

Perspectives

London, 22 May 2007

September 2007

The members of the Forum participating in the meeting were:

Harald Arnkværn Nordea Bank
Jan Hommen ING Group
Archie Hunter Royal Bank of Scotland
Drs. Jan de Jong Heineken
Lars Kann-Rasmussen AP Moeller-Maersk
Professor Dr. Klaus Pohle Sanofi Aventis
Dr. Erhard Schipporeit SAP
Russell Walls Aviva

Also in attendance for all or part of the meeting:

Mark Stock Group Audit Director, Vodafone
Sir Andrew Likierman Acting Dean,
London Business School
Joachim Schindler KPMG in Germany
Richard Bennison KPMG in the UK
Timothy Copnell KPMG in the UK

The European Audit Committee Chairman's Forum provides audit committee chairmen from some of the most respected organisations in Europe with the opportunity to debate issues of concern with their peers and to develop practical ways in which to enhance both audit committee effectiveness and the functioning of the capital markets. The Forum meets twice a year in major European cities. Each meeting is hosted by a member of the Forum. KPMG's Audit Committee Institute act as organisers and facilitators, providing the timetable and framework for each event and any associated material.

The Forum held its second meeting at St Paul's Cathedral, London on 22 May 2007. The meeting was attended by Mark Stock, Group Audit Director at Vodafone, and Sir Andrew Likierman, Acting Dean of the London Business School and Professor of Management Practice specialising in the choice and use of performance measures. Mr. Stock reflected on internal audit best practice and the relationship between the audit committee and the internal audit function. Sir Andrew shared his thoughts on how an audit committee might go about assessing its own effectiveness.



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Internal Audit

An internal audit function, designed and deployed effectively, can have a very positive impact on the control environment of a company and the effective design and operation of internal controls. As an important aspect of its mandate, internal audit can provide the audit committee with a means of monitoring whether the controls management has put in place are reliable, functioning properly and sufficient to address the risks facing the business and in particular those associated with the financial reporting process. However, the structure and remit of Internal Audit functions vary significantly across different businesses, with little consensus on a number of issues such as reporting lines, staffing models and focus.

People

There was general agreement that the audit committee should participate in the process surrounding the appointment, dismissal and remuneration of the head of internal audit. However, members recognised that there are different resourcing models that can be applied to the internal audit function, and that these are largely a matter of choice for the company.

Some companies favour ‘career auditors’ and other specialists while others prefer to use the internal audit function as a training ground for high-fliers from within the business. A number of members suggested that the latter model is very common in the US where it is often recommended that “successful managers should have a spell – usually two to three years - in internal audit.” One member commented that “the audit committee’s role is to ensure there is a steady group of experienced people in the audit function and that it shouldn’t become a home for lost accountants.” There was a strong feeling that the experience required in a modern internal audit function might go beyond finance and that the recruitment of engineers, chemists and other professionals has been valuable both to audit functions and businesses as a whole.

Some members noted the difficulties in encouraging appropriately skilled individuals to join the internal audit function. One member commented “the talent pool is too small – what’s needed are one or two champions to demonstrate to the business that a spell in internal audit has advantages.”

On a cautionary note, one member warned of overly ambitious individuals who, as a result of their experience gained in internal audit might “try to convince operational management that they were better equipped for a vacant management position than better qualified local management.” It was agreed that internal audit should have an open dialogue with the business to ensure this does not happen.

It is critical that the audit committee has confidence in the head of internal audit. There was general agreement that the committee should, when the head of internal audit is being appointed, ensure that appropriate competencies are understood, articulated and recruited against. The audit committee might not directly appoint the head of internal audit, but it should at least ensure an appropriate process is followed. Similar considerations apply to the remuneration of the head of internal audit. Performance related pay may be appropriate but, as one member commented, “the audit committee should be very clear about what performance conditions are, and are not, appropriate.” Members were unanimous in considering an independent mindset an essential characteristic for the head of internal audit and other audit professionals.

