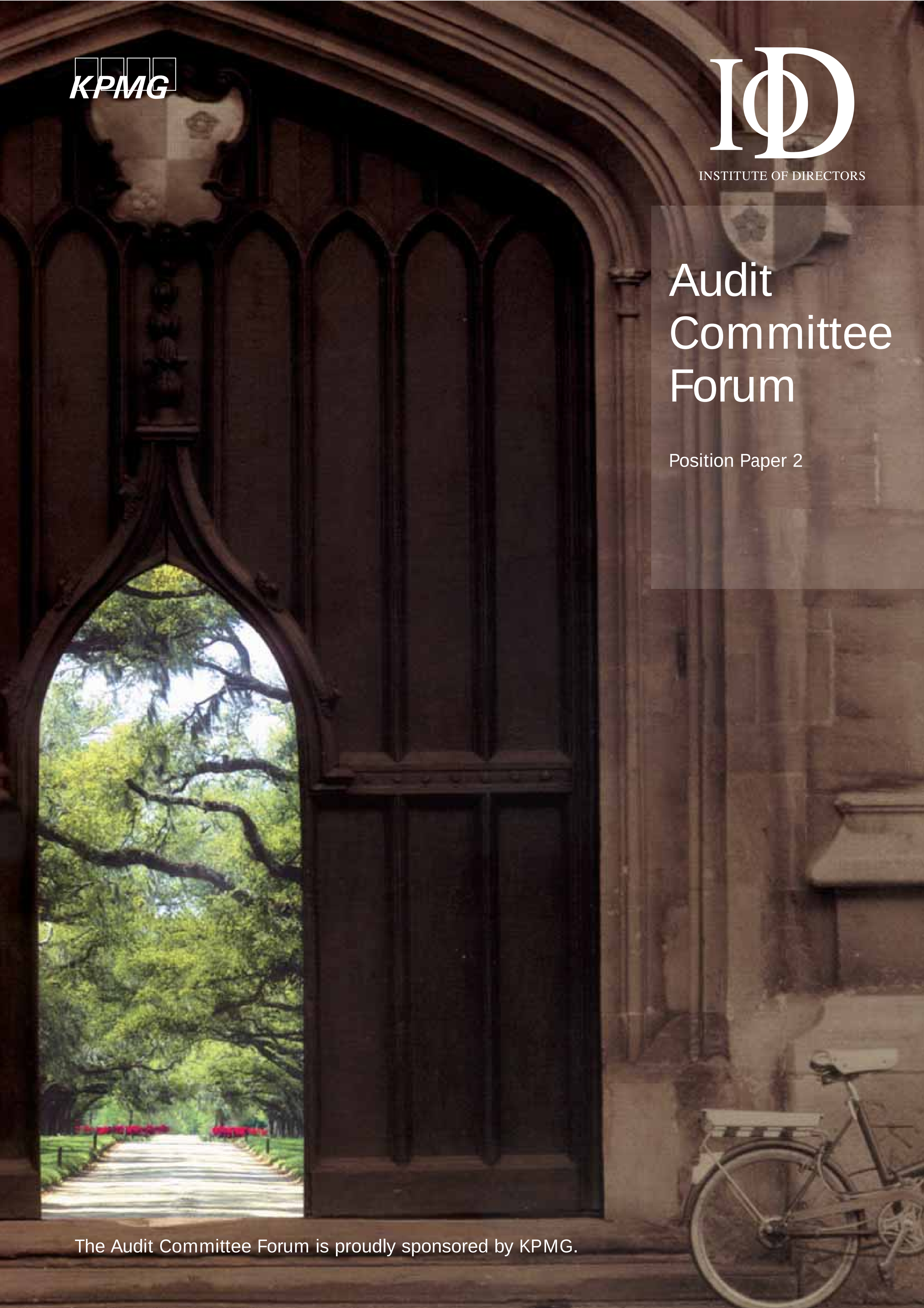

KPMG

INSTITUTE OF DIRECTORS

# Audit Committee Forum

Position Paper 2

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# Guidelines on questions that an audit committee could consider before recommending an entity's financial statements for approval by the board.



