composition of the audit committee

- Members† and secretary – names and appointment (short biographical details may be included or cross-referenced)
- Confirmation that the members of the audit committee met the definition of independence as required (by the board, the SEC or other regulation)
- Appointment process
- Relevant qualifications, expertise and experience of each member (if not included in biographical details).†

2 Role of the audit committee

- Main responsibilities of the audit committee
- The charter† (a copy may be included or made publicly available) and any changes made to it
- Principal activities during the year.

3 Resources

- Any dedicated resources available to the audit committee, internal or external.

4 Remuneration of audit committee members

- Remuneration policies in relation to the members of the audit committee (or cross-refer to the directors' remuneration report, if any).

5 Meetings

- Number of meetings, and attendance†
- Agenda covered by the meetings.

6 Financial reports

- Activities carried out to monitor the integrity of financial reports
- Confirmation that the audit committee reviewed and discussed with management and the external auditor the financial statements and supporting management commentary
- The audit committee's recommendation to the board on whether it should approve the audited financial statements
- The audit committee's recommendations to the board on whether the annual report prepared by management clearly articulates the company's performance against its strategy in a balanced and clear manner, and adequately sets out the operational, regulatory and financial risks (including the risk management strategy) facing the company.

7 Risk management and internal control

- Description of the audit committee's review of the company's systems of risk management and internal control as they affect financial reporting.

8 External auditor

- Procedures adopted to review the independence of the external auditor, including any policies about the provision of audit and non-audit services†
- Confirmation that the audit committee received from the external auditor a written disclosure of the auditor's independence, if applicable, and discussed with the auditor its independence from the company and from management
- Description of the audit committee's oversight of the external audit process, and confirmation that the external auditor's performance was reviewed
- The audit committee's recommendation to the board on the appointment of the auditor and, if applicable, the process adopted to select a new auditor.

9 Internal audit function

- Any reviews of internal audit's plans and work; if there is no internal audit function, the audit committee's consideration of whether such a function is needed
- Description of the audit committee's oversight of the internal audit function and whether any review of its performance was performed.

Regulatory, compliance & ethical matters

In the wake of recent corporate reporting failures stakeholders, the investor community and the regulator are sharpening their focus on director's responsibilities and how effectively these responsibilities are discharged.

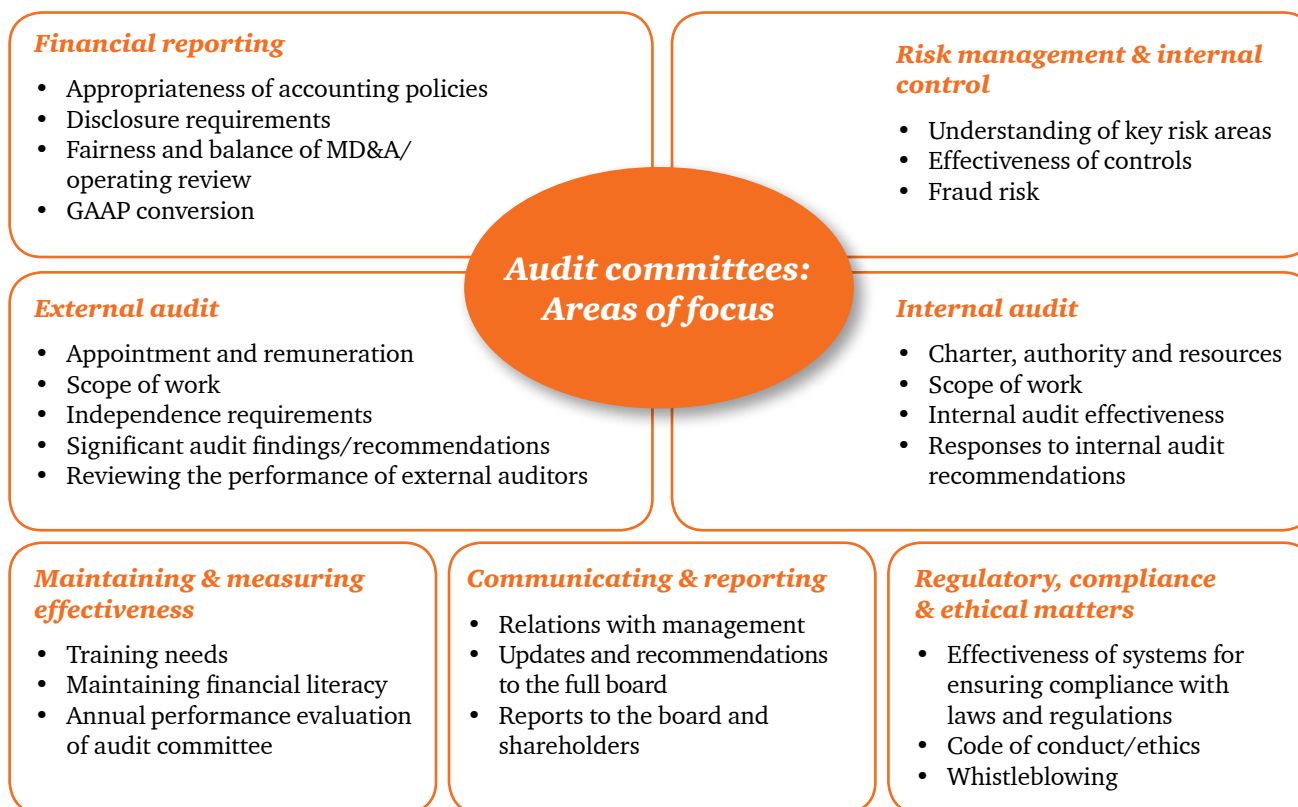
Whilst directors' responsibilities cannot be delegated, audit committees have an essential role to play in the governance of an organisation and ensuring the integrity and transparency of corporate reporting.

