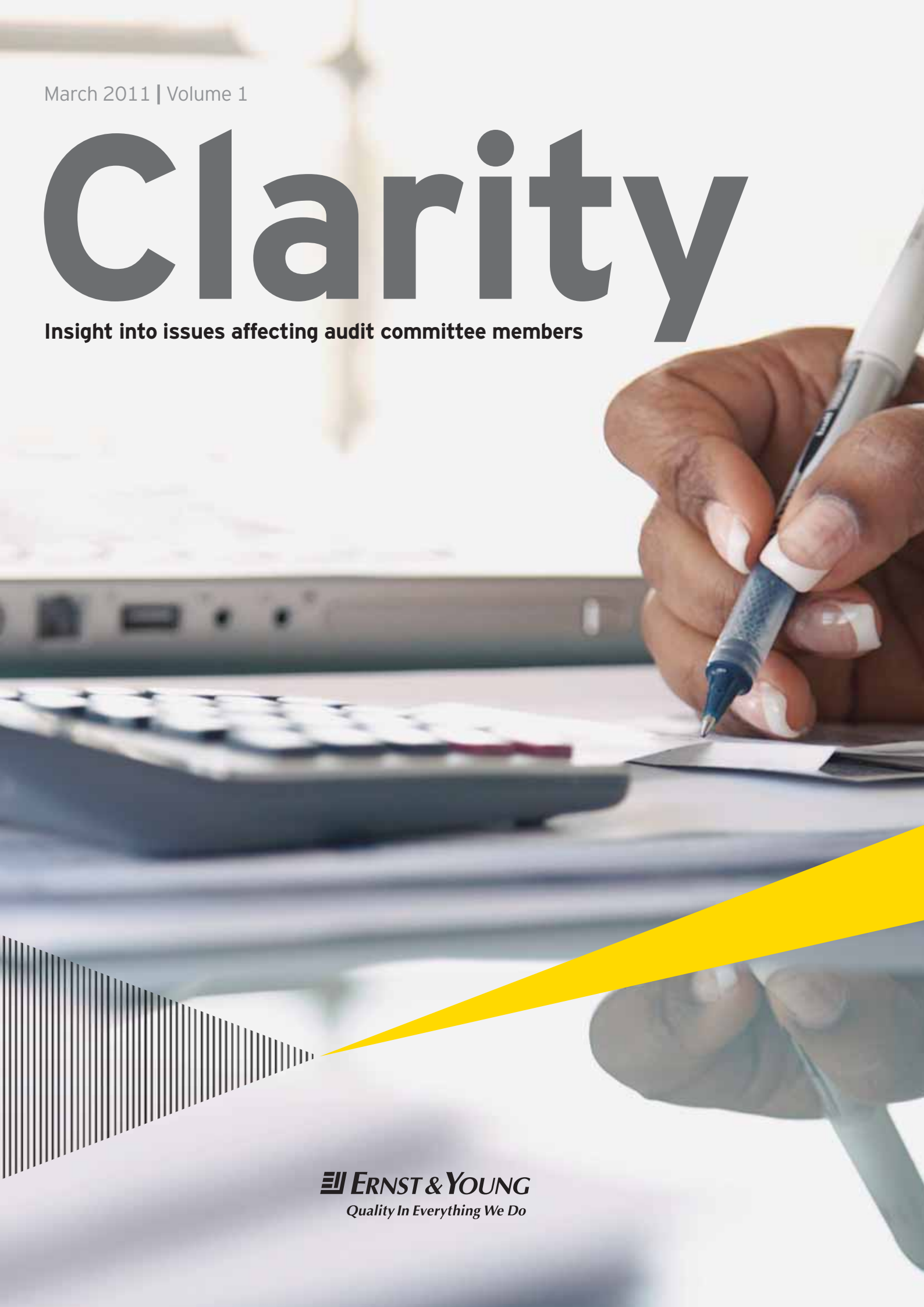


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Clarity

Insight into issues affecting audit committee members



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We are pleased to introduce the inaugural edition of our audit committee insights aimed specifically at Africa. In each issue, we share our knowledge and insights on a variety of topics, learned through our interactions with audit committee members.

Preparing for the challenges of 2011

Audit committees are set to play an increasingly important role in today's changing and uncertain business environment.

The regulatory landscape is being reshaped by financial reform, convergence of various reporting frameworks and tax policy. In addition, there is increased pressure for transparency in the manner in which financial and non financial information is communicated to a variety of stakeholders.