## Introduction

The scope of this position paper focuses on one aspect of the audit committee's responsibilities, and that is the considerations for review and approval of the financial statements. It is therefore not a comprehensive list of audit committee responsibilities.

## Types of assurance

The audit committee has three distinct providers of assurance over the accuracy, reliability and completeness of the financial statements at its disposal, namely management, internal and external audit. The audit committee has to have the necessary ability and financial literacy to use effectively these three forms of assurance in making an assessment of whether to recommend the financial statements to the board of directors for approval.

**Structure of paper**

This paper has been structured to detail seven items the audit committee should consider before discharging its responsibility for the fair presentation of the financial statements and the extent to which they can be relied upon. The audit committee has to assess whether it has the ability to ask appropriate questions and to critically assess management's, external and internal audit's responses under each of the seven categories. These categories form the basis for a framework for financial statement approval.

This paper has been structured to define the categories and to highlight the types of questions the audit committee member should be asking under each category within the framework.

## Summary

The audit committee has a significant responsibility in assessing the fair presentation of financial statements. It needs to effectively use its three separate forms of assurance namely management, internal and external audit, in approving the financial statements. It needs to ask pertinent, meaningful and specific questions of these assurance providers and consider the impact of their responses on the underlying financial statements.

In order to ensure that this is done it needs to adopt a framework covering the following seven broad categories:

- Review of financial reporting.
- Management overview of the financial results of an entity for the period.
- The suitability and applicability of accounting policies.
- The business transactions and accounting estimates presented in financial statements.

- Current developments in auditing, accounting, reporting and taxation.
- External auditors communication.
- Compliance with current regulatory environment.

The audit committee should obtain an undertaking from senior management, including executive directors and those present at audit committee or directors meetings, that they are not aware of any issues, happenings or transactions that would or could affect or influence the audit committee and/or the directors in recommending the approval of or approving the financial results, commentary and disclosure as tabled or distributed. This should be in the form of a formal management representation letter.

## Review of financial reporting

### Background

The audit committee assumes the responsibility to review the public financial reporting of the entity and should not focus only on the annual financial statements. This gives it a greater understanding of the entity and whether the financial statements are reliable and consistent with other results released. Information will vary from entity to entity, however, the committee should be reviewing the following types of financial information:

- Published financial results, including interim results;
- Public financial circulars eg, those pertaining to acquisitions;
- Earnings releases and financial announcements;
- Regulatory requirements pertaining to specific industries;
- Any other applicable adhoc issues as decided by the audit committee or as requested by the board.

The audit committee needs to understand the industry that the entity operates in. This will allow it to better understand the entity's financial results and the representations made by management through the financial statements.

### Considerations

- Do we as an audit committee have sufficient understanding of the industry within which the entity operates?
- Are we aware of the reporting requirements of the entity and the level of assurance or reliance placed on each of the reports issued?
- Have we understood the other financial information presented?
- Does management have a process to respond correctly to statutory and financial reporting changes and are these fairly presented?

The audit committee needs to understand how changes within the entity (such as mergers and acquisitions) and changes in its industry have been reflected in the financial statements.

- The audit committee also needs to exercise its judgement according to the complexity of the entity and the industry within which it operates and to this end should:
  - Seek input concerning the risk universe the entity operates in.
  - Seek expert or specialist input and guidance on compliance with the regulatory environment generally including the health, environment and safety concerns.
  - Enquire as to the processes in place, which management uses and relies upon in arriving at the assurance it seeks to give the board and the critical assumptions used in arriving at their conclusions.

## Management overview of the financial results of an entity for the period

### Background

The audit committee chairman should have an executive session with senior management, who present the results of the entity and justify the resultant performance. This presentation should compare the entity to its industry and its management's expectations. The audit committee members need to have seen and reviewed the financial results of the entity prior to presentation to the board. This will afford them the opportunity to assess and compare the results with industry, analyst and personal expectations.



It will also equip them with the ability to engage with management on the results presented.

### Considerations

Audit Committee members should consider whether the results:

- are consistent with their expectations having regard to the circumstances of the entity and the current environment of the industry within which it operates;
- are consistent with or adequately reconciled with the previous representations made by management;
- are in line with its discussions with other assurance providers, namely the internal auditors and the external auditors; and
- rationales presented are in line with its review of the financial results before their release.

