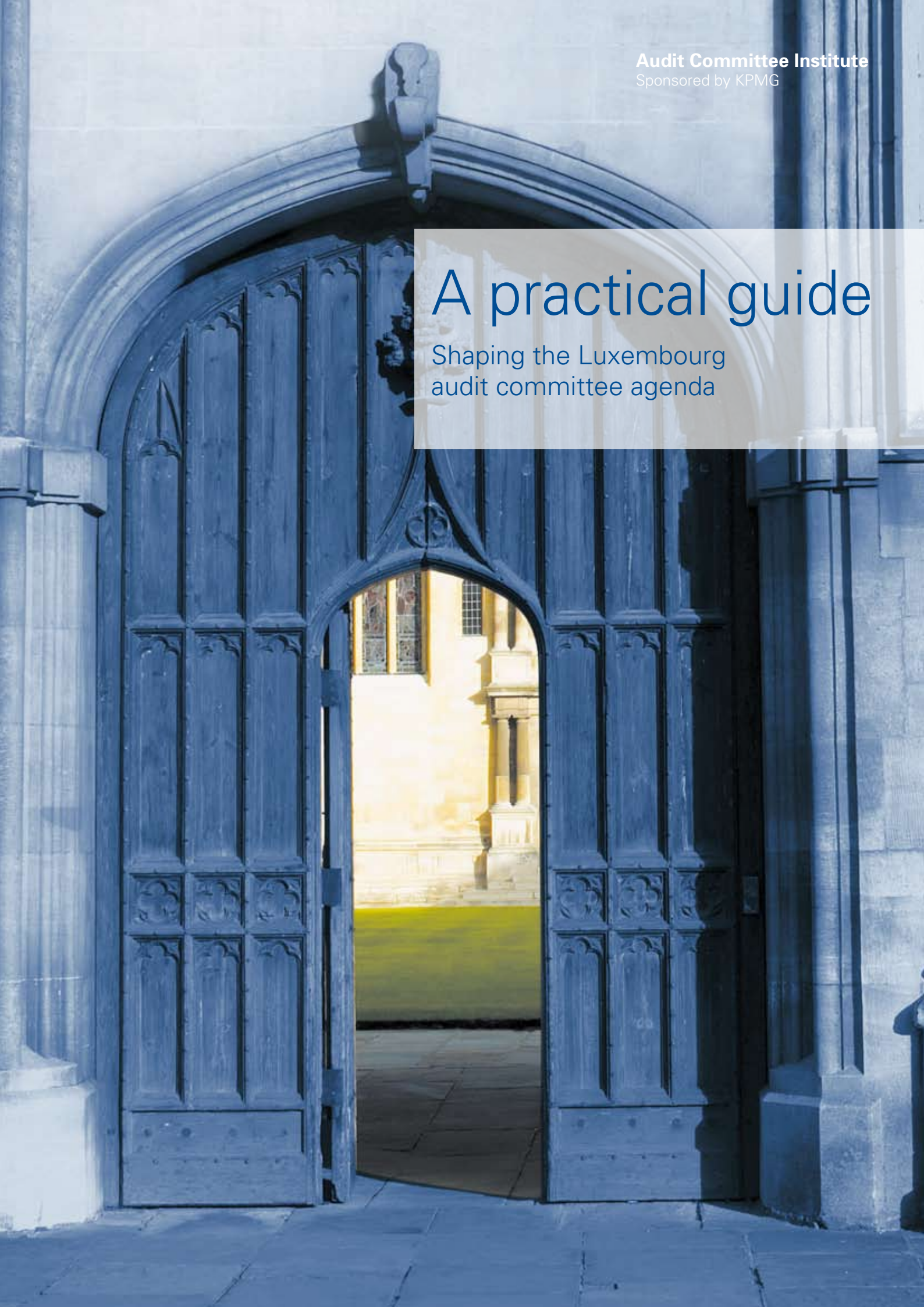


# A practical guide

Shaping the Luxembourg  
audit committee agenda



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# Foreword

By Mr John Li



We have great pleasure in introducing this practical guide for audit committees in Luxembourg. Historically, audit committees in Luxembourg have been set up on an entirely voluntary basis for various reasons, a few examples of which are: those who have experienced the benefits of such committees and have chosen to apply the concept in Luxembourg, those who have followed recommendations issued by a regulator, or those who have been encouraged by their groups to do so.

Given the increasing focus, both globally and in Europe, on the roles and responsibilities of those responsible for corporate governance and the financial reporting process, no doubt we shall be seeing more and more company leaders taking measures to reinforce their corporate governance processes, and thereby having to tackle the question as to whether to set up an audit committee or not. The EU eighth directive will even go further by removing this choice for listed companies and imposing the set up of an audit committee.

Contrary to popular belief, audit committees are not necessarily something for large companies. By bringing round the table a pool of highly skilled and experienced persons, audit committees often bring fresh ideas and act as a sounding board to questions and challenges which leadership faces, even in small and medium sized companies.

To assist company leaders in their process of setting up such a committee, the Audit Committee Institute has prepared a practical guide to serve as a basis for reflection and for indicating good practices used by a number of audit committees worldwide, including Luxembourg and its neighbouring countries. Through experience, we see that good audit committees are those who are able to apply, in a pragmatic and practical manner, the guidelines to the situation of their particular company and thereby deriving optimum benefits for their efforts.

Effective audit committees are supported by fundamental building blocks: an appropriate structure and foundation, reasonable and well defined responsibilities, and an understanding of current and emerging issues. Only through carefully designed practices can an audit committee maximise its contribution to an organisation.

We wish you well in your reflections, and we hope that this practical guide will be able to assist you in this process.

