

Across the board

A newsletter for Malaysian directors

MALAYSIA

Issue 01/June 2006

The changing roles of Audit Committee

“There is nothing so powerful as an idea whose time has come.”

–Victor Hugo

As corporate governance in Malaysia continues to undergo close scrutiny from the regulators, the public and investors, the board’s ability to effectively monitor the company’s financial integrity and internal controls is being increasingly focused through the audit committee.

Special attention has been given to the audit committee as the principal player in the effort to enhance the standard of corporate governance and strengthen public trust. Paragraph 15.13 of the Bursa Malaysia Securities Berhad Listing Requirements (LRs) and Best Practices BB I - VI of the Malaysian Code on Corporate Governance (the Code) for instance, set out the functions and best practices for the audit committee.

“The line between oversight and management is an admittedly fine one, and audit committee members are often perplexed about how best to tread it. Oversight is about making sure, in the event of a wound, a manager has thought about Band-Aids, has the necessary quantity in stock, and has the skills to apply them. It does not mean having board members roll up their own sleeves to lay on the gauze.”

– Risk from the CEO and Board Perspective by KPMG Partners Mary Pat McCarthy and Timothy P. Flynn

Providing effective oversight

In the current charged environment, the audit committee is a key component of the board of directors. While all directors have a fiduciary duty to act in the interests of the company, the audit committee has a particular role, as a committee of the board, to ensure that the interests of shareholders are properly protected through the oversight of:

- Financial reporting;
- Risk and internal controls; and
- Internal and external audit processes.

Financial reporting

The audit committee should oversee the timely and accurate disclosure of the corporate financial condition, and set expectations on how that will be achieved. This can be effectively achieved by monitoring the performance of senior management to help ensure the proper “tone at the top” is set, i.e., where senior management supports a structure of policies, procedures, values, actions, and messages that build and sustain a culture of open, honest, and credible financial reporting and effective internal control, in concert with the audit committee.

From the start, an appropriate “tone at the top” rests on two fundamental elements in the management audit committee relationship. First, the relationship must be reciprocal. Committee members need management to help them understand the details of corporate financial performance, reporting processes, and internal controls. The committee, in turn, must support management in its efforts to create an environment of sound financial reporting and effective internal control framework.



Case study: Audit committee oversight failure

On 4 June 2005, *The Straits Times* reported that “failure at every level” had led to the collapse of China Aviation Oil (Singapore) Corporation Ltd (CAO).¹ CAO, China’s main jet fuel supplier, had in December 2004 announced that it had suffered significant losses of approximately US\$550 million from speculative oil derivative trading.²

Several factors contributed individually or collectively to the losses, and these had included a failure on the part of the audit committee in particular and the Board in general to fulfil their duties in relation to risk management and controls applicable to CAO’s speculative derivatives trading.³

The CAO collapse refreshes the perspective that the audit committee plays a crucial oversight role in monitoring a company’s financial integrity, risk oversight and internal controls. The audit committee was aware about the speculative options trading from February 2004. However, even when the audit committee knew that speculative trading was ongoing, it failed to “investigate how this had transpired” and did not enforce controls on such activities.⁴

Second, the audit committee’s independence remains paramount. Of note, while the LRs allow for an executive board member to be a member of the audit committee so long as the majority members are independent directors, tighter composition of the audit committee is in place under the US’ New York Stock Exchange (NYSE) regulations and the UK’s Combined Code, where ALL members of the audit committee should be independent non-executive directors.

For the audit committee to be free to render a judgment and act upon what it sees, the members need to be independent in character and judgment and should not be hampered by relationships or circumstances which could affect, or appear to affect, the member’s judgment. This would allow the audit committee members to effectively investigate any matter within its terms of reference as recommended in Best Practice BB IV of the Code, and if compelled, to report breaches of LRs to the stock exchange if the audit committee is of the view that a matter reported to the board has not been satisfactorily resolved.⁵

Another way the audit committee oversees timely and accurate financial disclosure is the exercise of responsibility over the company’s internal and external auditor. The auditor works with management but the audit committee is directly responsible for the oversight of the audit work, the appointment and compensation of external auditors.⁶

The committee’s role as an arbiter of disagreements over financial reporting between management and the external auditor is a clear indicator of its primacy. The audit committee should clearly set the expectation with management and the external auditor that the auditor reports to them. This is a meaningful shift from the past, when external auditors were ultimately accountable to the audit committee, yet it was management that was often perceived as the client.

