Understanding the Role of Audit Committee in Governance, Risk & Compliance

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Introduction

- Audit Committee is a part of governance of entity.
- Governance is the system by which organizations are directed and controlled.
- It includes rules and procedures for making decision on corporate affairs to ensure success while maintaining the right balance with stakeholder’s interest.
- Audit Committee is one of the major pillars of governance system in public companies.
The IIA Corporate Governance Model

Board

Effective Governance

Management

External Audit

Internal Audit
Terms of Reference for Committees

- To effectively discharge its mandate, the Board shall establish Committees with specific terms of reference
- The Board shall appoint into committees members with requisite skills and competence to discharge their responsibility
- In the event that a committee lacks specific skills within its membership, the Board may coopt skilled non Board members to serve on the Committee, provided that the Chair of the Committee shall not be a co-opted member or the Chairperson of the Board.
- The Board may from time to time rotate Board members between the Committees.
- The Board will however determine the procedures and process within which committees may take independent professional advise at the organization’s expense.
Terms of Reference for Committees

- The Board remains collectively responsible for the decisions and actions taken by any committee.
- A committee may only perform the tasks delegated to it by the Board and may not exceed the authority or powers of the Board.
- The Chairman of each committee in consultation with the Board will determine the frequency of committee meetings as is necessary to fulfill their functions.
- The Chairman of each Committee, in consultation with management will develop the Committee’s agenda.
Principles of effective Committees

- Number and constitution may vary from organization to organization and should be determined by organizational need, Board size and strategy.
- Should not be many (3-5) at most would do for most organizations.
- Members of Audit and Finance Committees should not be the same.
- Strive to avoid multiple Committee membership.
- Avoid large committees for efficiency of work and expedient decision making (should be no more than half the total number).
“A committee composed of independent, non-executive directors charged with oversight functions of ensuring responsible corporate governance, a reliable financial reporting process, an effective internal control structure, a credible audit function, an informed whistleblower complaint process, and an appropriate code of business ethics with the purpose of creating long-term shareholder value while protecting the interests of other stakeholders”. (In the context of the agency theory).
Rationale for the Audit Committee

- Acting as forum of dialogue between accounting officer or governing body, executive management and the internal and external auditors
- Promote the integrity and quality of internal and external reports by providing a high level of assurance and check
- Fostering and promoting a more effective and efficient audit process by providing an independent review of the internal audit annual work plans and reports.
- Providing a “no surprise environment’ in an entity, particularly with regard to the prompt identification of risks and threats to the entity.
- Providing a depth of knowledge that assists management discharge its responsibilities in the most effective and efficient manner.
Audit Committee Relationships with Others

Audit Committee → Board of Directors
Works with other committees, assists board by bringing specialization and expertise in the areas of financial reporting, internal controls, risk management, and audit activities.

Audit Committee → Management
Asks appropriate questions pertaining to the company’s corporate governance structure, internal controls, financial reporting, audit activities, risk assessment, codes of ethics, and whistleblower programs. Management should provide sufficient information.

Audit Committee → External Auditors
Directly responsible for hiring, compensating, and firing external auditors, as well as overseeing their work. External auditors are held ultimately accountable to the audit committee and should submit their reports of the audit on ICFR and the audit of financial reporting to management via the audit committee.

Audit Committee → Internal Auditor
Should be responsible for hiring, overseeing, compensating, and firing the head of the internal audit department (CAE), and internal auditors should report their audit findings directly to the audit committee, being ultimately accountable to that committee.
Legislative Requirements of Audit Committees in the Public Sector

- Treasury Circular No. 16/2005-”Establishment & Operationalization of Audit Committees in the Public Service.


- Mwongozo Code of Governance for State Corporations
Legislative Requirements of Audit Committees in the Public Sector

- Public Finance Management Act, 2012 Sections 73 (5) and section 155(5) of PFM Act- establishes audit committees for national government entities and county government entities whose composition and functions are prescribed by the Regulations
- PFM Regulations, 2015
- The Constitution of Kenya, 2010 (Article 10 on National Values and principles of Governance & Article 225 & 226) providing principles of public service that ensure Economic, Efficient, Effective use of public resources.
Legislative Requirements for Audit Committee in the Private Sector

- Central Bank of Kenya Prudential Guidelines for Institutions Licensed Under the Banking Act, Section 3.2.2.9
- Insurance Regulatory Authority, Corporate Governance Guidelines for Insurance & Reinsurance Companies, June 2011, Section 4.1 (Audit functions)
- Companies Act, 2015- Division 3 (Director’s duties)
Constitution of Board Audit Committees

• The Board should establish *not more than four* committees of the Board provided that the Board shall be at liberty to establish such ad-hoc committees as required to deal with any ad-hoc matters requiring focused attention such as the recruitment of the CEO.