The PwC Audit Committee Guide is designed to help members of the audit committee work through the maze of director's responsibilities in a practical manner.



Regulatory, compliance & ethical matters

Thousands of pages on corporate governance have been issued. However, regulations seldom provide helpful guidance on how the Audit Committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be focused? This guide is designed to help audit committees answer these questions.



The guide consists of:

- Introduction
- Setting up the audit committee
- Financial reporting: Reviewing financial information
- Risk management & internal control
- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Regulatory, compliance & ethical matters
- Compliance frameworks
- Materiality in audits

We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.

Regulatory, compliance & ethical matters

Audit committee members need a wider understanding than just the financial reporting process.

Unless the company has a separate compliance committee, the audit committee usually oversees compliance matters beyond those relating to the integrity of published financial information.

The audit committee must therefore understand and be familiar with not only management's internal financial controls and its procedures for managing financial risks, but also legal, regulatory and industry standards, internal policies, other stakeholder requirements, and ethical matters. All of these areas/factors can have a potential financial, non-financial or reputational impact.



1. Code of conduct

The reputation of a business is a critical factor in determining its value. Given the increased attention that the media, public and investment community pay to ethical issues as a determiner of reputation, more and more boards are devoting resources to ethical programmes.

One sign of the importance attached to business ethics is the adoption by many companies of formal codes of conduct, setting out the board's guidelines for acceptable business practices.

What is a code of conduct?

A code of conduct is a statement about the company's position on ethics and compliance issues. Employees typically do not know, or even have easy access to, organisational policies on many conduct and compliance issues. The code of conduct therefore serves as a user-friendly guide to the company's policies on employee and organisational conduct.

A code of conduct will give employees basic information and direct them to resources for addressing questions and reporting problems and violations. A code of conduct is not typically a full statement of organisational policies and procedures, but it should demonstrate a connection between those policies and procedures and the company's mission and vision.

Finally, a code of conduct – whether it exists as a few pieces of paper, a bound manual, or an online resource – is only a collection of the company's stated positions on policy issues. It is intended to be supported by action, training and further resources.

The tone of the code

The tone of the code can emphasise the proactive ethical role of individuals within the organisation, or it can emphasise rule compliance and prohibitions on employee conduct. What is appropriate for an organisation will depend on that organisation's specific climate and culture.

The content and purpose of the code

The NZX Listing Rules, Appendix 16.1, require that companies should formulate a code of ethics to govern their conduct. The code of ethics should:

- address ethical issues
- establish compliance standards and procedures
- provide mechanisms to report unethical behaviour
- ensure that disciplinary measures are in place for any violations.

The SC 9 Principles recommend that the code of ethics sets out explicit explanations for ethical decision making and personal behaviour, and that the code of ethics should include measures for dealing with breaches of the code. The SC 9 Principles go on to recommend that the code of ethics is communicated to all employees, and is supported by employee training and a whistleblower hotline.²⁷

Although a code of conduct applies equally to all members of an organisation, some members, such as directors and senior management, may have unique responsibilities that entail emphasis on specific issues. Accordingly, for large and more complex organisations, it might be appropriate to consider more than one code.

In line with global best practice, an effective and appropriate code of conduct is therefore one that is designed to promote:

- honest and ethical conduct, including in the handling of actual or apparent conflicts of interest
- the exercise of due diligence and good faith in discharging responsibilities
- full, fair, transparent, accurate and understandable disclosure in reports and public communications

²⁷ Principle 1, SC Corporate Governance in New Zealand Principles and Guidelines.

1. Code of conduct

- compliance with applicable business obligations
- prompt internal reporting of violations to an appropriate person
- accountability for adherence to the code.

The SC 9 Principles recommends that every entity should publish its code of ethics and that annual reports should include information about the steps taken to implement the code and monitor compliance.

Tip:

Well-defined ethical standards and written guidelines for acceptable business behaviour help to influence attitudes and organisational culture, including promoting a sense of financial responsibility among employees.

Designing the code of conduct

The audit committee is not normally responsible for determining ethical standards. That responsibility should belong to the board as a whole. However, the board and management might consult the audit committee when designing a code or setting guidelines for business behaviour.

The following table sets out some matters for the audit committee to consider with regard to codes of conduct.

What to ask	Who to ask	Response to look for
Does a code exist?	CFO, head of HR, compliance	If yes, is the code clear, concise and easily understood? If not, has the company adequately disclosed, as required by regulation, why it has not adopted a code of ethics?
Does the code address all policy issues mandated by legislation or industry bodies?	CFO, compliance, legal, head of HR	A due diligence process has been applied when preparing the code to ensure all legislative and industry requirements have been incorporated.
To whom does the code apply?	CFO, compliance, head of HR	Everyone within the company (including directors, management and employees). External parties should comply as a condition of their engagement. Separate codes may be appropriate where specific duties apply (eg directors).
Does an effective implementation process support the code?	CFO, compliance, head of HR	Formal communication and training processes, including online tools. Reinforcement through senior management. 'Walking the talk'. Periodically refreshed.

1. Code of conduct

<i>What to ask</i>	<i>Who to ask</i>	<i>Response to look for</i>
Is the code accessible?	Compliance	The code should be readily accessible to all staff, using a variety of media if necessary.
How often is the code revised and distributed?	CFO, compliance, head of HR	Formal cycle of review or trigger points. Awareness/communication programme, including online tools.
Who is required to certify that they have read, understood and comply with the code's provisions?	CFO, compliance, head of HR	Annual certification process. Acknowledgement for new employees.
Is the code consistent with other corporate functional and business unit policies and procedures?	Compliance, head of HR	Links and cross reference to other policies and processes.
Does the process articulated in the code for the reporting and communication of problems or concerns work effectively?	Compliance	What issues have been reported/communicated? How were these addressed? Are there instances where issues have arisen and have not been reported? How were these addressed?