## The suitability and applicability of accounting policies

### Background

The audit committee members need to assess the appropriateness and applicability of the accounting policies used by management. In order for them to be able to exercise this responsibility they need to be financially literate. Financial literacy is broadly defined as the ability to read and understand financial statements, including a balance sheet, income statement and cash flow statement. The definition is not limited to accounting and auditing standards and the members need to have a good financial understanding of the industry and economy within which the entity operates. The complex financial environment requires that at least one of the attendees needs to be proficient in understanding the implications of current and planned accounting and auditing standards.

### Considerations

- Are we as an audit committee financially literate and in a position to understand the accounting policies used by management?
- Is at least one of the attendees technically proficient and able to assess the entity's compliance with latest standards? Technical expertise should be sought in order for business judgement to be applied.
- Are the accounting policies used by management appropriate in terms of generally accepted accounting practice?

  Accounting policies are updated and amended on a continuous basis and management need to ensure that they respond timeously to these changes.
- Do we understand all changes to accounting policies, the rationale behind management changing the accounting policies and whether they have been appropriately disclosed?

  Management may have proposed to change an accounting policy during a period or adopt a new accounting policy. The audit committee needs to understand and critically assess the rationale for the change and approve management's decision.
- How do the accounting policies used by the entity compare to industry and the benchmark treatments proposed by the accounting standards?

## The results of business transactions and accounting estimates presented in financial statements.

### Considerations

*Management*

- Have management responded appropriately to the underlying transactions in place?

  The audit committee needs to understand how management has responded to the transactions and whether they have put sufficient control measures in place to address them.
- What is management's assessment of the overall control environment?

  The audit committee should get management's assessment of the internal control environment in order to gauge the reliance that can be placed on the system of control?

*Internal audit*

The various governance reports have recommended that management should put an effective internal audit department in place to provide, inter alia, additional assurance over the reliability of the financial statements. The audit committee needs to consider the following when assessing and approving the financial statements.

- Has the scope and extent of the risk-based internal audit been performed in terms of the approved internal audit plan?

- Is the Audit Committee still happy with the approved internal audit plan and its impact on the risk assurance they are seeking?

  Are there any significant changes in the entity's risk profile, which would result in a change to the internal audit plan?

- What were the internal audit findings and conclusions and are there any pending issues?

  The audit committee should get an understanding of the results of audit tests conducted on the different areas. It should also get an understanding of management's response to internal audits, and the potential impact on the financial statements of any poorly controlled areas.

  The audit committee should also review all pending internal audit issues reported that have not been resolved by management and assess management's response.

  – What is internal audit's assessment of the overall control environment?
    The audit committee should get internal audit's assessment of the internal control environment in order to gauge the reliance that can be placed on the system of control.

  – What is internal audit's assessment of the potential impact of the areas of significance or relevance that have not been tested during the period?

*External audit*
The audit committee needs to seek assurance from its external assurance providers over transactions reflected in the financial statements. The following items need to be considered by the audit committee.

- Were the material areas not tested by the internal audit department audited by the external auditors?

- The audit committee needs to know that the external auditors gathered sufficient and appropriate audit evidence to support their opinion. The audit committee needs to get an understanding of the results of these audit tests and any pending concerns.

- How comfortable are the external auditors with the internal control environment and the extent of reliance placed thereon?

- How comfortable are the external auditors that the financial statements fairly present the results of the transactions?

### Accounting estimates

*Background*
An accounting estimate is an approximation of the amount of an item/items in the absence of a precise means of measurement.

### Considerations

Accounting estimates are raised and processed by management based on their interpretation of a series of indicators. These estimates pose significant risk for the audit committee as they are outside the scope of transactions and processes and typically no systems control environment is in place to manage them, except for high-level managerial review. The audit committee needs to understand these transactions, their effect on the financial statements and, where it is applicable, to make the appropriate disclosures.

### Management

- What are the significant accounting estimates included in the financial statements?

  The audit committee needs to use its industry and business understanding to determine whether the accounting estimates raised by management are reasonable. The audit committee also needs to get an understanding of these accounting estimates and management's justification for them.