John Li,  
*Chairman,*  
Audit Committee Institute in Luxembourg



## Interview with Mr Patrick Zurstrassen, Chairman of The Directors' Office and Chairman of the Institut Luxembourgeois des Administrateurs (ILA)



*ILA*  
Institut Luxembourgeois  
des Administrateurs

**ACI:** Based on your experience as an audit committee member in different companies, do you see any differences and similarities in the modus operandi, role and composition of audit committees in these different companies?

**Patrick Zurstrassen:** I am currently participating in the audit committees of three companies of different size and activities.

The first audit committee, which is within a smaller company, serves mainly as an extension of the internal control system. Responsibilities for overseeing internal control are shared amongst the members of the audit committee.

The second audit committee, which oversees investment funds, is monitoring closely whether the audits of the annual accounts of the investment funds are taking place properly, and whether reports which are communicated to shareholders, such as semi annual accounts and prospectuses have been prepared and reviewed properly.

The third audit committee, which is within a large investment management company, follows a more classic and broader role found in larger sized companies, such as examining and approving the audit plan, reviewing of internal audit reports, reviewing of management letters, follow up of the status of actions taken as a result of recommendations made by internal audit and external audit, assessment of the external auditor, etc.

Also, all three audit committees are asked by the respective Boards of Directors for their views on a number of matters affecting the company, such as distributions, good execution, and tax compliance.

In terms of composition, I expect that the audit committees within larger organizations will tend to be more in line with international recommendations on this subject. From my own experience, if I look at the composition of the audit committee of the large investment management company, the audit committee members are non-executive directors, and the chairman is an independent director. Executive directors, internal auditors, the risk manager, the compliance officer and external auditors are invited as necessary to provide input on relevant agenda items.

**ACI:** As an audit committee member, what are your views on the optimum composition of an audit committee, especially in terms of the spread of experience of the members (financial, business, internal control)?

**Patrick Zurstrassen:** I believe that collectively, there should be sufficient experience around the table to enable the audit committee to fulfil its role properly. Experience of the industry and related financial and internal control matters increases the effectiveness of the audit committee. For more technical matters such as Value Added Tax, or certain questions relating to ethics (e.g. when operating in different countries), the audit committee may well need experts to help them in assessing the significance of such issues and in evaluating different potential solutions.

What is of considerable help but in short supply is an audit committee member who has had significant experience as an auditor in his/her past career and can therefore bring his/her experience to the benefit of the audit committee. In the USA, we see more audit committee members with such profiles, and this may even be a requirement in certain cases.

**ACI:** From your experience, what kind of tools would be helpful to audit committee members, in order to fulfil their role properly?

**Patrick Zurstrassen:** Three examples come readily to mind:

- The first one is a quarterly or semiannual letter issued by the external auditor to the attention of the audit committee. It is not meant to be a dry statement but contains information which adds value to the audit committee's work, such as important issues which the external auditor has come across during his work, together with action which has been taken by or which is pending from the company, problems identified with respect to new accounting policies and as to their application to the company's activities, significant claims received and status of provisions and more generally, on financial risks to which the company may be exposed.
- The second one is a management information system which enables the audit committee to quickly see progress which has been made a) in carrying out internal audit assignments in accordance to the approved internal audit plan, and b) on actions taken with respect to recommendations issued both by internal and external audit. The audit committee can then focus on items which are still open, and assess the appropriateness of future corrective action to be taken by the company.
- The third one is a classification of audit recommendations, on the one hand, in terms of importance and on the other hand, in terms of investment and efforts necessary to implement these recommendations. This enables the audit committee to get a better view of the key recommendations, and to compare the alternative solutions also in terms of costs versus benefits.





**ACI:** There is a myth that audit committees cannot bring a lot of value to smaller/medium sized/unlisted companies? From your experience, do you think that this view is justified?

**Patrick Zurstrassen:** We should break this myth. From my experience, a smaller company benefits from its audit committee as it thereby gets access to a pool of valuable knowledge and experience which otherwise is outside the company. Therefore, an audit committee functioning well within a small organization can often identify both business and internal control issues early enough for these to be managed, thereby avoiding unwanted financial and reputational consequences to the company.

**ACI:** Finally, based on your experience as a director, how do you see the audit committee adding value to the Board of Directors governance efforts?

**Patrick Zurstrassen:** In many cases, audit committees are composed of independent directors and are meeting just before the meeting of the Board of Directors, either the day before, or in the same day. As a result, the audit committee in practice is taking away certain items of the Board's agenda, discussing these in detail, and then providing feedback to the Board of Directors. The Board is then able to discuss and agree on the potential solutions more effectively and efficiently.



# Introduction



Audit committees need to understand the building blocks and the specific practices that can be used in implementing governance activities.

By comparing practices currently being performed to leading practices, an audit committee can identify and select a set of practices as the most effective and efficient in its particular circumstances. The terms of reference to be adopted by each audit committee will vary by company. Each committee should develop a set of practices that is considered best in its individual circumstances. An audit committee should not, however, avoid practices simply because they appear onerous. Often, those are the practices that may be most effective and should receive additional attention.

Audit committees have evolved from ad hoc committees with few defined responsibilities to what they are today: critical committees. While tailoring its own agenda to reflect the guiding principles, an audit committee must, of course, be aware of the growing regulation and legislation affecting its responsibilities.

The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange (hereafter 'The Ten Principles') state that 'the board should establish an audit committee from among its member to assist in the discharge of its responsibilities in the areas of financial reporting, internal control and risk management'. The Ten Principles provide also best practice recommendations and guidance to assist directors serving on audit committees. Best practice requires that every board should consider in detail whether its audit committee arrangements are best suited for its particular circumstances. However, audit committee practices need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company.