<i>What to ask</i>	<i>Who to ask</i>	<i>Response to look for</i>
Is the code supported by other key components of effective compliance?	Compliance	High-level ownership and setting of the 'tone at the top'. Senior person with overall accountability. Training and other awareness activities. Due care in delegating authority. Performance management, including discipline and enforcement. Whistleblower protection mechanisms. Continuous improvement. Monitoring and auditing.

Matters normally covered in a code of conduct are set out in Appendix A.

Monitoring the effectiveness of the code of conduct

The audit committee will be interested in the extent to which ethical standards are embedded in the company's internal control and internal reporting procedures. It should also consider whether management has a programme for monitoring compliance with the code and for enforcing instances of non-compliance; for example, asking management:

- what it does to ensure employees read the code
- how it can be sure the code is followed (eg see last section of table above, and Section 3 on whistleblowing)
- how non-compliance is linked into the general compliance framework.

To assess the acceptance of a code of conduct, some audit committees undertake cultural surveys.

2. An effective compliance framework

An effective compliance framework enables a company to demonstrate how (through its policies, processes, systems and behaviours) it is meeting the obligations imposed on it by its stakeholders, including laws, regulations, industry codes, internal policies, standards of good corporate governance and other community expectations. Unless a separate compliance committee exists, the audit committee usually oversees all other compliance matters beyond those relating to the integrity of published financial information.

Compliance is an outcome of doing business the right way and must be integrated seamlessly into all process components of the organisation. Companies should not view compliance as a stand alone activity or role within the organisation, or as something that is performed outside of, or in addition to, day-to-day business activities.

Achieving compliance therefore means that all components of the organisation, not just the compliance function, contribute to doing business the right way.

Assessing the effectiveness of the compliance framework

The audit committee will be interested in challenging the effectiveness of the company's compliance framework. The following questions provide a guide to what to look for in this assessment.

<i>What to ask</i>	<i>Who to ask</i>	<i>Response to look for</i>
Does a formal compliance policy and framework exist?	Compliance	A single, clearly articulated board-endorsed compliance policy and framework exists, and is clearly aligned to strategy and business objectives. The policy is clearly visible to all employees.
What is the scope of the compliance framework?	Compliance	The company has understood and articulated who its key stakeholders are and takes account of obligations to them as well as obligations to comply with laws, regulations, industry codes, internal policies and the code of conduct.
How do you know if we are compliant?	Compliance	The company has listed all systems, processes and controls that exist to manage compliance with its business obligations, and keeps this list up to date.
How do we get staff buy-in to make compliance 'stick'?	Compliance	The company actively builds and maintains a culture that fosters and rewards compliance, including through: <ul style="list-style-type: none"> communications/training performance management setting an appropriate 'tone at the top' transparency and clear accountability, including ownership at a senior executive level a 'no blame' culture.

2. An effective compliance framework

What to ask	Who to ask	Response to look for
How do we promote sustainable business and continuous improvement?	Compliance	<p>All staff are held accountable for compliance.</p> <p>Compliance is embedded into business processes rather than being dealt with as a separate process. This is particularly important when business obligations change.</p> <p>Compliance issues are investigated and treated as opportunities for improvement.</p>
What resources exist to develop and maintain the compliance framework?	Compliance	The company has appropriately skilled resources to develop and maintain the compliance framework so that it adapts to changes in the business and in the external environment.
Do we take a risk-based approach to compliance?	Compliance/ risk/business managers	<p>Policies and processes are developed, designed and implemented to support the intent to be compliant.</p> <p>Business units ensure that appropriate controls are in place to manage the risk of non-compliance to an acceptable and predetermined level, and that these controls operate effectively through risk-based monitoring.</p>

What to ask	Who to ask	Response to look for
Is the effectiveness of the compliance framework assessed?	Compliance	<p>The compliance framework is tested and monitored by the business, compliance functions and internal audit.</p> <p>Issues identified are analysed and any areas identified for improvement are addressed.</p> <p>The programme is regularly reviewed by the business and independent parties.</p>

The audit committee's role

Audit committee members are not expected to know the detail of every law, regulation, internal policy or key stakeholder expectation to which the company is subject. Their role is to have oversight of the company's process for monitoring compliance within these business obligations.

To gain an understanding, the audit committee will normally receive briefings from management – such as the compliance officer, company legal counsel, chief financial officer or tax manager – on the procedures for ensuring compliance, as well as how management assesses the potential impact on the company and its financial statements. The audit committee will also receive and review reports on the company's compliance with business obligations.

Tip:

Acknowledge that being 100 per cent compliant in all parts of the organisation at all times is a practical impossibility – instead, implement processes to comply, and manage the risk of being non-compliant through appropriate controls.

3. Whistleblowing and customer complaint handling

The audit committee needs to know that:

- management has whistleblowing and complaint handling systems in place
- key issues from these systems are being brought to its attention.

This is important because these issues may have an impact on its other responsibilities, such as the accuracy/tone of external reports, fraud, and compliance with legislation.

The audit committee will therefore take responsibility for approving and reviewing the policies, processes and framework for identifying, analysing and addressing complaints, including whistleblowing. This framework is a valuable mechanism for identifying issues that might have a financial, non-financial or reputational impact.

Whistleblowing

So that staff who are aware of possible breaches of legislation and regulations or of malpractice have a safe channel through which to report, the audit committee may be expected to establish or review whistleblowing procedures. The role of the audit committee is to ensure that concerns are properly investigated and any necessary follow-up action taken.