Placing reliance on internal audit

While the value of a strong internal audit function was universally accepted, participants held different views as to the degree to which an audit committee can place reliance on the work carried out by internal audit. Some members raised concerns over the independence, or the perceived independence of internal audit noting that an independent review can not be fulfilled under the current system as ultimately internal audit is under the control of management. “Internal audit is used as a management tool, not an audit committee tool. Internal audit therefore lacks independence, at least from an external viewpoint.” This inevitably led to questions around the need for audit committees to commission external independent reports.

Other members were strong advocates of internal audit and supported a system where the internal audit function had a direct reporting line to the audit committee chairman; thus allowing greater reliance to be placed on their work. “Internal audit must have both a right and obligation to report to the audit committee – transparency is essential and it is better for the audit committee to receive the same information from both management and internal audit than remain uninformed. Never assume things have been said.”

The audit committee has a choice as to how much reliance it places on internal audit and a number of members were adamant that, where necessary, the audit committee can and must ask for more work to be done. One member commented “the audit committee must have ability to deploy internal audit resources without the approval of the executive directors if need be.”

Another member advocated greater involvement in audit planning and attendance at the organisations internal audit annual conference noting that “it is difficult to gain confidence in the work of auditors when you only ever meet one or two times each year.”

Assurance and/or consultancy

In addition to the traditional assurance role, many internal audit functions provide consulting services designed to add value and improve an organisation’s operations. Protecting the independence of internal audit in these circumstances was identified as a concern. One member commented, “There is an inherent conflict between providing control assurance and providing advice. Advice is about how to go about it rather than whether it is working.” Other members warned of the dangers of over emphasising the independence of the internal audit function stating that “internal audit must be close enough to the business to understand the risks facing the business and therefore carry out an effective audit.”

Some members referred to simple ground rules that could be employed to ensure the objectivity of the internal audit function such as “using different staff for consulting and assurance activities in any given area” or even “increasing independence by using auditors from different countries to those providing consultancy advice.”

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It was universally accepted that in some circumstances an internal audit function was ideally placed to advise management and coach the business. “Internal audit’s ability to work across silos makes them very privileged and able to provide useful advice to the business.” Members considered that many factors determined the appropriate balance between the provision of assurance and more forward looking advisory services. “In established businesses more assurance work falls to line management and internal audit provide a check as to whether the board can rely on line management operating controls effectively. As businesses mature, the relationship shifts from 90 percent backwards looking and 10 percent forward looking to 60 percent : 40 percent.” Members were convinced that preventing control breakdowns is more effective than detecting control breakdowns. “Internal audit lose credibility if they raise the same points every year so it is better to help management understand any issues and work together to resolve them going forward.”

Straying into aspects of line-management

Members also considered the dangers of internal audit straying into aspects of line-management – in particular, in the area of risk management. One member said “Management should own risk within the business, not internal audit.” It was upheld that internal audit should not have a role in determining the right risk management strategy to follow but might, in some businesses, reasonably be expected to help management understand what the significant risks are and what controls are appropriate. Members thought it essential that in such cases the internal audit function should work with operational management because they have more experience of the risks facing the business. Members were adamant that internal audit should “never dilute the responsibility of operational management to the executive directors.”

Assessing audit committee effectiveness

Assessing the effectiveness of the audit committee is considered good practice, but how an audit committee goes about assessing its own effectiveness is an open question. Sir Andrew outlined the differences between measurement and quantification. When assessing audit committee effectiveness a balance should be struck between defined quantifiable measures and nuanced qualitative information. Time and cost implications come into play, but the precise balance is a matter of choice for the audit committee.

There was also a debate around the meaning of ‘effective’ and how an effective committee might differ from a successful committee. An effective audit committee might be one that simply meets the criteria set out in any applicable regulations and/or codes of best practice, and discharges the duties set out in its terms of reference. However this might not get to the heart of the matter. By contrast, a successful audit committee might, in addition to the above, seize initiative and take opportunities; compare favourably to other audit committees; exceed expectations; and seek improvements.

Sir Andrew identified a number of problems associated with assessing audit committee effectiveness and success; and a number of actions that might be taken to improve the manner in which such assessments are often undertaken.