# The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange ('LSE')

The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange is based on a 'comply or explain system' that allows listed companies to deviate from the provisions of the Ten Principles when their circumstances so justify, subject to the provision of adequate explanation.

## **The Ten Principles:**

- 1 The company shall adopt a clear corporate governance structure;
- 2 The company shall have an effective and efficient board taking decisions in the corporate interest;
- 3 The composition of the board will be balanced so as to enable it to take well-informed decisions;
- 4 The company shall establish a formal procedure for the appointment of directors and executive managers;
- 5 The board shall take decisions in the best interests of the company;
- 6 The company shall regularly evaluate its performance and its relationship with the executive management;
- 7 The company shall set up an effective structure of executive management;
- 8 The company shall remunerate directors and executive managers fairly and responsibly;
- 9 The board shall establish strict rules, designed to protect the company's interests;
- 10 The company shall respect the right of its shareholders and ensure they receive equitable treatment.



Transparency is an essential ingredient of the Ten Principles, allowing external control to function effectively. The disclosure of information is done through two different documents: the Corporate Governance Charter posted on the company's website and the Corporate Governance Chapter in the annual report.

Although this publication focuses on practices that audit committee members can undertake to improve their effectiveness, an audit committee also needs the support of the board, management and the auditors. These people must work with the committee to help ensure the audit committee meets its objectives in a dynamic environment.



# Chapter 1

Creating and sustaining an effective  
audit committee





## Chapter 1

# Creating and sustaining an effective audit committee

**Relevant extract(s) from the Ten Principles<sup>1</sup>****Principle 3:**

The composition of the board should be balanced so as to enable it to take well-informed decisions. It should ensure that any special committees necessary for it properly fulfil its duties are set up.

**Recommendation 9.1:**

The board should establish an audit committee from among its members to assist in the discharge of its responsibilities in the areas of financial reporting, internal control and risk management. It should define the committee's internal regulations.

If the company does not have an audit committee, the need to create one should be assessed annually. Until an audit committee has been set up, the board should deal with these tasks and responsibilities, in close collaboration with the internal and external auditors.

Until such time as the board sets up an audit committee, it should meet at least twice a year with the internal and external audit to discuss issues corrected with financial reporting, internal control and risk management.

**Recommendation 9.2:**

The board or, where relevant, the audit committee, should regularly examine the effectiveness of the financial reporting, internal control and risk management system adopted by the company. It should make sure that the audits carried out and the subsequent audit reports conform to the audit plan approved by the board or the audit committee.

**Recommendation 9.3:**

The audit committee should be composed exclusively of non-executive directors. It should contain a sufficient number of independent directors. The chairman of the board should not chair the audit committee.

The board should ensure that the audit committee has access to the necessary skills to effectively fulfil its role, in particular in the area of finance.

The chairman of the audit committee should prepare minutes of its meetings.

The audit committee should be chaired by an independent director.

The audit committee should be composed of a majority of independent directors.

At least one of the members of the audit committee should have had training in finance or accounting.

<sup>1</sup> Luxembourg Stock Exchange, the Ten Principles of Corporate Governance of the Luxembourg Stock exchange, April 2006

Audit committees are established by boards to help discharge their responsibilities in the area of financial reporting, internal control and risk management  
*(Extract from recommendation 9.1 of the Ten Principles of Corporate Governance of the Luxembourg Stock 'LSE')*

Audit committees are established by boards of directors to help discharge their fiduciary responsibility. How the committee fulfils that mandate varies according to the abilities of the committee’s members, the clarity of the committee’s mission, and the tone set at the top of the governance structure. An audit committee that operates effectively is a key feature in a strong corporate governance culture and can bring significant benefits to the company. We present some of the characteristics and practices that, based on our experience, mark a strong and effective audit committee. We encourage each audit committee to review these characteristics, not as elements carved in stone, but as components in a process that can be - and should be - continually improved to enhance the committee’s effectiveness.

## Terms of reference

### **Audit committee terms of reference**

In essence, the focus of the audit committee’s terms of reference should define the scope of the committee’s oversight responsibilities and how these are to be discharged. The role of the audit committee is for the board to decide, and it should tailor its terms of reference to the company’s specific needs and clearly outline the committee’s duties and responsibilities, including structure, process and membership requirements. The terms of reference should ideally describe the background and experience requirements for committee members and set guidelines for the committee’s relationship with management, the internal and external auditors, and others.

An audit committee’s terms of reference and responsibilities should be coordinated with other committee responsibilities. Some companies have a risk committee, others have committees focused on a particular business risk (e.g., investment committee, compliance committee, etc). Care should be taken to define clearly the roles and responsibilities of each. Terms of reference should be detailed enough to clarify roles and responsibilities, but not so detailed that they include items that cannot be reasonably accomplished. The terms of reference should serve as a guide in establishing the audit committee work plan and meeting agendas. The work plan would specifically set out how the audit committee intends to fulfil each of its responsibilities, as disclosed in the terms of reference. Terms of reference prepared by the audit committee should be approved by the full board. Appendix 1 includes an example of an audit committee’s terms of reference to assist committees in creating or updating their complete terms of references consistent with the code and leading practices. It is very important that the audit committee reviews and approves the responsibilities laid out in the terms of reference and related work plan as each meeting’s agenda is set, and that all responsibilities are reviewed on at least an annual basis. This review could be incorporated into any self-evaluation process that the audit committee undertakes.

Once established, the audit committee terms of reference should be updated for any change at least annually. The annual assessment should reflect changes to the company’s circumstances and any new regulations that may impact the audit committee’s responsibilities. Changes should be recommended to the board.