Risk oversight and internal controls

The audit committee is commonly tasked to assist the board in discharging the following two key responsibilities of the board’s stewardship responsibilities:

- Identifying principal risks and ensure the implementation of appropriate systems to manage these risks; and
- Reviewing the adequacy and integrity of the company’s internal control systems and management information systems, including systems for compliance with applicable laws, regulations, rules, directives and guidelines.⁷

¹ *The Straits Times*, (4 June 2005.)

² Company announcement on proposed scheme of arrangement, (30 November 2004.)

³ Company announcement on findings of special investigation report, (3 June 2005).

⁴ Val Chua, *When ambition crashed*, (TODAYonline, 4 June 2005).

⁵ *Listing Requirements (LRs)* (Bursa Malaysia Securities Berhad), paragraph 15.13.

⁶ *Best Practices in Corporate Governance AA I* (Malaysian Code on Corporate Governance, March 2000), p. 9.

⁷ *Best Practices in Corporate Governance AA I* (Malaysian Code on Corporate Governance, March 2000), p. 9.

Particularly for larger companies, a committee such as the audit committee, the risk management committee or other relevant committee can be a more efficient mechanism than the full board for focusing the company on risk oversight and management and on internal control.⁸ However, the existence of a committee should not be seen as implying a fragmentation or diminution of the responsibilities of the board as a whole.

Except where the board or appropriate board committee is expressly responsible for reviewing the effectiveness of the internal control and risk management systems, the audit committee should receive reports from management on the effectiveness of the systems they have established and the results of any testing carried out by internal and external auditors.⁹ It is common practice for Malaysian public listed companies to require the audit committee to review and recommend for the board's approval the corporate governance and internal control statements included in the annual report where these relate to internal control and the management of risk.

Not only must members meet the evolving expectations of shareholders and regulators regarding their independence and financial literacy, they must also have a thorough understanding of the business of the company whose financial reporting they

oversee. This requires an understanding of a broad range of risk issues and opportunities associated with:

- The business model - the company's strategies and objectives;
- The key risks to economic success and long-term sustainability of the company; and
- The adequacy and integrity of internal controls maintained by management, the risk management framework, as well as the accuracy and transparency of the reporting of its financial results.

It is important for audit committees to help the board take a fresh look at their company's risk oversight and management and internal control. This is to enhance the environment for identifying and taking opportunities to improve performance as well as taking action to avoid or reduce the chance of something going wrong.

Internal and external auditing processes

Oversight of internal auditors

"Internal auditors are rock stars now. This is their day in the sun."

– Pitney Bowes, CFO Bruce Nolop, "New Terrain", CFO.com (2004)

Internal audit's relationship with the audit committee is undergoing dramatic change. Historically, internal audit has reported to,

and primarily served, management; however, internal audit's accountability and responsibility are now towards the audit committee.

The Code recommends that the board should establish an internal audit function. Where an internal audit function does not exist, the board should assess whether there are other means of obtaining sufficient assurance of regular review and/or appraisal of the effectiveness of the system of internal controls within the company. The board should explain, in summary, the means that exist for obtaining such assurance of regular review and/or appraisal.¹⁰

While our LRs do not make it mandatory for listed companies to have an internal audit function, it is noteworthy that the NYSE listing standards require companies to have an internal audit function to "provide management and the audit committee with ongoing assessments of the company's risk management process and system of internal control".

Additionally, the US Public Company Accounting Oversight Board (PCAOB), in its promulgation of Audit Standard No. 2 (2004), *An Audit of Financial Statements*, was unequivocal about the importance of the internal audit function: "[That the Standard will result in] a high quality audit of internal control and that [it will] have a complementary benefit of encouraging companies to invest in competent and objective internal audit functions".

⁸ *Principles of Good Corporate Governance and Best Practice Recommendations* (Australian Stock Exchange Council, March 2003), p. 43.

⁹ Sir Robert Smith, comp., *Audit Committees - Combined Code Guidance* (Financial Reporting Council, January 2003), p. 11.

¹⁰ *Best Practices in Corporate Governance BB VII* (Malaysian Code on Corporate Governance, March 2000), p. 14.