- Who has the authority to raise accounting estimates and what limited review procedures have been put in place?

  The audit committee needs to get an understanding of whether these estimates were reviewed by a competent and qualified member of senior management.

- Is management adopting a conservative or aggressive accounting policy by raising the accounting estimates?

  The raising of accounting estimates can either be aggressive or conservative and can have a significant effect on the reported results of an entity. The audit committee therefore needs to have

an understanding of the effect of accounting estimates on the financial statements. The audit committee also needs to assess various assumptions underlying accounting estimates in financial statements.

*External audit*

- How did the externals auditors gain sufficient and appropriate audit evidence to support the accounting estimates?
- A formalised control environment will not govern the processing of accounting estimates and the external auditors will have to substantively assess the accounting estimates raised by management through an understanding of the business and discussions with management. The audit committee needs to get an understanding of the approach followed and the results obtained by the external auditors.
- What are the external auditors conclusions on each of the significant accounting estimates processed?

  The external auditors will critically assess the accounting estimates processed by management and reach a conclusion on the suitability of these estimates. The audit committee needs to get an understanding of the areas where the external auditors differed from management in interpreting the factors used to justify the accounting estimate.
- How do these accounting estimates compare to the accounting policies and norms adopted by the client?

## Current developments in auditing, accounting, reporting and taxation

### Background

The audit committee provides assurance on the fair presentation of the financial statements and therefore needs to stay up to date and be aware of accounting, auditing and tax related issues affecting the entity and the industry within which the entity operates. At least one of the attendees should be technically proficient and able to assess the entity's compliance with latest standards.

### Considerations

*Auditing*

- The audit committee must have reasonable assurance that the assurance providers have the necessary competencies and resources to perform their functions; that the assurance providers have performed their functions; and that they have been properly assessed by the audit committee.

*Accounting*

The audit committee needs to ask and consider the response to the following types of questions.

- Have we as audit committee members stayed up to date with developments in the accounting standards that apply to the entity?
- Is the audit committee aware of the implication of new accounting standards on the accounting policies currently employed and the effect on the underlying financial results presented?

  A vital step that it performs is to review the reliability and understandability of the financial statements. If it is unable to interpret, apply and assess accounting standards adopted and pending, it will not be able to achieve its goal of corporate governance in this regard.
- Have we as an audit committee, access to specialist expertise as and when deemed necessary?

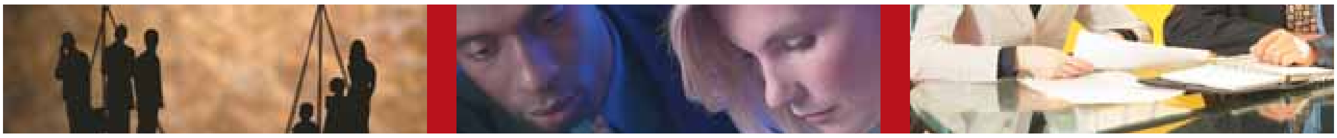
  The audit committee needs to put the necessary structures in place to ensure that it remains technically proficient.
- Have we asked the external auditor to brief us as committee members on any pending changes to the accounting standards?

  The external auditors are financial experts and need to be aware of all pending changes to accounting and auditing standards. The audit committee needs to request the external auditors to brief them on pending changes and their effect on the entity. The audit committee needs to enter into dialogue with the external auditors proactively.

*Taxation*

- What is the tax status of the entity and is this adequately reflected in the financial statements? Eg, up to date with tax returns and assessments. Is management adopting a conservative or aggressive taxation approach?

  The audit committee has to ask what the tax status of the entity is and whether the resultant tax liabilities or assets are appropriately reflected.
- Are the entity and the South African Revenue Services in dispute with



regard to the treatment of any item and has this been adequately reflected in the financial statements?

The audit committee needs to assess whether the disclosure of all tax related issues is complete and adequately reflected in the financial statements. The audit committee needs to have candid discussions with both management and the external auditors to identify any areas of dispute.

- Have we asked the external tax advisor to brief us as committee members on any pending changes to taxation?