The Ten Principles recommend that the audit committee's terms of reference be disclosed to shareholders through inclusion on the company web site's published Corporate Governance Charter. However, audit committees should be mindful of the implications of increased disclosure, and ensure they are not undertaking so many responsibilities that they cannot be reasonably accomplished.

## Choosing the right members



### How many?

The Ten Principles recommend that audit committees be composed exclusively of non-executive directors and should contain a sufficient number of independent directors. The board needs to satisfy itself that at least one member has recent and relevant financial experience. The size of the audit committee will, however, vary depending upon the needs and culture of the company and the extent of responsibilities delegated to the committee.

Ensuring that there is the 'appropriate' number of directors on the audit committee allows the committee to function efficiently, encourages all members to participate and provides for diversity of experience and knowledge. Committees of three to five individuals are generally most appropriate to achieve this. Appointments to the audit committee can be made by the board on the recommendation of the nomination committee (where there is one), in consultation with the chairman of the audit committee. Terms of three years, with staggered expiration dates to help ensure continuity, are common today.

### Rotation policy

Rotation of audit committee members can provide a practical way to refresh and introduce new perspectives to audit committee processes. Rotation also creates the opportunity for a greater number of board members to gain an in-depth and first-hand understanding of the functioning of the audit committee, which can contribute to board cohesion. However, given the complex nature of the role, this needs to be balanced with the desire to have members that possess the necessary accumulated knowledge to discharge their responsibilities effectively. Where a company has no formal rotation policy, it is important for the board of directors to evaluate an audit committee member's performance to help ensure that it meets both the board's and committee's expectations.

### Independence

This potential benefit is recognised by the Ten Principles which recommends that every board should have a sufficient number of independent directors. Audit committee independence is the cornerstone of the committee's effectiveness, particularly when overseeing a company's financial reporting integrity and evaluation of areas where judgments and decisions are significant. Audit committee members must be adept at communicating with management and the auditors and ready to ask key, probing questions about the company's financial risks, accounting and financial reporting.

The audit committee should be composed exclusively of non-executive directors. It should contain a sufficient number of independent directors  
*(Extract from recommendation 9.3 LSE)*

It is up to the board to assess the integrity and independence of an audit committee candidate, so every member's appointment is an occasion for careful deliberation. The board needs to have a good understanding of the relevant definitions of independence, and of how a lack of independence or conflict of interest situation may arise. The board should also be cognizant and mindful of situations in which the definition of independence is met, yet perceived conflicts of interest may still arise.

Appendix D of the Ten Principles provides further information on the notion of independence as elaborated by European Commission Recommendation, as given below.

The board needs to have a good understanding of the relevant definitions of independence, and of how a lack of independence or conflict of interest situation may arise

It is not possible to list comprehensively all threats to directors' independence; the relationships or circumstances which may appear relevant to its determination may vary to a certain extent across Member States and companies, and best practices in this respect may evolve over time. However, a number of situations are frequently recognized as relevant helping the board or supervisory board to determine whether a given non-executive or supervisory director is independent or not, even though it is widely understood that assessment of the independence of any particular director should be on substance rather than form. In this context, a number of criteria, to be used by the board or supervisory board, should be adopted at national level. Such criteria, which should be tailored to the national context, should be based on due consideration of at least the following situations:

- a) non-executive or supervisory director is not an executive director (or manager) of the company or an associated company and has not been in such a position for the previous five years;
- b) is not an employee of the company or an associated company, and has not been in such a position for the previous three years;
- c) does not receive, and has not received, significant additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director. Such additional remuneration covers in particular any participation in a share option or any other performance-related pay scheme; it does not cover the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior services with the company (provided that such compensation is not contingent in any way on continued services);
- d) is not and does not represent in any way a strategic shareholder with a 10% or greater holding;



- e) does not have, and has not had within the last financial year, a significant business relationship with the company or an associated company, either directly or as a partner shareholder, director or senior employee of a body having such a relationship. Business relationships include the situation of a significant supplier of goods or services (including financial, legal, advisory or consulting services), of a significant customer of the company, and of organisations that receive significant contribution from of the company or its group;
- f) is not, and has not been within the last three years, a partner or employee of the present or former external auditor of the company or an associated company;
- g) is not an executive director (or manager) in another company in which an executive director (or manager) of the company is a non-executive or supervisory director, and does not have other significant links with executive directors of the company due to positions held in other companies or bodies;
- h) has not served on the board or supervisory board as non-executive (or supervisory) director for more that twelve years;
- i) is not a close family member of an executive director or manager, or of persons in the situations referred to in point disclosed above.

The independent director undertakes:

- a) to maintain in all circumstances his independence of analysis, decision and action;
- b) not to seek or accept any unreasonable advantages that could be considered as compromising his independence; and
- c) to clearly express his opposition in the event that he finds that a decision of the board may harm the company. When the board has made decisions about which an independent non-executive or supervisory director has serious reservations, then that non-executive or supervisory director should draw all the appropriate conclusions from this. If he were to resign, he should explain his reasons in a letter to the board or the audit committee.

## Recent and relevant financial experience

The board should ensure that the audit committee has access to the necessary skills to effectively fulfil its role, in particular in the area of finance

*(Extract from recommendation 9.3 LSE)*

Like any other non-executive director, audit committee members should (at least as a group) possess a wide range of knowledge, skills and personal attributes: sound judgement, integrity and high ethical standards; strong interpersonal skills; and the ability and willingness to challenge and probe. Specifically, audit committee members must have expertise, or access to expertise, that goes beyond mere familiarity with financial statements. They must be able to understand the rules, and, more importantly, the principles that underpin the preparation of financial statements. They must be prepared to invest the time necessary to understand why critical accounting policies are chosen, how they are applied and satisfy themselves that the end result fairly reflects their understanding.