On top of the changing regulatory environment and the economic outlook (however improving), remains uncertain.

Together, these trends raise a number of financial reporting and risk management issues that audit committee members should consider.

To help prepare audit committee members for their increasingly important role, Ernst & Young is proud to launch a quarterly digest of insight focused specifically on audit committees.

This issue of Clarity is dedicated to assist audit committee members to gain insight into the:

- ▶ best practices of leading audit committees;
- ▶ leading practices for audit committees most difficult areas of responsibility;
- ▶ impact of upcoming financial reporting requirements; and
- ▶ role of audit committees in overseeing taxation and IT governance processes.

We have laid out questions audit committee members should consider asking as they prepare for their interactions with management and the external auditors.

Please feel free to contact us with your feedback or with your ideas for future issues. We encourage you to share this information with your colleagues and ask that you let us know of others who would benefit by receiving this publication.

Please send your feedback and ideas for future issues to Jeremy Grist.

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Best practices of effective audit committees

Given these challenges, it is probably true to say that the chairs of audit committees are constantly wondering whether their committees are effective, and how they can prepare themselves for the challenges of the future.

To help audit committees answer this question, Tapestry Networks performed research to investigate just what audit committees are doing to enhance their effectiveness. Researchers spoke with some 60 chairs of audit committees on the Fortune 500 companies and with 24 subject-matter professionals, including investors, analysts, legal counsel, internal and external audit executives.

In general, respondents expect pressure on audit committees to increase as they respond to changes initiated in response to the financial crisis, and to new regulatory requirements. Participants identified four factors that drive audit committee effectiveness, noting a range of leading practices within these areas that they believe generate higher performance.

1. Ensuring the audit committee has the right skills and support

Respondents pointed to two key areas of focus:

- ▶ The audit committee needs to have the right mix of skills. International best practices on governance recommends that a financial expert be appointed on the committee, while respondents noted that a mix of background and expertise was vital in order to build a truly strong committee. Audit committees should therefore cast a wide net when recruiting, and board members on the audit committee should be rotated. Another key issue was providing a succession plan for the chair.
- ▶ The research strongly suggested that the audit committee chair's role in working with management between meetings is vital. The audit chair needs to develop and maintain a relationship based on candour and respect with the CFO, and also gain insight into the bench strength of the finance staff below him or her.

Other key relationships include the internal and external audit teams. Internal audit teams should be used as advisors, and to help shape audit committee charters and agendas. Internal audit can also guide executives on how to present to the audit committee. When it comes to external audit, respondents recommend scheduling a standing meeting between the audit chair and audit partner before each committee meeting.

Audit committees should also get the external auditor's view of key members of management. Some recommended that one member of the external auditor's leadership attend a meeting of the audit committee annually.

Questions for the audit committee to consider

- ▶ *How does the audit committee recruit new members?*
- ▶ *How involved is the audit chair in determining the skills needed on the committee?*
- ▶ *What is the best mix of financial expertise and broader business experience for today's audit committee?*
- ▶ *What is the audit committee's succession plan for the chair?*

2. Having a skilled, energetic and creative audit committee chair

Respondents were clear that the audit chair plays a vital role in enhancing the committee's effectiveness by carefully crafting the agenda and managing meetings effectively. Good chairs develop creative strategies to keep committee members engaged, such as inviting business leaders to meetings to share stories. They also play a key role as coach and advocate for executives who have to present to the committee.

Questions for the audit committee to consider

- ▶ *In what way could the audit chair customise the agenda to maximise effectiveness of time spent in meetings and between meetings?*
- ▶ *What else could be done to enhance the efficiency of meetings?*
- ▶ *How could the audit chair encourage more open dialogue in the meetings?*
- ▶ *How could the meetings be restructured to increase the amount of dialogue?*

3. Ensuring high-quality content and effective information flow

Audit chairs emphasised the value of the right content at the right time. Important strategies to ensure this happens include sending pre-meeting reading in advance, and offering materials in reader-friendly formats that focus on trends rather than lengthy sheets of figures and graphs. Some respondents report that they are developing journalistic skills in order to write clear, concise reports, while the use of new technology can also help ensure better information flow. When it comes to presentations to the committee, many executives do “dry runs” beforehand. Some respondents also advocated monthly reports from internal audit and the CFO in order to keep committee members up to date on the company between meetings. Finally, several audit committees have explored innovative ways to get external input on key issues.