## External auditors communication

### Background

The external auditors are the independent assurance providers to the shareholders of the entity and reach an independent conclusion regarding the fairness of the financial statements presented. The audit committee needs to use the external auditors extensively to achieve its goal of recommending financial statements for approval. The audit committee could consider asking the following questions of the external auditors.

### Considerations

- What is the final audit opinion expressed on the financial statements and how comfortable are the external auditors with their opinion?

  The external auditors will express either a modified or an unmodified opinion on the financial statements. The audit committee should enquire over any areas of concern and what matters were debated before the external auditors expressed their modified or unmodified opinion.

- In producing the final external audit report to the audit committee, they should report what items were omitted or amended at the specific request of management and why?

  The external auditors will prepare audit committee papers that are reviewed by local management prior to submission and this report may be altered or points omitted at the specific request of management. The audit committee should understand the details of all areas amended prior to audit committee approval.

- What are the areas where the external auditors were in direct dispute with management and how where these areas resolved?

  The audit committee needs to understand all areas of dispute between the external auditors and management. The understanding is required to ensure that the correct solution has been achieved and presented. These issues could be identified in a separate meeting.

- What is the nature and amount of the items reflected on the summary of unadjusted audit differences? The audit committee should have an understanding of the nature of the items reflected on the summary of unadjusted audit differences. This understanding should be used to assess the reliability of the underlying financial statements.

- What are the details of all accounting principles and policies applied by the entity for which there are acceptable alternative principles?

  The audit committee should request that the external auditors report on how the accounting policies adopted by the entity affect transparency, understandability and usefulness of the underlying financial information. These discussions should be used by the audit committee to determine whether the accounting policies used by management present the financial information faithfully, consistently and reliably.

- Have they identified and considered the impact of all special financial structures used (eg, special purpose vehicles)?

  The audit committee should request the external auditor to comment on material special purpose entities in operation at the entity and when these were created. It is intended that the audit committee be aware of the following types of transactions that may not be adequately reflected in the accounting records:

- Off balance sheet finance.
- Special purpose financing structures.
- Unusual transactions that affect ownership rights (such as leveraged re-capitalisation or joint ventures).
- What are the details of transactions entered into with related parties that are not in the ordinary course of business and have these been adequately disclosed?

Example of these kinds of related party transactions include compensation agreements, loans, related party leases, use of the entity's assets, or employment of close relatives.

- What unusual arrangements and/or transactions did you identify during the completion of the audit?

  Examples of unusual arrangements would include sale and leaseback of assets, self-insurance, etc. Such arrangements should be brought to the attention of the audit committee members to ensure that they understand how the financial reporting is being affected.

- What is your interpretation on the clarity and transparency of the financial statements prepared?

  Management, the audit committee and the external auditors should discuss the clarity and transparency of the financial statements and disclosures, to ensure that they are complete, accurate and a fair reflection of the past performance of the entity. This discussion will be dependant on how widely the financial statements are distributed.

- What is your assessment of the quality of the earnings?

  This would include, amongst others, concerns such as any use of provisions to smooth earnings, once-off adjustments, aggressive use of provisions, booking earnings too early and the sustainability of earnings as reported.

## Compliance with other legal and statutory requirements

The entity will be subject to numerous laws and regulations, some of which may be specific to the industry. The audit committee should ask the following types of questions of their three separate assurance providers and themselves in this regard.

- Are we and they aware of the legal framework within which the entity operates?
- Have they (the three assurance providers) performed any procedures to provide assurance to us, as the audit committee, regarding compliance with the relevant legislation, and what were the results of these procedures?
- Are we and they satisfied that sufficient work has been performed during the period testing compliance of the entity with the relevant legal framework? It may be necessary to obtain assurance from the compliance officer, where such a function exists.
- Has there been sufficient access to any necessary legal representation?
- Are any areas of non-compliance, past and present, adequately reflected in the financial statements?

## Conclusion

This position paper should assist audit Committee members in their consideration and review of the financial statements for recommendation to the board.

## Contact details

**Lindie Engelbrecht**
ACF National Co-ordinator
011 647 8778 or
lindie.engelbrecht@kpmg.co.za