The Ten Principles state that the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience. It is sensible that the other members are, at least, financially literate. Recent and relevant financial experience is deliberately undefined - each board should determine its own criteria. However, it is clear that it must go beyond a basic familiarity with financial statements. Past employment experience that may include experience as a CEO, with financial reporting oversight responsibilities, or a finance director or a qualification in finance or accounting seems appropriate.

Meeting attendance also figures in the issues surrounding the financial expert debate. If an audit committee relies on the collective experience then what happens if one member does not attend a meeting? Does this mean that they do not have the requisite recent and relevant experience to operate? Equally, those audit committees that have identified one member as having the recommended experience need to be cautious of holding meetings when that individual is not in attendance.

Of course not every member need have recent and relevant financial experience. Indeed there is great value in having members of the committee from diverse backgrounds who are not afraid to ask the obvious questions which others have taken for granted, or perhaps are too afraid to ask. This being said, the committee as a whole must possess sufficient financial acumen to discharge their responsibilities effectively.

## A US requirement – financial expert

In determining whether the audit committee has a member with recent and relevant financial experience, the board may also consult existing definitions and guidance issues by other regulators, to decide on criteria which it wants to retain. For example, the Securities Exchange Commission's (SEC) defines a financial expert as a person who has all of the following attributes:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

The SEC rules go on to set out that an individual may not be considered an audit committee financial expert solely by virtue of prior service as an audit committee member. An individual must have acquired the attributes of an audit committee financial expert through:

- education or experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or
- other relevant experience.

An individual may not be considered an audit committee financial expert solely by virtue of prior service as an audit committee member



## Personal qualities and experience

Members should have experience in areas pertinent to the entity

In determining the composition of the audit committee, it is important to balance formal qualifications with consideration of personal qualities and relevant experience. In some circumstances, it may be more appropriate for the audit committee to seek expert advice as the need arises, rather than trying to maintain particular expertise within the audit committee at all times. The members of the audit committee should, as a group, possess a wide range of knowledge, skills and personal attributes including:

- integrity and high ethical standards;
- strong interpersonal skills;
- sound judgement;
- the ability and willingness to challenge and probe; and
- the time and personal commitment to perform effectively.



Members should have experience in areas pertinent to the entity. A committee's effectiveness in performing its mission can be enhanced by, and is often dependent upon, the members' experience, knowledge and competence in business and operational matters, financial reporting, internal controls and auditing. It is important that the audit committee is not reliant solely on management to provide it with such experience.

## The audit committee chair

The chairman of the board should not chair the audit committee  
*(Extract from recommendation 9.3 LSE)*

Effectiveness and true independence often hinge on the chair's effectiveness. The essential characteristics of a strong chair are often personal attributes. The chair should be recognised for his or her leadership and vision, and be perceived by other committee members and management as able to set and manage the audit committee's agenda. The chair should be acknowledged as having the personal courage to raise and deal with tough issues and support other members to do the same.

Formal meetings of the audit committee are at the heart of its work. They are not, however, its only point of contact with the company. The audit committee chair and, to a lesser extent, the other members need to keep in touch with the board chairman, the chief executive officer, the chief financial officer, the external audit partner and the chief internal auditor, as well as senior members of those audit teams. In many companies, the audit committee chair meets regularly with each of these individuals as part of the process of developing the meeting agenda and preparing for each meeting. A successful audit committee chair should not only understand the importance of the audit committee's relationships with these individuals but also has the interpersonal skills to build and maintain effective working relationships.

## Audit committee compensation

The audit committee should be provided with sufficient resources to undertake its duties

In many public companies worldwide, the remuneration committee recommends the compensation for directors, usually considering a director's committee participation. Some boards have increased the remuneration for audit committee members, acknowledging the increasing demands: the frequency and duration of meetings, the significant preparation time required, and the onerous responsibilities assumed on behalf of the full board.

## Resources for the audit committee



The audit committee should be provided with sufficient resources to undertake its duties. It should have access to the services of the company secretary on all audit committee matters including: supporting the chair in planning the audit committee's work and drawing up meeting agendas, maintaining minutes, drafting material about the committee's activities for the annual report, collecting and distributing information, and other support as needed. As noted earlier, the chair must maintain the committee's independence while securing the necessary input and support from management. The board should also make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the audit committee reasonably believes it necessary to do so.

## Induction for new members

The company ensures that new directors receive an induction into the way the company functions, enabling them to contribute in the best possible manner to the work of the board  
(Extract from recommendation 3.6 LSE)

It is now common practice to provide a formal induction programme for new board members. This helps to ensure they understand their responsibilities, current issues and the intricacies of the particular company. The programme may include meetings with senior management and site visits; the objective of which is to give new board members an insight into the operation of the business. Given the complex nature of the audit committee's role, additional time may be spent with new audit committee members to help ensure that they are aware of their particular responsibilities and the expectations of the board.

This programme can include:

- providing copies of:
  - the committee's terms of reference and recent committee minutes and presentations to the board;
  - relevant company policies, including the code of conduct and whistle-blowing policy;
  - the most recent annual and interim reports to shareholders;
  - management's and any auditor's report on the effectiveness of internal control over financial reporting;
  - recent press releases, material change reports and correspondence with any securities regulatory authorities;
  - the internal audit terms of reference, work plan and recent reports to the audit committee;
  - the external auditor's work plan, the most recent year-end report to the audit committee and the most recent management letter;
- obtaining an explanation from management and the internal auditor of the company's control, risk and compliance frameworks;
- meeting with management to discuss current audit and financial reporting issues including significant accounting policies and estimates, unusual transactions, outstanding contingencies and litigation; and
- being introduced to the internal and external auditors. Written materials should support oral presentations, so that new audit committee members have appropriate reference materials and tools as a result of the induction programme.