• Establish an Audit Committee, and a maximum of three other Committees (*by whatever name called*), to discharge the following functions: Governance, Technical matters, Risk, Strategy, Compliance, Human Resources & Finance (*............Mwongozo Code*)
Constitution of Board Audit Committees

• The Board shall establish relevant Committees with written terms of reference, which sets out their authority and duties. The Board shall establish committees to cover broad functions of the company such as: Audit, Board Nominations, risk management, remuneration, finance, investment and governance.

• The Board shall establish an AC with written terms of reference

• The Board shall establish an AC of at least three independent and non-executive directors. (CMA Code of Corporate Governance for issuers of securities to the Public 2015)
Constitution of the Board Audit Committee

- The members of the AC shall be appointed by the Board serving at the pleasure of the Board and for such terms as the Board may determine.
- Usually consist of not less than three and not more than five members of the Board.
- No director may serve as a member of the Committee if such director serves on the AC of two or more other institutions unless the Board determines that such simultaneous service would not impair the director’s ability to serve effectively on the AC.
- A director shall not simultaneously serve both in the AC as well as Finance or such other functional Committees.
An Audit Committee Charter is a blueprint for its operation and should address:

- Processes
- Procedures
- Responsibilities
Contents of the AC Charter
Governance, Risk Management and Compliance defined

**Governance:** is the oversight role and the process by which companies manage and mitigate business risks.

**Risk management:** enables an organization to evaluate all relevant business and regulatory risks and controls and monitor mitigation actions in a structured manner.

**Compliance:** ensures that an organization has the processes and internal controls to meet the requirements imposed by governmental bodies, regulators, industry mandates or internal policies.
Quick Survey

a) How many members make up your BAC?

b) What are the career backgrounds of your BAC (e.g. former CEO, CFO etc.)?

c) How many hours do you commit for BAC meetings in a year?

d) In how many BACs do you serve?

e) How many meetings do you hold in a year?

f) How do you conduct your meetings (teleconference, face to face etc.)?
Role of the Board Audit Committee

1. Financial Reporting

2. Risk Management and Internal Control

3. Oversight Over Internal Audit

4. Oversight over External Audit

5. Regulatory, Compliance and Ethical Matters

6. Maintaining and Measuring Effectiveness

7. Communication and Reporting
1.0 Financial Reporting

- Audit committees should review financial statements quarterly, semi-annually and annually in most organizations.
- Ensuring that financial statements are understandable, transparent, and reliable.
- Review significant reporting issues and accounting policies
- Monitor and approve material related party transactions
- Audit committee members should know the right questions to ask to build their financial acumen.
- The Committee may institute a special investigation using an expert as deemed necessary.
1.0 Financial Reporting

- Understand the basic financial Reports
  - *Statement of financial performance*
  - *Statement of financial position*
  - *Statement of cash flows*
  - *Statement of changes in equity*

- Understanding the organization
  - *Visit company operations, zones and facilities*
  - *Meet the business unit leaders to grasp the operational details*
  - *Meet the finance management, internal audit, and the external auditors*
  - *Review the competitors financial statements and non financial information*
  - *Understand the major business transactions and changes during the period*
  - *Understanding the company’s regulators*
  - *Meet the finance, taxation, and treasury personnel to understand capital structure, tax structure and investment strategies.*
1.0 Financial Reporting

The other areas of financial reporting includes;

- Complex, difficult and risker areas
- Materiality
- Accounting policies
- Accounting estimates
- Significant changes during the reporting period
- Related party transactions
- Interim financial statements
- Timing issues
2.0 Risk Management & Internal Control

- Ensuring the risk management process is comprehensive and ongoing, rather than partial and periodic.
- Ensure a comprehensive internal controls framework is in place
- Ensure presence of a risk management policy document.
- Helping achieve an organization wide commitment to strong and effective internal controls, emanating from the tone at the top.
2.0 Risk Management & Internal Control