An effective whistleblower protection system

The following are some key considerations for ensuring effective whistleblower protection.

1. Establish multiple avenues for reporting concerns

One of the challenges of making an ethics and compliance programme viable and truly effective is gaining the trust of the people whom it is targeted at – the employees and in some instances contractors. If the reporting options are narrow, at too senior level in the organisation, or require reporting to one's direct supervisor, it is unlikely that employees will feel encouraged to use the facility without fear of retaliation or the matter not being taken seriously.

It is important to offer a number of functional/departmental options, eg an ethics officer, a toll-free helpline, a secure email address and a confidential PO Box with a response system, ready to address issues.

Employees must also be informed that every effort will be made to keep their concerns confidential and/or anonymous if requested, but that in the pursuit of an investigation this might not always be possible.

2. Establish guidelines for the recording, investigation and analysis of alleged misconduct

If the company is to demonstrate its commitment to an effective ethics and compliance programme, it will need to be able to highlight potential areas that may need focus or improvement. A formal tool for recording and tracking issues as they are reported is helpful in this regard. Any system for maintaining this kind of sensitive data must also have built-in security measures, allowing various levels of restricted edit and view access. It can also assist in tracking trends which may be emerging in one business area or across the business.

It is critical that people with the requisite authority and experience perform the investigations. All employees should be made aware, through training and the company code of conduct, that they are required to co-operate fully in any investigation into allegations of misconduct.

Statistics and trends should be periodically analysed business-wide to ensure the system established for reporting and resolving issues is functioning properly. Trends that require further action – such as training course development and delivery – can be readily identified.

A checklist for developing a whistleblower programme is provided in Appendix B to this section.

Further guidance on establishing, implementing and managing a whistleblower protection programme is set out in AS8004-2003 Whistleblower Protection Programs for Entities.

Regulatory and legal support for whistleblowing

The Protected Disclosures Act 2000 provides for an employee of an organisation to disclose information about serious **wrongdoing** in or by their organisation if the employee: believes on reasonable grounds that the information is true or likely to be true; and wishes the serious wrongdoing to be investigated and their disclosure to be protected.

3. Whistleblowing and customer complaint handling

Serious wrongdoing includes any of the following:

- (a) an unlawful, corrupt, or irregular use of funds or resources of a public sector organisation
- (b) an act, omission, or course of conduct that constitutes a serious risk to public health or public safety or the environment
- (c) an act, omission, or course of conduct that constitutes a serious risk to the maintenance of law, including the prevention, investigation, and detection of offences and the right to a fair trial
- (d) an act, omission, or course of conduct that constitutes an offence
- (e) an act, omission, or course of conduct by a public official that is oppressive, improperly discriminatory, or grossly negligent, or that constitutes gross mismanagement.

In this regard companies should have internal procedures in place for receiving and dealing with information about serious wrongdoing. Public sector organisations are required to have an appropriate internal procedure.

A disclosure of information may be made to: the head or a deputy head of the organisation; or subject to certain conditions, to an appropriate authority (eg Police or The Serious Fraud Office); or to a Minister of the Crown or an Ombudsman.

Customer complaint handling

Complaint handling is another component of a compliance framework that allows potential or actual compliance issues to be identified, analysed, escalated and rectified. Where a separate compliance committee does not exist, the audit committee may be allocated responsibility for monitoring the complaint handling programme and key resulting issues.

An effective customer complaint handling system:

- provides an efficient and equitable mechanism for receiving, addressing and resolving customer complaints
- ensures that customers have clear and transparent information about the complaint handling process
- enables complainants to have their complaints referred to an independent party for further consideration
- is a key component of continuous improvement in products, services and processes
- increases customer satisfaction through better customer service and attention to customer rights, resulting in a better reputation and financial performance.

The FMA's Code of Professional Conduct for Authorised Financial Advisers (Code Standard 11) requires Authorised Financial Advisers to have an appropriate internal process in place for resolving client complaints in relation to their services.

Assessing the whistleblower and complaint handling programmes

The following table sets out matters the audit committee can consider when assessing the company's programmes.

<i>What to ask</i>	<i>Who to ask</i>	<i>Response to look for</i>
Does a formal programme exist?	Compliance	A single programme exists across the organisation. There are documented policies and procedures in relation to whistleblowing and handling complaints.
Who is responsible for the programme?	Compliance	An individual or team independent of the relevant operational area should exist to manage whistleblowing and complaints. The compliance manager often oversees the programme.
What is the scope of the programme?	Compliance/ parties responsible for the programme	The complaint handling programme should cover more than just formal, written complaints. Customer queries and issues that can be resolved at points of contact (eg call centres) might not be part of the programme but there should still be a mechanism for capturing and analysing associated issues that arise.

3. Whistleblowing and customer complaint handling

<i>What to ask</i>	<i>Who to ask</i>	<i>Response to look for</i>
Does the programme address all appropriate policy issues mandated by legislation or industry bodies?	Compliance/legal/ parties responsible for the programme	The programme and procedures ensure complaints and issues are dealt with in a manner consistent with AS/NZS ISO10002:2006 and any specific industry requirements. There are sufficient controls in place to ensure procedures are undertaken.
How was the programme implemented and made accessible to the business/ customers?	Compliance/ parties responsible for the programme	All customer-facing staff receive training on employment entitlements and receive periodic updates. Programme information is readily accessible to staff. Employees and customers may be made aware through various channels, including advertising, brochures, hotlines, annual reports. Customers are not charged or employees disadvantaged when making a complaint.
What information is retained/captured and in what way?	Compliance/ parties responsible for the programme	Complete and accurate information is retained for analysis and reporting purposes. There may be a central repository for all complaints and issues.