Newly appointed board members may feel overwhelmed if they are given all the necessary information on their first day. It is important that the company secretary, or appointed person, plans the director's induction so that the programme is staggered over a suitable period of time. After a few months on the board, they should be given an opportunity to review the induction programme and raise questions on any areas.

## Ongoing professional development

All members should seek periodic continuing professional education both inside and outside the boardroom

Change is never-ending, not only in the area of financial reporting but also in regulatory compliance, technology and business risk. It is essential that members have sufficient training to enable them to keep abreast of such developments. The committee chair, in consultation with the board, should monitor the needs and opportunities for further education. All members should seek periodic continuing professional education both inside and outside the boardroom. Management, internal and external auditors, and legal counsel are sources of background information and training for audit committee members. Periodic briefings, reports and presentations for audit committee members should cover operational and financial issues specific to the company and the industry, and updates on new accounting, auditing and regulatory standards. Companies should offer, and audit committees should insist on, the kind of training that could enhance their financial literacy and make it possible for them to fulfil their fiduciary responsibilities.



# Chapter 2

Running an effective audit committee





## Chapter 2

# Running an effective audit committee



The question 'what makes an effective audit committee?' has a different answer for each organisation

### Relevant extract(s) from the Ten Principles

#### Recommendation 9.5:

The audit committee should regularly evaluate its own effectiveness and make recommendations to the board for the necessary adjustments in its internal regulation

The question 'what makes an effective audit committee?' has a different answer for each organisation. What may work within one organisation may be wholly unsuitable for another. Of course, there are varying degrees of effectiveness and the characteristics of any given audit committee will, to some extent, be influenced by the culture of the company.

An audit committee that strives to add value in addition to achieving basic compliance is likely to discharge its oversight responsibilities more effectively. For this to be achieved the relationship between the chief finance officer (CFO) and the audit committee, particularly the chairman, should be one of trust and mutual respect. Those audit committees that work best are kept well informed by their CFOs and in return the committee constructively challenges and supports the CFO. Similar relationships between the audit committee and the internal and external auditor can also enhance effectiveness.

Whilst it is difficult to give precise formulae on what marks a strong and effective audit committee the following practices are some that audit committees may consider.

## Setting meeting agendas

A detailed agenda helps to keep the committee focused. Effective agendas are set with input from the CEO, CFO, and the internal and external auditors. The audit committee chairman, however, needs to maintain accountability for the agenda and not delegate it to management.

The meeting agendas should be carefully linked to the committee's terms of reference and detailed annual work plan. A wide-ranging work plan helps members stay focused on their job. However, the nature of audit committee responsibilities and the ever-changing environment in which companies operate make it difficult to determine a fixed agenda of topics for each meeting. The committee should assess what is currently important and develop its agenda accordingly.

The audit committee should meet as often as it deems necessary, but at least twice a year  
 (Extract from recommendation 9.6 LSE)



The audit committee agenda for the year should ideally originate from a detailed work plan. In turn, the detailed work plan would originate from the terms of reference. Appendix 2 includes a sample of audit committee agenda topics that should be considered when developing a detailed audit committee agenda for the year. A sample audit committee agenda for the year is presented as Appendix 3. It provides an annual framework for planning the agendas that could be covered in each audit committee meeting for a committee that meets at least four times a year. Management should make sure that the audit committee receives the meeting agenda and supporting materials in a timely manner to enable committee members to give full and proper consideration to the issues.

Because matters to be discussed by the audit committee may be of interest and importance to other directors, many audit committee chairmen routinely send the agenda for upcoming audit committee meetings to the board chairman, who communicates it to others on the board. Interested directors can then contact the audit committee chairman who can decide who should attend the meeting.

It is important that the audit committee is clear on what its responsibilities are and attempts to stick to its annual agenda.

## Meeting frequency and timing

The audit committee may invite any other person whose collaboration it deems to be advantageous to assist it in its work and to attend its meeting  
 (Extract from recommendation 9.4 LSE)

The audit committee should meet as often as its role and responsibilities require. The Ten Principles for audit committees recommend that there should be no fewer than two meetings during the year, held to coincide with key dates within the financial reporting and audit cycle. A number of Luxembourg companies have an average of three audit committee meetings a year. The following diagram illustrates the result of a survey carried out by the KPMG Audit Committee Institute in 2007, on the number of audit committee meetings in different countries or regions.



Having sufficient time available at each meeting is critical. The committee must be able to cover all agenda items, undertake as full a discussion as may be required and enable all parties to ask questions or provide input. There should be sufficient time for the audit committee members only to have a private session at each meeting.

An appropriate interval should be allowed between audit committee meetings and main board meetings to allow any work arising from the audit committee meeting to be carried out and reported to the board as appropriate.

## Meeting attendees

No one other than the audit committee members should be entitled to attend any meeting of the audit committee. It is the audit committee itself that should decide who should attend any particular meeting (or part of a meeting).

As noted previously, circulating the meeting agenda to the board chairman may generate interest from other independent directors and the chairman. The audit committee may also choose to invite specific directors or members of another board committee because of their knowledge and perspective on the issue being discussed.

Many audit committees regularly invite the CFO, the external audit partner, chief internal auditor, and perhaps the CEO to attend committee meetings. The CEO often has valuable insights to share, but the chair of the audit committee should make sure that the CEO does not inhibit open discussion at the meeting. In addressing a significant and complex issue, some audit committees choose to invite all directors - essentially operating as a 'committee of the whole' with the meeting chaired by the audit committee chairman. This approach enables all directors to understand the issue and apply their knowledge to an important issue.