Questions for the audit committee to consider

- ▶ *How can the company improve the quality and timeliness of information prepared for the audit committee and how can technology help?*
- ▶ *What improvements in the existing communications would help the audit committee to become more effective?*
- ▶ *How does the audit chair provide feedback to members of management about the quality of information they provide?*
- ▶ *How does the audit committee ensure it has access to external perspectives?*

4. Instituting ongoing performance feedback

Many respondents felt that the current annual evaluations are insufficient to help improve performance, particularly as assessments tend to become nothing more than routine. Some suggestions for improving performance feedback included holding feedback sessions with company executives at the start of each audit committee meeting, and one-on-one meetings between the key parties (audit chair, committee members, executives and external auditor). Other evaluation methods included detailed written surveys or checklists to evaluate the committee's performance.

Questions for the audit committee to consider

- ▶ *Does the audit committee conduct its own, independent evaluation of its performance?*
- ▶ *What is assessed in this evaluation, and how is effectiveness measured?*
- ▶ *How could the evaluation be altered to yield more insightful feedback?*
- ▶ *Which stakeholders (external and internal) should give feedback?*
- ▶ *How effectively does the audit chair incorporate ongoing feedback from key stakeholders throughout the year?*
- ▶ *How well does the audit committee provide ongoing feedback to executives?*

The leading practices for the audit committees most difficult areas of responsibility

Based on this research, Tapestry Networks compiled the following recommended practices for four of the audit committee's most difficult areas of responsibility.

1. Accounting judgements

The way a company forms its accounting judgements in creating earnings announcements is an extremely risky process—and unlike formal filings, these announcements lack the support of lawyers, finance people and the external auditor. To help them understand how their companies apply accounting standards, leading audit chairs spend time learning where their company falls in the spectrum between conservative and aggressive accounting. They would review the position taken on such issues that were identified or discrepancies that were resolved and then discuss them with the people involved. In order to stay abreast of change, respondents recommend providing easy-to-read updates on accounting changes, and holding education sessions as needed.

Questions for the audit committee to consider

- ▶ *Does the audit committee periodically discuss where the company is on the spectrum of accounting practice?*
- ▶ *Does the audit committee talk candidly about accounting close calls?*
- ▶ *How does the audit committee ensure that management is on top of important accounting issues?*
- ▶ *How does it stay abreast of key accounting changes?*
- ▶ *How does it ensure that management comments on relevant rule and standards proposals?*

2. Financial communications with the market

The audit committee is taking greater responsibility for overseeing certain financial communications. Leading practices highlighted by respondents included going through press releases line by line, with particular focus on forward-looking earnings guidance. Many respondents reported listening in to earnings calls to tap into investor concerns, and also providing feedback to management on analyst presentations.

Questions for the audit committee to consider

- ▶ *How engaged is the audit committee in how the company presents its financials to its shareholders?*
- ▶ *How, if at all, does the audit committee review press releases, analyst presentations and other investor-focused materials?*



3. Enterprise risk

Today's business environment contains numerous threats to companies, but audit chairs reported varying degrees of ability to oversee risk. For many, risk oversight is a work in progress. Some leading practices included pressing the board to determine the right risk oversight approach, constantly exploring the leading ways to prioritise risk, and ensuring that risk reporting to the audit committee focused on "gross risk". Other recommendations included devoting time to an indepth discussion on key topics, and ensuring that the right board members are present during discussions on risk.

Questions for the audit committee to consider

- ▶ *Is the audit committee satisfied that there is an appropriate enterprise wide risk management system in place?*
- ▶ *Is the audit committee aware of the five most significant risks facing the organisation?*
- ▶ *Does the audit committee's mandate extend beyond the financial risks?*
- ▶ *What is the level of the interaction between the risk committee and audit committee?*
- ▶ *Is the audit committee satisfied that there is appropriate risk disclosure to stakeholders as part of the financial reporting process?*

4. Compliance and fraud prevention

A majority of audit committee charters cite overseeing compliance and regulatory requirements as a main responsibility. In order to fulfil this mandate amidst so much change, respondents identified several best practices. Some of the best ways to keep abreast of compliance changes is to form a knowledgeable team and monitor the corporate culture throughout the company. Internal audit should be used to perform spot checks throughout the company, and the external auditors should be asked to brief the audit committee as they have a much more detailed view of the company's operations and interact with employees more frequently. Finally, it is advisable to make sure that the audit committee's charter is clear.