The AC have responsibility of overseeing the RM process;
- How Mgt identifies events that could put the company at risk and how it assess the likelihood and impact of identified risks
- How Mgt has tailored the process to meet the company specific needs - Top 10 strategic risks?
- Whether the process of risk management is continuous
- If individuals are assigned primary responsibility for RM and has appropriate expertise, statute within the company and available time.
- Ensure that all key risks are subject to the Board-level oversight
- Understand the internal auditor’s role in RM and the extent of its audit plan covers the key risks
Role of AC in Fraud Risk Management

• Assessing the tone at the top
• Overseeing company compliance programs
• Review the whistleblower programs
  ✤ The whistleblowing must be reported periodically to the audit committee.
  ✤ It is important to get a summary of all complaints received at least annually.
  ✤ Audit committees should determine how often they wish to receive information.
3.0 Oversight of Internal Audit

- Ensuring Internal Auditors’ access to the Audit Committee, encouraging communication beyond scheduled committee meetings.
- Review and approve the Internal audit Charter
- Review the integrity by way of qualification and relevant experience of internal audit, risk management and compliance personnel.
- Reviewing internal audit plans, reports, and significant findings.
- Review and approve the proposed annual internal audit plan and ensure that it addresses key areas of risk.
3.0 Oversight over Internal Audit

- Evaluate performance of the internal audit function.
- Receive internal audit quality assurance reports.
- Ensure that significant findings and recommendations made by the internal auditors and management’s proposed response are received, discussed and appropriately acted on.
- Meet separately with the Head of Internal Audit/External Auditors to discuss any matters that the committee/ internal & External Auditors believe should be discussed privately.
- Participate in the appointment, promotion or dismissal of the Head internal audit and discuss with the external auditor the standard of work of internal audit staff.
4.0 Oversight over External Audit

- Audit committees should ensure that External Auditors are independent as they issue an opinion on the accuracy of the entity's annual financial statements.
- Establishing a direct reporting relationship with the external auditors.
- Changing an EAs typically also requires AC approval.
- Review EAs proposed audit scope and approach.
- Review other sections of the Annual report before its release and consider whether the information is understandable and consistent with members knowledge about the Co. and its operations.
4.0 Oversight over External Audit

- Review performance of the EAs and make recommendations to the Board.
- Ensure significant findings & recommendations of the EAs are received and discussed in a timely manner.
- Make recommendations on fees payable to the external auditors and any revisions thereof.
- Share with the external auditors, the Committees understanding of the risk environment and suggest risks and locations to be incorporated in the audit plan.
- Focus on judgmental areas e.g. those involving valuation of assets and liabilities, provisions for debts, guarantees, litigation, commitments taxation and contingencies.
5.0 Regulatory, Compliance, and Ethical Matters

- Reviewing corporate policies relating to compliance with laws and regulations, ethics, conflicts of interest, gifts and the investigation of misconduct and fraud.
- Ensure new developments in the regulatory field are infused into the Company’s operations.
- Reviewing current and pending corporate governance related litigation or regulatory proceedings to which the organization is a party.
- Ensure code of conduct is in place and distributed to staff.
- Ensure whistleblowing arrangements are in place.
6.0 Regulatory, Compliance and Ethical Matters

- Understand the nature of any significant issues that come to light and management’s investigation and follow-up, including disciplinary action.
- Review trends in compliance and management’s plans to address systematic issues.
- Review findings and reports of examination by regulators.
- Being satisfied that disciplinary actions management has taken to respond to violations are appropriate.
- Understand how internal audit assesses the risks inherent in the compliance and ethics program and covers them in the audit work plans.
6.0 Regulatory, Compliance and Ethical matters

• Review and recommend for approval of policies, processes and framework for identifying, analysing and addressing complaints (including whistle blowing) and for reviewing material complaints and their resolution.

• Review the effectiveness of the system for monitoring compliance with laws, regulations, internal policies and industry standards.

• Obtain regular updates from management and the head of compliance about compliance matters that may have a material impact on the entity’s financial statements, strategy, operations or reputation.
7.0 Maintaining & Measuring Effectiveness

• Audit committees need to be independent and must review management decisions with healthy skepticism. This process necessarily includes a close analysis of the way companies assess and manage risk.