## *In camera* or private meetings

It should be authorized to meet with individuals without the presence of any executives. It should meet with the internal and external auditors at least once a year without the presence of any executives  
(Extract from recommendation 9.4 LSE)

Increasingly, many audit committees are beginning their meetings with only the committee members present. According to these committees, starting the meeting *in camera* gives the members a good opportunity to discuss any issues or concerns among themselves and positions them to understand and also challenge management and the auditor at the audit committee meeting.

At some point during the audit committee meeting, many committee agendas provide for the audit committee to hold separate *in camera* or private meetings with the external auditor. Frequently, such sessions are held at the end of the scheduled audit committee meeting. The executives are asked to leave, and the committee then invites comments from and asks questions of, the external auditor. The audit committee should also meet *in camera* with the chief internal audit executive at key points during the year.

## Identifying issues early

Questions of substance should not be raised for the first time at the year-end audit committee meeting. Serious problems may result if there are unexpected answers. If the year-end audit committee meeting is to be conducted effectively, the chair should be communicating with financial management as well as the internal and external auditors during the weeks before the meeting. The chairman

should also bring matters of potential concern to the attention of the audit committee members ahead of time. The relationship with the auditors should be such that any serious concerns are brought to the audit committee's attention promptly, but in a non-adversarial way.

An effective annual plan for meeting agendas can help the audit committee identify issues and discuss them as early as possible during the year. Management should be expected to discuss key accounting estimates and subjective adjustments for each accounting period. The external auditor should periodically discuss the appropriateness of accounting, including accounting alternatives and choices made by management.

## Audit committee reporting

After each meeting of the audit committee, its chairman should make a report to the board, identifying the issues in respect of which he considers that action or improvement is called for and making recommendations on the measures that should be taken  
(Extract from recommendation 9.7 LSE)

### Reporting to the board

Minutes should be prepared, circulated to external and internal auditors as appropriate, and approved by the audit committee. Important documents related to the meeting, including the agenda, should be attached to the minutes. The audit committee chair should report to the board after every audit committee meeting, in sufficient depth, to enable the board to fulfil its oversight responsibilities. The chairman's report should reflect the committee's views of what happened in the meeting, not management's. Each board should decide whether that report should be provided in writing or orally, and whether the minutes and related documents should be provided to all directors.

### Reporting to shareholders

There is no specific recommendation for audit committee reporting to shareholders in Luxembourg. In certain countries, boards may disclose some of the following, in relation to audit committees, in their annual report and accounts:

- the name of each audit committee member and matters pertaining to the members' independence;
- the number of meetings of the audit committee and individual attendance by directors;
- the work the audit committee has undertaken during the year to discharge its responsibilities;
- where there is no audit function, the reasons for the absence of such a function;
- where the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, a statement from the audit committee explaining the recommendation and the reasons why the board has taken a different position; and
- an explanation of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

The audit committee should regularly evaluate its own effectiveness and make recommendations to the board for the necessary adjustments in its internal regulations  
(Extract from recommendation 9.5 LSE)

### Assessing audit committee effectiveness

The audit committee should regularly assess its own effectiveness and the adequacy of its terms of reference, work plans, and forums of discussion and communication by:

- questioning the board about its satisfaction with the committee's performance;
- comparing the committee's activities to the relevant recommendations of the Ten Principles;
- comparing the committee's activities to leading/current practices;
- comparing the committee's activities to the terms of reference and any other objectives the board set for the committee; and
- consulting with external auditors to improve the audit committee's performance.

Any necessary changes should be recommended to the board. Appendix 4 – Audit committee self-assessment, is a suggested framework for an audit committee's annual review of its own effectiveness and the adequacy of its terms of reference and work plans. The results of the evaluation and any action plans arising should be reported to the board after discussion with the chairman of the board. Each year, the board should also make its own assessment of the performance of the audit committee's effectiveness, requesting feedback on the committee's performance from senior management, and the internal and external auditors.

### What can make an effective audit committee chairman?

Someone who is:

- an independent proactive leader with confidence and integrity;
- a highly respected and experienced director, who possesses strong financial literacy skills and time available to develop and closely monitor the committee agenda;
- a person with an excellent working knowledge of an audit committee's functions and risk management frameworks;
- a good listener and communicator and one who can facilitate successfully;
- able to champion open and frank discussion with discipline; and
- tenacious and prepared to ask the tough questions.





# Chapter 3

Overseeing financial reporting  
and disclosures





## Chapter 3

# Overseeing financial reporting and disclosures

## Relevant extract(s) from the Ten Principles

### Recommendation 9.1:

The board should establish an audit committee from among its members to assist in the discharge of its responsibilities in the areas of financial reporting, internal control and risk management. It should define the committee's internal regulations.

If the company does not have an audit committee, the need to create one should be assessed annually. Until an audit committee has been set up, the board should deal with these tasks and responsibilities, in close collaboration with the internal and external auditors.

Until such time as the board sets up an audit committee, it should meet at least twice a year with the internal and external auditors to discuss issue connected with financial reporting, internal control and risk management.

### Recommendation 9.2:

The board or, where relevant, the audit committee, should regularly examine the effectiveness of the financial reporting, internal control and risk management system adopted by the company. It should make sure that the audits carried out and the subsequent audit reports conform to the audit plan approved by the board or the audit committee.

### Recommendation 9.9:

The audit committee should assist the board in monitoring the reliability and integrity of the financial information provided by the company, in particular by reviewing the relevance and consistency of the accounting standards applied by the company.