<i>What to ask</i>	<i>Who to ask</i>	<i>Response to look for</i>
How is the programme linked to other compliance processes and performance management systems?	Compliance/HR/ parties responsible for the programme	Complaint handling is integrated into the overall compliance framework and, in particular, breach identification processes. Risks in the programme have been identified and addressed as part of the risk management framework. The investigation and remediation of complaints includes training and disciplinary actions where necessary. Monitoring occurs to ensure that procedures and controls are followed and working effectively. Systemic issues arising from complaints are identified and analysed.
How often is the programme reviewed?	Compliance/ parties responsible for the programme	The programme is reviewed regularly (annually or biennially) by the business and independent parties.

Reporting issues to the audit committee

The procedures set up for whistleblowing and customer complaint handling will include provisions for material issues to be reported promptly to the audit committee.

What is a 'material issue'?

The audit committee can formulate its own definition of 'material issue', and must then make sure that its definition is communicated appropriately.

A material issue could be one that meets a monetary threshold. Alternatively, it could be related to a sensitive subject matter, could be serious from an ethical viewpoint, could involve senior management or may involve significant harm to reputation.

3. Whistleblowing and customer complaint handling

Usually an audit committee determines a combination of factors it believes would constitute a material issue. Consideration should also be given to relevant legislation that may indicate or dictate how the audit committee should classify a customer complaint as material.

What to do with material issues

When a material issue is received, the audit committee should question and challenge management to understand:

- the background, nature and actual or potential implications of the issue, including external reporting requirements
- whether and how the issue has been resolved and what steps have been taken to prevent recurrence
- that if the issue has not been resolved, appropriate further investigation is in progress.

If the issue relates to senior management, the audit committee should be prepared to instigate further investigation outside the usual company process – for example, by the directors or committee members themselves, by the external auditor or by a trained investigator. If the investigation indicates genuine problems, the audit committee should ensure that the responsible manager or director has taken charge and acted quickly and decisively.

Actions that might be taken could be:

- instigating disciplinary action
- reporting to regulators
- acting to ensure employees and shareholders are informed and reassured that appropriate action is being undertaken
- employing legal counsel.

In certain situations, the audit committee will need to involve the board so that it can take leadership. In an environment of increasing public scrutiny and cautious investor sentiment, the audit committee and the board will specifically want to consider external communications, to ensure that messages relayed to the market do not result in misleading rumours. The requirements of the NZX Listing Rules, Section 10: Disclosure of Information will also need to be considered.

Non-material issues

The audit committee also has a role in relation to other, non-material issues. For these, there are a number of reporting options to choose from:

- request reports setting out details of all issues, how they were followed up, what investigations were required and the results of the investigations/actions taken by management (eg any systemic issues, regulatory reportable events, risks)
- request a summary of issues and investigations with supporting material to be available if required
- reports tabled at every meeting
- half-yearly or annual reports only.

However the audit committee chooses to receive reports, it is useful for members to be informed at each meeting of the number of issues received each month, separated into:

- issues relating to employees vs external issues
- how many issues have been resolved
- how many issues are still under investigation
- how many issues were referred to external government agencies or governance bodies.

Purpose of the audit committee's involvement

It is worth remembering why the audit committee should be involved in the whistleblowing/complaint handling process, as this will help the audit committee decide on the best reporting method for its purposes.

Investigations into corporate scandals have highlighted that employees and others generally knew of specific issues, but their concerns and allegations were not reported to the directors. A company policy that includes specific reporting to the audit committee can address this shortcoming.

In addition, a large number of issues is usually indicative of other serious underlying problems in the company's operations, which are of direct concern to the audit committee. Conversely, an absence of reported issues may also be indicative of an underlying problem.

4. Performance management – compliance scorecards

Performance management influences organisational behaviour through the establishment of performance targets, and through consistent management against those targets. This is particularly important for compliance initiatives, as it helps drive responsibility and accountability into every part of the organisation.

Organisations should be able to respond to questions regarding the effectiveness of their compliance efforts and how these are contributing to the overall business value, just as they would for any other critical aspect of performance. To achieve this, compliance ‘performance’ must be measured to evaluate the results of compliance initiatives. Many organisations are attempting this by using compliance ‘scorecards’.

Getting the compliance scorecard right can be achieved by:

- identifying the key business drivers (eg growth, cost efficiency)
- determining the influences on those drivers – that is, the key success factors or barriers
- identifying the compliance-focused activities that support the success factors or are necessary to overcome the barriers
- identifying the desired compliance outcomes, taking into account the relevant business rules
- establishing compliance KPIs that are accepted by management and staff and which contain a mixture of ‘lead and lag’ indicators
- reporting performance against the KPIs on a regular basis.

An example of a compliance scorecard is set out below.

Performance measurement	
Organisation, people and culture	Processes
Is the organisation ready?	Are we doing the right things, and doing things right?
KPIs of the level of organisational awareness and readiness	KPIs of the effectiveness of internal processes for managing regulatory, compliance and ethical matters
Stakeholders	Values
Are we meeting stakeholders’ expectations?	How are we delivering value to the organisation?
KPIs of how stakeholders view the organisation’s management of regulatory, compliance and ethical matters	KPIs of the efficiency and business value of the programme for managing regulatory, compliance and ethical matters

Tip:

Compliance KPIs should be a measurable indicator of an outcome (whether positive or negative) to determine whether controls in place to ensure compliance are operating effectively. There should be a clear link between the compliance KPIs and the related business drivers and activities.

4. Performance management – compliance scorecards

Although scorecards vary in terms of their content, sophistication and presentation style, they have a common feature: feedback to management and the board regarding a number of prescribed KPIs – a fundamental element of good corporate governance and business ethics.