Questions for the audit committee to consider

- ▶ *How does the audit committee ensure it spends sufficient time on compliance and fraud matters?*
- ▶ *How does the audit committee keep abreast of the company's greatest compliance and fraud risks?*
- ▶ *How does the audit committee evaluate the tone of the corporate culture?*

Keep new financial reporting requirements on your radar

Convergence of accounting standards

The Financial Accounting Standards Board is continuing to focus on several convergence projects with the International Accounting Standards Board. During 2011, the final standards on accounting for financial instruments, revenue recognition and leases are expected. These proposals are very far-ranging and it is worth beginning to explore the potential implications.

Integration of IFRS into US financial reporting system

An allied project is the possible move to a set of global accounting standards. The Securities Exchange Commission issued its first progress report in October 2010. When this work is complete, and the Financial Accounting Standards Board's convergence project is completed, the Commission should be able to determine whether to incorporate International Financial Reporting Standards (IFRS) into the US financial reporting system.



Questions for the audit committee to consider

- ▶ *Has management evaluated the effects of the new disclosure requirements and presented its analysis to the audit committee?*
- ▶ *Have the audit committee and management discussed the scope of changes of the proposed standard?*
- ▶ *Is the company actively participating in the standard-setting process and providing comments to the International Accounting Standards Board?*

Making sure that tax is on the audit committee agenda

Tax needs to be seen holistically, and tax requirements are an integral part of the enterprise. Some of the pressing tax issues that audit committees should be considering in 2011 are:

Tax risk and corporate governance strategy

Tax risk management is increasingly being seen as part of overall corporate governance by boards. In order to avert the risks of “getting it wrong” with regard to tax, companies are looking for ways to manage their relationships and tax profiles with tax authorities, taking a proactive approach to resolving disputes and obtaining certainty.

The bottom line is that companies that are prepared are better able to address challenges, manage risk, reduce costs and improve their relationships with tax administrators.

Tax administration without borders: risks and opportunities

As business globalises, companies are treating their tax profiles holistically to ensure they consider the full range of indirect and direct corporate taxes and to gain any tax advantages they can. Similarly, tax authorities are increasingly sharing information, making global tax risk a corporate governance issue. Companies need systems, resources, policies and procedures in place.

Fundamental reform

Is the company's tax function keeping pace? In the wake of the financial crisis, cries for tax reform continue to mount. At the same time, most countries are likely to pursue new revenue-raising measures.

Questions for the audit committee to consider

- ▶ *How is management keeping current on tax issues and the potential for changes in its tax policy?*
- ▶ *Does the company have adequate resources to address the multiple jurisdiction changes fully?*
- ▶ *Does the company have programs in place to monitor changes in tax policies and compliance?*
- ▶ *Does the company understand how these changes might affect financial reporting and its effective tax rate?*
- ▶ *Are tax disclosures included in the company's annual financial statements comprehensive and understandable?*



Audit committees face up to challenge of IT governance

IT has become one of business's most critical success factors, but is also one of the trickiest areas in terms of risk and governance. Both the board of directors and the audit committee have roles to play in IT oversight.

The following key points are worth considering about the manner in which boards and audit committees oversee IT governance.

Boards and audit committees regularly address IT

Boards generally only hear from the CIO once a year unless strategic IT-related issues, such as a major implementation, are underway. The audit committee reviews a broader set of IT issues, often several times a year. The audit committee also takes an interest in the calibre of the CIO.

Oversight of IT encompasses a broad range of issues

The board and audit committee oversee a diverse array of IT-related issues, often tackling strategic as well as operational aspects of these issues. Information security and business continuity, major implementations, outsourcing, and the impact of IT trends such as the growth of social media are among the most important issues considered.

Controls over financial reporting are also a core concern, and when mergers and acquisitions occur, the associated integration challenges may move to center stage.

Directors supplement their knowledge of IT with internal and external resources

Members admit that IT expertise is not widespread on boards and audit committees, which makes effective communications between management and the board essential.

While some members would like to recruit more expert members, others prefer to supplement the board/committee's knowledge with the expertise of internal audit IT specialists, the external auditor and outside consultants.

IT has become a strategic asset, but it also creates complex risks. At present, audit committees tend to rely on internal or external experts for guidance, but their approach is likely to become more systematic in the future, with IT specialists possibly joining the committee.

Questions for the audit committee to consider

- ▶ *How does your company view the role of IT in business strategy?*
- ▶ *How are oversight responsibilities divided up between the full board, the audit committee and other committees?*
- ▶ *What does the audit committee look for in a CIO?*
- ▶ *How does management communicate to the board and the audit committee about IT?*
- ▶ *What IT issues and risks are most important to the audit committee?*

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