Indeed, demanding corporate governance requirements across the globe have resulted in companies, particularly those impacted by the US Sarbanes-Oxley Act of 2002 requirements, to establish processes for CEO and CFO certification of financial reports and the documentation and assessment of internal controls. Such requirements have significantly elevated the role of internal audit as well as its potential value to the company and the audit committee.

The audit committee can play a central role in enhancing internal audit's value and effectiveness by helping to ensure that the internal audit has:

- Sufficient independence from management;
- The focus, resources, and competence to assess the company's risk management processes and internal controls;
- Knowledge of the company's financial reporting and audit processes;
- The stature and confidence to bring forward controversial financial reporting issues; and
- A process for communicating directly with the audit committee on a timely basis.

Oversight of external auditors

"The audit committee should be the external auditor's biggest fan and harshest taskmaster."

– SEC Chief Accountant
Donald T. Nicolaisen, Remarks before the
2003 AICPA National Conference on
current SEC Developments,
December 11, 2003

Under the LRs and the Code, the audit committee has direct responsibility for the oversight of the company's external auditor^{11,12}. To meet this responsibility, audit committees are considering a variety of issues and approaches relative to the external auditor, including the following:

- **Hiring, retention and evaluation.** Audit committees are becoming more involved in the interviewing and hiring process, including evaluating the external auditor's qualifications and independence. Audit committees are also playing a more prominent role in evaluating the auditor's performance. In addition, to help control disruptions caused by the rotation of the audit firm's lead partner, many audit committees are starting the informal transition to the next lead partner well ahead of the scheduled transition.
- **Compensation.** Many audit committees are participating in audit fee discussions, often working directly with the auditor and management before granting approval. Increasingly, audit

¹¹ LRs (Bursa Malaysia Securities Berhad), paragraph 15.13.

¹² *Best Practices in Corporate Governance BB II* (Malaysian Code on Corporate Governance, March 2000), p. 13.

committees are willing to consider fees which are fair and reflective of the effort required in conducting the audit, particularly with the introduction of new or revised financial reporting standards to be in line with the International Financial Reporting Standards regime. The significant increase in the scope of audit work and higher operational costs incurred by the audit firms as a result of additional compliance work and in some cases “hand holding” the clients, have elevated the importance of the audit committee’s role in fee discussions and the approval process.

- **Oversight.** Audit committees are meeting and communicating with the external auditor more frequently and, in many cases, outside of formal audit committee meetings. The goal is to establish a closer working relationship with the auditor resulting in more in-depth view of its work and performance and to gain additional insights concerning the company’s risks and the people and processes supporting its financial reporting. Audit committees are evaluating and pre-approving non-audit services provided by the external auditor and asking more questions about audit scope and complex accounting matters, including alternate accounting treatments that may have been discussed with management.

To help establish and reinforce the audit committee’s expectations relative to the interaction of all participants in the financial reporting process, a good practice is for the audit committee chair to conduct “set-the-tone” meetings. The audit committee chair can use such meetings to articulate the roles, responsibilities, and reporting relationships within the financial reporting process, particularly the following:

- The external auditor is accountable and reports directly to the audit committee;
- The head of internal audit’s primary reporting responsibility is to the audit committee; and
- Management is expected to support the external and internal audit efforts.

The audit committee chair may also specify the type of support or feedback the audit committee expects to receive from management and the auditors.

Moving forward

Successful audit committee oversight will require not only compliance with the regulatory requirements and other reforms, but a process of open communication, balanced attention to due diligence and independence, and the clear application of authority with respect to both management and the external auditor.

Clearly, no two audit committees will have identical oversight processes. However, a

structured and qualified audit committee plays a key role in assisting the board to fulfil its responsibilities whilst improving overall risk management and corporate governance.

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More information

Audit Committee Institute (ACI) Malaysia is sponsored by KPMG in Malaysia and supported by the Institute of Internal Audit Malaysia (IIAM). The Institute's primary mission is to serve as a forum and dedicated resource to keep audit committees informed of regulatory matters, company law and accounting and auditing issues. Ultimately, the Institute seeks to enhance the committees' awareness of, commitment to, and ability to implement effective audit committee processes.

To learn more about Audit Committee Institute Malaysia or to access our resources, please visit our web site (www.kpmg.com.my/aci) or contact us by e-mail (aci@kpmg.com.my). You may

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