• A process for assessing and reporting on not only financial controls, but also fraud prevention and detection program should be established.
8.0 Communication and Reporting

- Continually communicating with Senior Management regarding status, progress, and new developments, as well as problematic areas.
- The AC should balance their role as advisor and counsellor to Management with their fiduciary duty to monitor and oversee management is, to say the least, challenging for most audit committees.
- They must communicate openly and often with management, carefully review information received, and challenge management as appropriate.
Challenges facing Audit Committees

- Limited time available for the Agenda items
- Limited pool of potential candidates
- Being influenced by management views.
- Strong CEO vis-à-vis weak Board Committees
- Poor relationship with External Auditors, Internal Auditors & Management
- Inadequate critical information from Management.
Challenges facing Audit Committees

• Ability of Committees to raise relevant questions and pursue them with Management.
• Lack of a deeper understanding of IT systems and operations.
• Complexity of today’s business and a wide range of risks beyond the experience of members e.g. IFRS
• High expectations by stakeholders
Challenges facing Audit Committees

• Over reliance on certain key management executives
• Lack of regular reviews on actual business situations
• Delay or failure to implement audit recommendations
• Corporate governance systems are not well-developed in many Kenyan organisations.
• Lack of a deeper understanding on risk management
• Lack of anti-fraud programs/whistle-blowing systems
• Emphasis on independence resulting in directors having limited knowledge of the business.
Best Practices for Audit Committees

- Members to comprise of independent & non-executive directors.
- Chairman of the Board should not be an AC member, but may attend the committee meeting as an invited guest.
- At least one member of the AC should have significant, recent and relevant financial experience at senior level.
- Members should have experience in corporate financial matters.
- Should at least annually meet the external and internal auditors, without management, to discuss issues arising from the audit.
Best Practices for Audit Committees

- Should have sufficient resources to undertake its duties - Budget
- New committee members should be given an induction program:
  - Role of audit committee, ToR,
  - Overview of company’s business
  - Identifying the main business and financial dynamics and risks
  - Meeting some company staff
- Regular training should be given to all members of AC:
  - Understanding the financial reporting and financial statements
  - Company law or entity memorandum
  - Formal courses
  - Internal company talks and seminars
  - Briefing by external advisers lawyers, bankers, professional advisors
• AC should review financial reporting issues on financial statements, interim reports and related statements
  ❖ Judgments
  ❖ Clarity
  ❖ Completeness of disclosure
• AC should monitor the integrity of internal financial controls.
• AC should assess the scope and effectiveness of the systems established by management to identify, assess, manage and monitor risks (unless there is a separate Committee on risks)
Best Practices for Audit Committees

• Annually, the AC should consider whether there is a need for internal audit function and make recommendation to the Board
• AC should review the complementing effect of internal and external audits
• AC should approve the appointment or termination of appointment of CAE.
• AC to play an active role in the performance evaluation of the internal auditor. This should not be left to Management
• AC should review and monitor internal audit activities.
AC should ensure that:

- CAE has direct access to the Board Chairman (*PS 1111*) and AC and is accountable to the AC.
- AC should review and assess annual internal audit work plan.
- AC should receive a report on the result of the internal auditors’ work on a periodic basis e.g. quarterly.
- Review and monitor management responsiveness to the internal auditor findings & recommendations.
- Meet with the Head of Internal audit & external auditors at least once a year without the presence of Management.
- Monitor and assess the role and effectiveness of internal audit function in overall company context of risk management.
Best Practices for Audit Committees

• AC should ensure independence and objectivity of the external auditor annually.

• At start of audit cycle, the AC should ensure that appropriate plans are in place for the audit.

• AC should review with the external auditors, the finding of their work.

• At end of audit work, the AC should assess the effectiveness of external audit process.
Conclusion

- One size does not fit all
- Set and monitor expectations of integrity and accurate financial reporting at the ‘top’
- Have the ‘right’ individuals on the Audit Committee to provide independent, objective, and effective oversight
- Set and exercise the committee’s direct responsibility for internal and external auditors
- BAC oversight process should facilitate its understanding and monitoring of key roles, responsibilities, and risks within the financial reporting environment
Conclusions

A strong Audit Committee is important for all organizations. Growing organizations as well as established ones benefit from the experience, oversight and direction that an audit committee may provide.

‘I have in mind a person with the intelligence, experience and understanding to know the right questions to ask of management or the auditors and the forcefulness and tenacity to ask a direct question and insist on a straight answer. Ideally, all audit committee members should have these qualities’ – US SEC Commissioner, February 2003
Questions & Answers
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