Potential problems	Potential improvements
<p>Choice of measures – easy to focus on what has to be done rather than how well it was done.</p> <p>Comparisons – few appropriate measures and limited exposure to different experiences.</p> <p>Action points – again skewed towards the measurable and focused on activities rather than outputs or outcomes.</p> <p>Interpretation – results can rarely be linked to audit committee actions. Triumphs are ‘prevented failures’.</p>	<p>Agreeing objectives up-front – establish what the committee is trying to achieve and what success would look like.</p> <p>Better comparisons – establish criteria against which to benchmark performance. These might be previously identified shortcomings, good practice elsewhere or aspirational targets.</p> <p>Review agenda – ensure appropriate time is spent on each agenda item and that excessive time is not spent on agenda items of little importance.</p> <p>Contact with audit committee best practices – attend conferences, seminars and networking events with other audit committee members.</p> <p>Improve understanding – ensure key stakeholders like other board members; the internal and external auditors; and the heads of finance and risk understand the audit committee’s role and what it can and can’t do.</p> <p>Improve consultation and feedback – questionnaires are useful, but there is also merit in talking to the audit committee’s key stakeholders.</p> <p>Adjust expectations – the audit committee should have realistic expectations about what it can do.</p>

Different approaches

Members reported a number of different approaches to assessing audit committee effectiveness. One member commented “the process adopted by any board should be measured and appropriate for the board and the individuals concerned.” No single process will be appropriate for all companies; however, there was general agreement that evaluation processes should be non-mechanistic, non-bureaucratic and non-personal. It is important to recognise that audit committee assessment is about raising the performance of the audit committee as a whole not criticising any particular individual’s contribution.

“The volume of audit committee papers can be a problem – especially as they are often prepared for other purposes rather than being specially tailored for the audit committee.”

There was some discussion around the benefits of using external facilitators when assessing the audit committee’s effectiveness. Members believed that there were both advantages and disadvantages in involving ‘outsiders’ in the assessment process. Points in favour of outsider involvement include “outsiders can bring out tensions in a non critical way; bring experience and rigor to the process; and engender a willingness to listen.” In contrast, others argued that external facilitators might “use standard processes that are not always appropriate to the company, committee and individuals involved.” One member commented that assessment processes can become stagnant and that “a mixture of approaches – for example, involving an external facilitator once every three years – might be beneficial.”

Some members saw an advantage in the chairman of the board (or supervisory body) sitting on the audit committee. One member commented “after all, the chairman forms his views on the CEO, he should have useful independent views about the audit committee too.” Other members questioned the objectivity of the board chairman and considered that whilst their views might usefully contribute to the assessment process, they should not be formal members of the audit committee. Both internal and external auditors were thought to be in a position to contribute to the assessment process either formally or informally. One member noted a degree of circularity in that “many regulations/codes require the audit committee to assess the effectiveness of the external audit, yet at the same time, the external auditors might usefully contribute to the assessment of the audit committee. In some cases [eg, PCAOB Auditing Standard No. 2] the external auditors are formally required to evaluate the effectiveness of the audit committee’s oversight of the external financial reporting and internal control over financial reporting.”

Information

There was a debate about the impact of ‘information’ on the effectiveness of the audit committee. It was agreed that audit committees are only as good as the information they receive and are usually reliant to some extent on the finance director and both internal and external auditors. However, “management of the key processes is very important to success.” One member commented “audit committees must make sure they have reasonable confidence in management; they must ensure that management’s information systems are sufficient, which brings in the role of internal auditors; and they must seek the external auditor’s views about internal audit as well as their observations of management.”

Trust also has an important role to play. Audit committees must put a great deal of trust in their executive colleagues and auditors to tell them what they need to know. However, if they experience surprises (e.g., material effects of a change in accounting policy come to light just before they are due to approve the financial statements), they need to start questioning their relationship with management and consider how they can ensure they get relevant and timely information.

One member commented that “the volume of audit committee papers can be a problem – especially as they are often prepared for other purposes rather than being specially tailored for the audit committee.” Another member suggested that “there wouldn’t be a problem with volume if clear and succinct executive summaries were prepared.” It was generally agreed that members would like to see more industry statistical comparisons; better identification of important issues; a concise description of specific issues; and the elimination of irrelevant information in the pre-meeting materials.

Members also stressed the importance of the time between meetings. This was when audit committee chairmen could invest time in “better understanding the business and liaising with the finance and risk officers and internal and external auditors.”