Considerations regarding the use and effectiveness of compliance scorecards include the following:

- The most effective scorecards do not concentrate solely on ethics-and compliance-related KPIs (eg breaches and complaints), but also include reference to the organisation's broader business performance and its objectives (eg measures of process efficiency or re-work required). This provides management with a much broader view of the organisation's ethics and compliance performance, and allows for more immediate identification of the underlying issues that may be causing poor ethics and compliance performance.
- The scorecard should be devised in such a way that it enables cross-referencing of KPIs and easy identification of correlations. The scorecard should show the KPIs as trends other than one-off figures. What is of interest to management is the way in which the KPIs change over time.
- Finally, scorecards have traditionally had a historical focus; they report what has happened in the recent past. If scorecards contain the trend and correlation analysis capabilities described above, they can also become a tool for future planning. By extrapolating trends, and by using the correlations already identified as predictive tools, the scorecard can be used for scenario planning and impact assessment, and show the cause-and-effect links between the various factors involved.



Appendix A: Content for a code of conduct

The specific policies that are addressed in a code of conduct depend on the company's values and culture, its industry, and the geographies of its operation. Below is an overview of typical sections that may be found in codes of conduct.

Code section	Outline of content
1. Organisation mission statement (if available)	<ul style="list-style-type: none"> Cites the purposes of the organisation's business activities Briefly mentions the methods used to accomplish the organisation's mission, referenced to ethical standards of conduct.
2. Letter from a key senior executive	<ul style="list-style-type: none"> States that ethical values are critical to the success of the business Introduces the code of conduct, its purpose and how to use it Demonstrates leadership in promoting the code and its benefits.
3. Organisation principles/values	<ul style="list-style-type: none"> Presented as the positive, proactive principles shaping the code policies Identifies stakeholder groups and the organisation's commitments to each of them.
4. General statement of compliance with laws, regulations, industry standards, internal policies and other stakeholder expectations (business obligations)	<ul style="list-style-type: none"> Emphasises compliance with the letter and spirit of the law – ie 'doing the right thing' Mentions a strategy for addressing the variability of law in international practice Emphasises that compliance with the law is a minimum standard of acceptable behaviour.
5. Ethical conduct policies	<ul style="list-style-type: none"> (See below for detail.)
6. Frequently asked questions	<ul style="list-style-type: none"> Includes examples to aid the understanding of the code (if not dealt with in specific sections).

Topics that might be addressed in ethical conduct policies include:

Affirmative action/equal opportunity/discrimination	Financial reporting/record keeping	Private investments and outside business activities
AIDS/HIV	Gifts and entertainment	Product safety
Antitrust/fair competition	Gifts and entertainment – international customs	Product suitability
Bribery/kickbacks/financial inducements	Human rights	Professional development
Community service and philanthropy	Insider trading	Protection of proprietary and confidential information
Compensation and benefits	Intellectual property/copyright	Responsible supply chain
Conflicts of interest	Joint ventures	Sexual harassment
Corporate giving	Media relations	Substance abuse
Corporate governance and structure	Money laundering	Travel and expense reporting
Criminal convictions and civil actions	Personal use of company assets	Union relations
Divestment/international boycotts	Political activities/lobbying/contributions	Use of computer systems and phone systems
Employee safety, health and welfare	Privacy – customers and clients	Wage laws and fair labour practices
Environmental compliance	Privacy – employees and agents	Work and family

Appendix A: Content for a code of conduct

Each ethical conduct policy should contain the following information:

- a statement of the relevant business principles and the positive intent of the organisation's policy
- a clear and succinct statement of the policy
- brief descriptions and examples of acceptable and unacceptable conduct
- consequences to the organisation and the employee of misconduct
- reference to the specific policy (if applicable).

Administering compliance and ethics

Code subsection	Outline of content
Certification form	<ul style="list-style-type: none"> • Employees sign this form, certifying that they have read the code of conduct and understand that they are subject to its provisions • Consider: Where does the form go? Who maintains it? Is the process electronic, paper or a combination?
Directory of contact persons	<ul style="list-style-type: none"> • A list of offices, phone numbers and email addresses for assistance, including: <ul style="list-style-type: none"> – security – human resources – compliance – general counsel – other (consider helpline, ethics personnel, etc).
Links/references to related information	<ul style="list-style-type: none"> • An index of relevant policies.
Compliance and ethics reporting procedures	<ul style="list-style-type: none"> • Describes the process for reporting a suspected compliance issue, including whistleblowing procedures.

Code subsection	Outline of content
Corporate due process regarding compliance and ethics	<ul style="list-style-type: none"> • Describes the process used to investigate compliance issues and the internal firm processes employees can use to ensure fair treatment.
Compliance and ethics decision-making tool	<ul style="list-style-type: none"> • A standardised decision tool for analysing and resolving complex compliance and ethics issues • This should be made available to guide managers and employees in situations that create dilemmas.



