BOARD

Role of the audit committee

An independent audit committee is a fundamental component of good corporate governance.

The audit committee is established by the board and its powers are delegated by the board. The board retains responsibility for decisions, performance and outcomes of the audit committee and is therefore continually required to monitor the audit committees' activities. It is good practice for the audit committee minutes to be circulated to all board members, once approved by the audit committee chair. The audit committee will report to the board on a regular basis.

The roles, composition and necessary powers and responsibilities of the audit committee are set out in its charter. This is one of the recommendations by the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (ASX Principles).[1] As a matter of best practice, the charter will be evaluated (at least) annually to ensure that it is operating effectively and fulfilling its functions. Revisions to the charter, or further training and development for committee members may be necessary as a result of the evaluation.

The audit committee plays a key role in assisting the board to fulfill its oversight responsibilities in areas such as an entity's financial reporting, internal control systems, risk management systems and the internal and external audit functions.

A good practice of the audit committee is to schedule, at least annually, a meeting with the external auditors without management of the entity present, to enable them to have a discussion about any matters of significance arising during the audit process.

Depending on the nature of the entity, risk may be included within the ambit of the audit committee or as a separate committee.[2]

The AICD publication *Audit Committees: A guide to good practice*[3] sets out the role of the audit committee as including:

- corporate reporting, including external financial reporting, the directors' report and annual report;
- external audit;
- internal audit;
- risk management and internal control;
- compliance;
- ethics and organisational culture; and
- fraud and corruption.

1. ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th edition, February, Recommendation 4.1, p 19, **https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf**, (accessed 5 June 2019).
2. Refer to AICD Director Tool *Board Committees*.
3. Auditing and Assurance Standards Board, Australian Institute of Company Directors and the Institute of Internal Auditors-Australia, 2017, *Audit Committees: A guide to good practice*, 3rd edition, July, Australian Institute of Company Directors.

What are the objectives of an audit committee?

The main objectives of an appropriately established and effective audit committee may include assisting the board to discharge its responsibility to exercise due care, diligence and skill in relation to the following areas:[4]

- Promoting and monitoring an ethical culture throughout the entity;
- Ascertaining that a code of conduct is appropriately designed and implemented and compliance with the code is monitored;
- Reviewing the effectiveness of risk oversight and management;
- Assessing the entity's fraud risk and action to mitigate that fraud risk;
- Assessing the effectiveness of the internal control system in relation to accounting and financial records and reporting;
- Assessing the adequacy of financial management practices
- Overseeing the systems in place to protect the entity's assets;
- Reviewing the adequacy of internal and external reporting (financial and non-financial) for users of financial reports;
- Overseeing compliance with applicable laws, regulations, standards and best practice guidelines, including reviewing correspondence with regulators;
- Providing a formal forum for communication between the board and senior financial management;
- Obtaining an independent, effective and efficient external audit, including assessing audit quality and independence matters;
- Facilitating effective communication between the board and the internal and external auditors, and providing timely and appropriate responses to matters arising from audits; and
- Considering significant matters that were raised during both the internal audit and external audit.

The audit committee should maintain independence from management so that it is both free from undue influence within the organisation and seen to be so. Therefore, it is recommended that members of the audit committee do not have any executive powers or functions or delegated responsibilities within the organisation.

Is an audit committee mandatory?

ASX Listing Rule 12.7 specifies that an entity that was included in the S&P All Ordinaries Index (the 500 largest entities by market capitalisation) at the beginning of its financial year must have an audit committee during that year.

There are further requirements if an entity was also included in the S&P/ASX 300 Index at the beginning of its financial year. In this case, the entity it must also comply with the best practice recommendations set out by the ASX Principles, in relation to the composition, operation and responsibility of the audit committee.

Other listed entities are required to disclose whether they have an audit committee, on an if not, why not basis, in accordance with the ASX Principles.

Some organisations may feel that they are not big enough to justify an audit committee. This is an acceptable decision so long as board members are confident that there are appropriate board processes in place to raise issues that would otherwise be considered by the audit committee. It is particularly important that these organisations disclose how their alternative approach ensures that the integrity of the financial statements of the entity and the independence of the external auditor are dealt with.

Unlisted and not-for-profit organisations are not required to have an audit committee.

4. Ibid.

Who should be members of the audit committee?

The audit committee should be of sufficient size and its members should be independent and have technical expertise to ensure that it is able to discharge its mandate effectively. Principle 4 of the ASX Principles states that: "A listed entity should have appropriate processes to verify the integrity of its corporate reports".[5]

Recommendation 4.1 reinforces this view by requiring that the board will have an audit committee which:

- has at least three members, all of whom are nonexecutive directors and a majority of whom are independent directors; and
- is chaired by an independent director, who is not the chair of the board.

Audit committee members may be appointed for specific terms and need to have an appropriate mix of skills, experience and expertise. The members of the committee should have a mix of accounting and financial expertise, as well as industry knowledge, to enable them to discharge their mandate effectively. It is recommended that at least one member be a qualified accountant or other finance professional with experience in financial and accounting matters; while other members have an understanding of the industry in that the entity operates within.

Recommendation 4.1 goes on to state that the board should disclose:[6]

- the charter of the committee;
- the relevant qualifications and experience of the members of the committee; and
- in relation to each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or
- if it does not have an audit committee, disclose that fact and the processes it employs that independently verify and safeguard the integrity of its corporate reporting, including the processes for the appointment and removal of the external auditor and the rotation of the audit engagement partner.

It is generally accepted that the CEO and CFO of an entity and other experts are not members of the committee, but it is often important and helpful for these people to attend audit committee meetings from time to time.

Where a listed entity does not have a stand-alone risk committee, then the audit committee may be charged with the responsibilities of a risk committee, as set out in Principle 7 of the ASX Principles: "A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework".[7]

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5. ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th edition, February, Principle 4, p 19, **https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf**, (accessed 5 June 2019).
6. Ibid, p 19.
7. Ibid, p 26.

What may be included in the audit committee's charter?

The audit committee's charter clearly sets out the audit committee's role and responsibilities, composition, structure and member requirements and the procedures for inviting non-committee members to attend meetings.

The audit committee may cross reference its annual plan to its charter, to ensure that it fulfills its responsibilities. It is good practice for the board to regularly review the audit committee's charter.

Key matters commonly included within a charter cover the following:

- purpose;
- authority;
- composition;
- meetings;
- responsibilities:
- financial reporting;
- working with the external auditor;
- working with the internal audit activity;
- risk management and internal control;
- compliance with laws, regulations, ethical requirements, internal policies and industry standards;
- management and reporting of fraud;
- reporting responsibilities;
- evaluating performance;
- review of the audit committee charter; and
- other responsibilities as deemed important.

What is the relationship between an audit committee, an external auditor and an internal auditor?

External auditors perform an audit to form an opinion about whether annual and half yearly financial reports comply with the requirements of the *Corporations Act 2001* [particularly ss 307-309] and accounting standards and give a true and fair view of the entity's financial affairs. Because the independence of the external auditor is critical, auditors are generally nominated by the audit committee and approved by the board and not by management.

The audit committee reviews the scope of the audit and oversees the relationships with the auditors. Where an entity has determined that there is a need to have a separate internal audit function. The internal audit function usually evaluates and monitors the adequacy and effectiveness of the internal control systems and so plays a vital role in managing risks. Internal auditors usually report to the audit committee directly. The audit committee must monitor the scope of the internal auditor's work and review their reports and management responses.

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