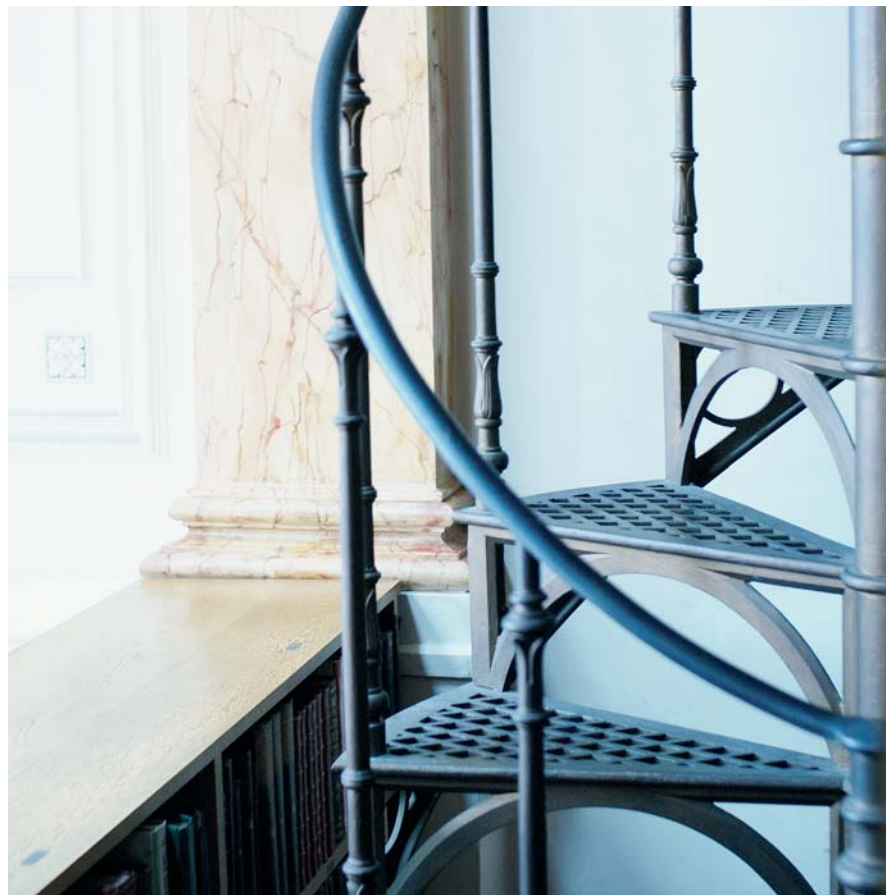
Other matters

It was universally accepted that “a good audit committee chairman is an important factor in fostering an effective and successful audit committee.” However, while the role of the audit committee chairman is not to be understated, a good chairman is only one piece of the jigsaw. If an audit committee is to be effective, “the right people, processes and systems must also be in place.”

A number of members commented on the skills expected of audit committee members and the importance of phasing membership. When assessing the effectiveness of the audit committee, the committee chairman should consider whether, as a collective unit, the committee includes members with the right skills, experience, availability and even geographic location. These are all simple matters that might be tested if the company is plunged into a crisis situation. One member commented that “the audit committee must be good in a crisis, but equally it must be able to work effectively in ‘normal’ circumstances with a view to averting any potential crisis.”

The next meeting

The Forum agreed that a third meeting should be held on 21 November in Amsterdam. The meeting will address both audit committee best practices and Sarbanes Oxley – with a particular emphasis on how organisations might use the section 404 compliance process to drive value for the business.



About the European Audit Committee Chairman's Forum

The European Audit Committee Chairman's Forum has been created to provide audit committee chairmen, from some of the most respected organisations in Europe, with the opportunity to debate issues of concern with their peers and to develop practical ways in which to enhance both audit committee effectiveness and the functioning of the capital markets.

Membership is by invitation only and limited to a select group of audit committee chairmen drawn from the 50 or so largest and most respected companies in Europe.

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Designed and produced by KPMG LLP (UK)'s Design Services

Publication name: Perspectives - September

Publication number: 309-017

Publication date: September 2007

Printed on recycled material.