Appendix B: Checklist for developing a whistleblowing programme

(based on AS 8004-2003)

1. A general statement of the company's commitment to a culture of corporate compliance and ethical behaviour. The tone must be set at the top.
2. A statement of the company's opinion of reporting wrongdoing through appropriate channels.
3. A statement of the benefits and importance to the company of having a whistleblowing mechanism.
4. Details of how and to whom whistleblowing concerns can be directed.
5. The types of concerns for which it is appropriate to use the whistleblowing mechanism.
6. Who may invoke the whistleblowing mechanism (eg employees, contractors, the general public).
7. Guidelines about how sure the whistleblower should be of the truth of their concerns before invoking the whistleblowing mechanism (ie the degree to which the whistleblower will be required to prove their concerns).
8. A statement that reporting will be kept confidential and secure within the law.
9. A guarantee that whistleblowers will receive feedback.
10. A statement of the company's commitment to protect and respect whistleblowers, including a commitment to protect the whistleblower's identity to the extent permitted by law, and a prohibition on reprisals, discrimination, harassment or victimisation against any suspected whistleblower, their colleagues or relatives.
11. A description of the rights of the whistleblower to request positive action by the entity to protect them; eg relocation or leave of absence during the investigation where it will not be possible to maintain the whistleblower's anonymity.
12. A commitment to appoint and maintain an appropriately qualified whistleblower protection officer who is accessible to all staff.
13. Whether reports may be made anonymously.
14. A description of the investigation process which the company is committed to follow on receipt of a whistleblowing report, including the principles of fairness that will apply to the investigation, and a commitment to rectify any wrongdoing verified by the investigation to the extent practicable in all the circumstances.
15. A commitment to review the effectiveness of the whistleblowing programme regularly.



Appendix C: Summary of AS/NZS ISO 10002:2006 – Complaints Handling

AS/NZS ISO 10002:2006 element	Summary
Commitment	There must a culture that is committed to an efficient and fair resolution of complaints. The tone must be set at the top. There must be a formal written complaints policy.
Fairness	The complaint process should be unbiased.
Resources	Adequate resources should be in place to manage complaints. Responsible staff should be independent of the complaint.
Visibility	Both employees and staff should be aware of the complaint process, which should be well publicised.
Access	Information on the complaint handling process should be clear and readily available.
Assistance	Complainants should be given assistance in forming and lodging complaints.
Responsiveness	Complaints should be dealt with promptly.

AS/NZS ISO 10002:2006 element	Summary
Charges	The complaint handling process should be free.
Remedies	There should be clear policies and delegations to determine what remedies can be made.
Data collection	There should be appropriate systems for recording complaints and their outcomes, identifying systemic issues and facilitating continuous improvement.
Systemic and recurring problems	Complaints should be classified and analysed to identify and rectify systemic issues.
Accountability	There should be clear accountabilities for complaint handling and criteria for the performance of complaint handling procedures.
Review	The complaint handling systems should be reviewed on a regular basis.
Complaint handling procedures	This section of the standard provides guidelines for processing oral and written complaints.
Disputes	Where complaints are not resolved, they become disputes. A system needs to be implemented that ensures the early and efficient resolution of disputes.

Compliance frameworks

In the wake of recent corporate reporting failures stakeholders, the investor community and the regulator are sharpening their focus on director's responsibilities and how effectively these responsibilities are discharged.

Whilst directors' responsibilities cannot be delegated, audit committees have an essential role to play in the governance of an organisation and ensuring the integrity and transparency of corporate reporting.

The PwC Audit Committee Guide is designed to help members of the audit committee work through the maze of director's responsibilities in a practical manner.



Compliance frameworks

Thousands of pages on corporate governance have been issued. However, regulations seldom provide helpful guidance on how the Audit Committee should go about its work. What knowledge or experience is required? Which areas should it focus on? How should its activities be focused? This guide is designed to help audit committees answer these questions.

An effective framework

Management is responsible for day-to-day operations, including the design and implementation of an effective compliance framework. This framework is an essential element in ensuring the company is meeting its obligations. This makes it an important area for the audit committee to focus on.

The audit committee's role is not to design the framework, but to understand it and constructively challenge its effectiveness.

This section aims to increase audit committee members' understanding of the elements and components involved in the design of a compliance framework.

Components of a compliance framework

When integrated with existing risk management, governance and management practices, a compliance framework will help an organisation achieve its business strategy and objectives.

The most commonly used reference about the elements of an effective compliance framework is the Australian / New Zealand Standard for Compliance (AS/NZS 3806).

This standard describes compliance concepts and is a useful point of reference when considering a company's compliance framework. However, it is necessarily conceptual in nature and requires considerable judgement, interpretation and customisation to be successfully applied.



Compliance frameworks

The key components of a good compliance framework can include:

Strategy and objectives

An organisation's approach and commitment to managing compliance and risk by the board, committees, management and staff.

Policy and process

The approach an organisation uses to manage compliance. Policies should be aligned to the organisation's strategy and business objectives. Tools and procedures should be developed and embedded into business processes to ensure compliance.

Resources and people

How an organisation allocates appropriate resources to develop, maintain and improve its compliance programme. This includes implementing an appropriate organisational structure, human resource mechanisms, change management, performance measurement, training, communication and education.

Culture

How an organisation creates and supports a culture of compliance to encourage business innovation while managing its compliance and risk objectives.

The audit committee's role

Matters for the audit committee to consider in relation to assessing the effectiveness of the compliance framework, and setting a compliance scorecard, are set out in the Regulatory, compliance & ethical matters section of this guide. The Risk management and internal control section of the guide also provides some detail regarding integrating the compliance framework into the risk management process. The challenge for the audit committee is to understand the relationship between these elements and their impact on the company.



