Audit Committee Forum™ Alert 5

Issue Date: January 2010

The audit committee's role in the risk management process (King III)

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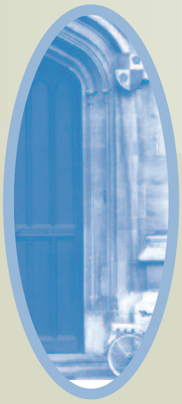

This Alert is being issued ahead of the relevant effective date[1] of King lll as a guideline to inform entities and afford them the opportunity to prepare themselves for these requirements.

[1] King III is effective 1 March 2010

Unless otherwise stated, all references in this document relate to extracts from "The King Report on Governance for South Africa" (King III), Chapter 3. These sections have been reproduced with the permission of the Institute of Directors in Southern Africa.

The board is responsible for the governance of risk, and management is responsible for risk management. The board may delegate the oversight of risk to an appropriate board committee. This alert is drafted on the basis of separate audit and risk committees. Refer to Position Paper 6 – "The role of the audit committee in respect of risk".

Integrated reports[2]

Para 58-64

"The responsibility for a company's risk management function, specifically implementing risk management processes, is that of management.

The board should assign oversight of the company's risk management function to an appropriate board committee (for example a risk committee or the audit committee). Smaller companies need not establish formal committees to perform these functions but should ensure that these functions are appropriately addressed by the board.

The audit committee's charter should be clear on the scope of the audit committee's responsibilities for risk management.

Where the board assigns the oversight of the risk management function to the audit committee, the audit committee's responsibility for overseeing the risk management function should be identical to that of a risk committee in a company where a risk committee is separately established.

[2] Refer to Alert No. 3 – "Responsibilities of the Audit Committee with regard to Integrated Reporting".

The board should ensure that there is effective communication and coordination of its oversight activities to ensure that the audit committee is informed of all significant actual or potential financial and non-financial risks (such as operational, strategic, regulatory risks) that may have implications on the integrated report.[2]

Regardless of the board's method and framework of assignment of overseeing the risk management function, the audit committee should have an understanding of, and have an adequate level of comfort regarding, the company's process for identifying, managing and reporting on risk.

The audit committee should satisfy itself that the following areas have been appropriately addressed by itself, failing specific assignment by the board:

- *financial reporting risks;*
- *internal financial controls;*
- *fraud risk as it relates to financial reporting; and*
- *IT risks as it relates to financial reporting."*

Where the board assigns this responsibility to the audit committee, this should be carried out with careful consideration to the resources available to the audit committee for dealing adequately with risk governance in addition to its audit responsibilities.

Financial reporting risks

Para 65

"The audit committee should be responsible for overseeing financial risk management and controls and ensuring that the controls:

- *provide guidance that embeds internal financial control in the business processes and evolves to remain relevant over time*
- *follow a risk-based approach*
- *weigh up not only the likelihood of financial risks materialising but also the costs of operating certain controls relative to the benefit gained in managing these related financial risks i.e. the cost-benefit analysis."*

Internal financial controls

Para 67, 69, 70

"The audit committee should evaluate the nature and extent of the formal documented review of internal financial controls to be performed by internal audit on behalf of the board every year. Internal audit's review should cover all significant areas of financial reporting to enable the audit committee to perform its responsibilities to oversee the integrity of the integrated report, specifically financial information published by the company. The audit committee should ensure that internal audit has adequate capacity to perform such formal documented review. Management may assist internal audit to perform the review."

"The audit committee must conclude and report yearly to the stakeholders and the board on the effectiveness of the company's internal financial controls. Before the audit committee concludes and reports to the board on the effectiveness of internal financial controls, it should holistically consider all information brought to its attention from all sources, including communications with, and reports from, internal audit, other assurance providers and the management, as well as the external auditors."

"Weaknesses in financial control, whether from design, implementation or execution, that are considered material (individually or in combination with other weaknesses) and that resulted in actual material financial loss, fraud or material errors, should be reported to the board and the stakeholders. It is not intended that this disclosure be made in the form of an exhaustive list, but rather an acknowledgement of the nature and extent of material weaknesses and the corrective action, if any, that has been taken to date of the report."

Fraud risks

Paras 71-73

"The audit committee should:

- *review arrangements made by the company to enable employees and outside whistleblowers (including customers and suppliers) to report in confidence their concerns about possible improprieties in matters of financial and sustainability reporting, or non-compliance with laws and regulations that may have a direct or indirect effect on integrated reporting*
- *be aware of and approve any amendments to the company's code of conduct as it applies to integrated reporting and should satisfy itself that the management monitors compliance with the code of conduct*
- *consider matters that may result in material misstatements in the integrated report due to fraud;"*

Paras 74

"The audit committee must receive and deal appropriately with any concerns or complaints (whether from within or outside the company) or on its own initiative, relating either to the accounting practices and internal audit of the company or to the content or auditing of its financial statements, the internal financial controls of the company or to any related matter."

Information technology (IT) risk as it relates to financial reporting

Chap 5, Para 46-48

"Areas that are highly dependent on IT are more exposed if IT risks are not appropriately governed. The risk committee should obtain appropriate assurance that controls in place are effective in addressing these risks.

IT as it relates to financial reporting and the going concern of the company should be the responsibility of the audit committee. The risk committee has the responsibility to oversee the broader risk implications of IT.

The audit committee should also consider the use of technology and related techniques to improve audit coverage and audit efficiency."

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