Materiality in audits

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Materiality in audits

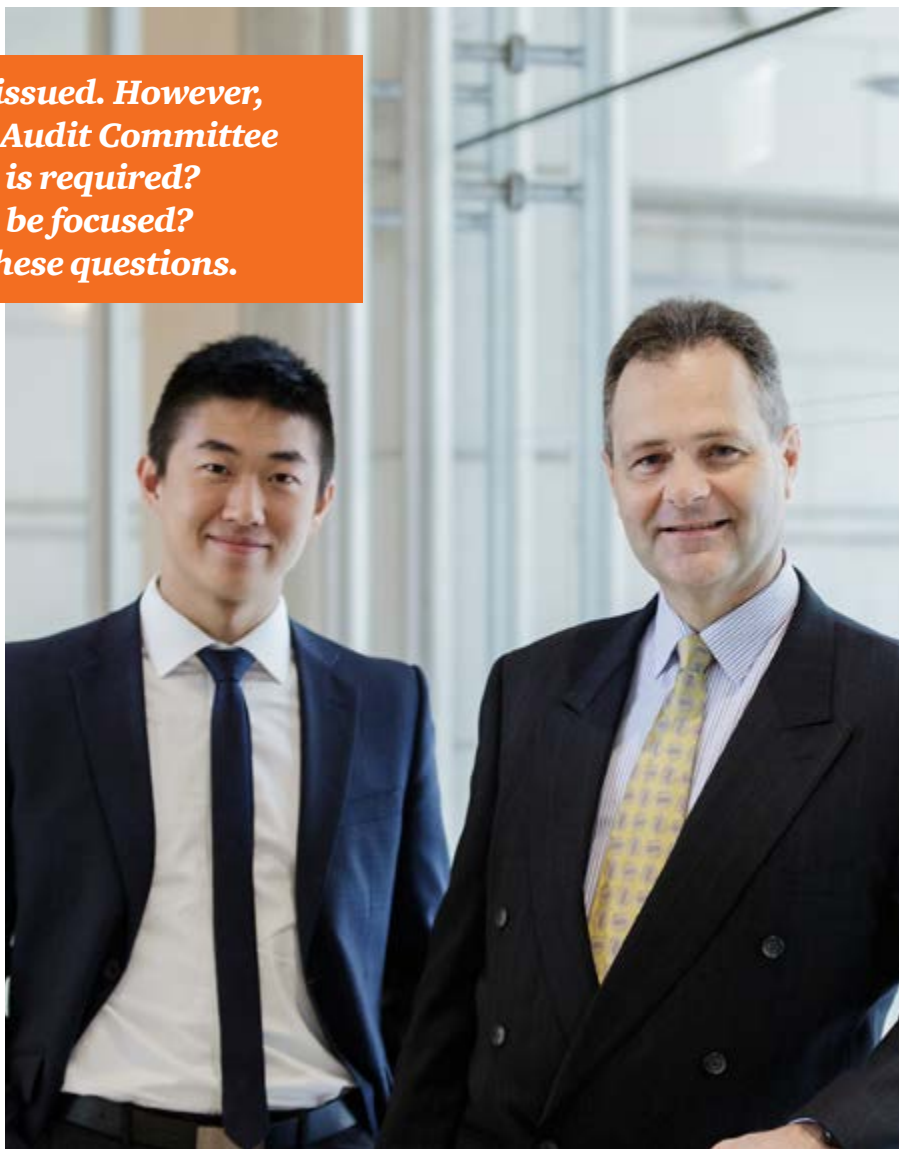
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What is materiality?

The International Accounting Standards Board defines materiality as follows:

“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.”

When preparing financial statements, an entity must determine materiality and ensure its financial statements are materially correct.



Materiality in audits

How does materiality apply in an audit?

The objective of a financial statement audit is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. This is a separate responsibility and a separate decision from that made by the entity itself when preparing the financial statements.

In auditing, materiality means not just a quantified amount, but the effect that amount will have in various contexts.

During the audit planning process the auditor decides what the level of materiality will be, taking into account the entirety of the financial statements to be audited. Materiality relates to both the content of the financial statements and the level and type of testing to be done. The decision is based on judgements about the size, nature and particular circumstances of misstatements (or omissions) that could influence users of the financial reports. In addition, the decision is influenced by legislative and regulatory requirements and public expectations.

If, during the audit, the auditor acquires information that would have caused it to determine a different materiality level, it will revise the materiality level accordingly.

Materiality = quantity and quality

Both the amount (quantity) and nature (quality) of misstatements are relevant to deciding what is material.

Quantitative

The materiality level is often determined by applying a percentage to a chosen benchmark. There is no definitive figure for this percentage, such as more than 10 per cent is material, because of the number of variables which could apply. Examples of benchmarks are categories of reported income such as profit before tax, total revenue, gross profit, total expenses, total equity and/or net asset value.

- Profit before tax from continuing operations is often used for profit-oriented entities.
- When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

Using a percentage as a numerical threshold may provide the basis for a preliminary assumption that a deviation of less than that percentage is unlikely to be material. However, quantifying the size of a misstatement in percentage terms is only the start, and cannot be used as a substitute for a full analysis of all relevant considerations.

Materiality in audits

Qualitative

Materiality also relates to the nature of the item in the context of the particular circumstances of its misstatement.

Therefore magnitude alone, without regard to the nature of the item and the circumstances in which the decision has to be made, will not generally be sufficient basis for a materiality judgement.

The auditor also needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect. For example, an error in a month-end procedure could be an indication of a potential material misstatement if that error is repeated each month.

Similarly, if there is a deficiency in an internal control process, for example, the auditor needs to consider whether that deficiency might, by itself or in combination with other deficiencies, result in a material misstatement not being prevented or detected.

Examples of qualitative misstatements

- The inadequate or improper description of an accounting policy.
- Failure to disclose a breach of regulatory requirements when the imposition of regulatory restrictions will significantly impair operating capability.

The final call

There are no rules that can be applied consistently to determine materiality. Materiality is a relative term. What may be material in one circumstance may not be material in another.

The concept of materiality recognises that some matters, either individually or in aggregate, are important if the financial statements are to be presented fairly, in all material respects, in accordance with generally accepted accounting principles.

The auditor must therefore consider not only each misstatement separately, but also the aggregate effect of all misstatements.

In the end, the assessment of what is material is a matter for the professional judgement and experience of the auditor.



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