## Audit committee responsibilities

The board of directors is responsible for presenting a balanced and understandable assessment of the company's position and prospects.

The Ten Principles state that the board can be assisted in its role by charging the audit committee with the specific responsibility of monitoring the integrity of the financial statements of the company and any formal announcements.

The audit committee's responsibilities can and usually include the following

- to consider significant accounting policies, any changes to them, and any significant estimates and judgements; and
- to review the clarity and completeness of disclosures in the financial statements and consider whether the disclosures made are set properly in context.



Where, following its review, the audit committee is not satisfied with any aspect of the proposed financial reporting by the company, it shall report its views to the board.

To fulfil these responsibilities the audit committee must understand current developments and emerging issues affecting financial reporting and disclosure such as application of new standards, e.g. International Financial Reporting Standards ('IFRS'), changes in regulatory reporting, and increase in the level of disclosures as a result of changes in rules and regulations.

## Reviewing financial statements and related information

### Understanding the context for financial reporting

Clearly understanding the company's financial statements is crucial for audit committee members. Audit committee members need to begin by understanding:

- management's responsibilities and their representations to the committee;
- management's remuneration plan, including both the cash and non-cash components and, in particular, the incentive components in order to assess their motivations;
- the external auditor's responsibilities under generally accepted auditing standards;
- the nature of critical accounting policies, judgements and estimates; and
- unusual transactions.

In overseeing the company's financial reporting, the audit committee must remember that its responsibilities extend throughout the year, covering if applicable quarterly as well as annual financial statements, and earnings press releases. Because of this year-round focus, audit committees should be confident that they are being made aware of any accounting policy or disclosure issues or changes, and that this information is being communicated to them early enough to enable appropriate action to be taken.

In fulfilling their responsibilities, many audit committees look to the external auditor for year-round support.

These audit committees use the auditor's insights to help identify potential issues early and to help the audit committee oversee the quality and reliability of the company's periodical financial information.

In overseeing the company's financial reporting, the audit committee must remember that its responsibilities extend throughout the year



### Assessing financial statements and related disclosures

Management, not the audit committee nor the external auditor, is responsible for preparing complete and accurate financial statements and disclosures in accordance with generally accepted accounting principles and other applicable rules and regulations. The audit committee needs to understand and assess the financial statements and related information. The committee's relationship with management and the external auditor should allow a full, frank and timely discussion among the three parties, covering all material issues.

At the core of the audit committee's discussions with management and the external auditor should be their assessment of the appropriateness of the company's accounting policies, underlying judgements and estimates, and the transparency of the financial disclosures in reflecting financial performance. The discussion should consider the numerous qualitative factors that can affect financial statements.

The committee's relationship with management and the external auditor should allow a full, frank and timely discussion among the three parties, covering all material issues

### Critical accounting policies, judgements and estimates

The audit committee needs to understand and assess the quality, not just the acceptability, of critical accounting policies, judgements and estimates by asking such questions as:

- How appropriate is management's selection of accounting principles and critical accounting policies?
  - Have they changed in the current period? Why have they changed?
  - How might the changes affect current and future financial statements?
- What are management's judgements and critical accounting estimates?
  - What are the key assumptions behind those estimates?
  - How sensitive are current and future financial statements to changes in those assumptions?
  - What is the relative degree of aggressiveness or conservatism in the resulting estimates?
  - Is there potential management bias in developing the estimates?
- What are the alternative accounting treatments?
  - What are other comparable entities in similar circumstances doing, based on publicly available information?
- Is the external auditor satisfied that the accounting policies, judgements, and estimates made by management reflect an appropriate application of IFRS or Luxembourg Generally Accepted Accounting Principles (GAAP)?

Overall, the audit committee needs to assess the completeness, clarity and transparency of the financial statements and related disclosures

#### **Unusual transactions**

The audit committee should assess the treatment of any unusual transaction, asking the questions above in terms of the accounting policies, judgements and estimates relating to the transaction, as well as such transaction-related questions as:

- What is the business rationale?
- Is the transaction disclosed in the financial statements?
- What is the effect on the comparability of financial condition and performance among past and future periods?
- What are the factors affecting the accounting for any unusual transaction?
- How appropriate and clear is the disclosure regarding any commitments, contingencies, and uncertainties associated with the unusual transaction?

#### **External auditor's recommended audit adjustments and disclosure changes**

The audit committee should review the external auditor's recommended audit adjustments and disclosure changes, focusing on both the adjustments and changes made by management and those that management has not made. To establish a framework for these reviews, the audit committee should:

- tell the external auditor and management what audit differences the audit committee wants to hear about - material audit differences or a broader definition;
- convey its expectations that the external auditor should promptly identify, discuss with management and the audit committee, and recommend audit adjustments and disclosure changes;
- understand the reason behind any mis-statements;
- encourage management to adjust for all audit differences.

### Completeness, clarity and transparency of financial statements and related disclosures

Overall, the audit committee needs to assess the completeness, clarity and transparency of the financial statements and related disclosures, by asking such questions as:

- Do the financial disclosures consistently reflect the company's financial performance?
- How clear and complete are the financial statement note disclosures?
- What are other comparable entities in similar circumstances doing, based on publicly available information?

Management and the external auditor can greatly assist the audit committee in understanding and assessing these matters by providing the committee with clearly written materials, augmented with face-to-face discussions.

### Areas for attention

Specific areas of accounting require special attention. They can be particularly vulnerable to interpretations that may adversely affect the quality of reported earnings:

- **Revenue recognition:** Recognising sales revenue before a sale is complete, or at a time when the customer still has options to terminate, void or delay the sale, has attracted great attention in recent years. This area is particularly important for companies where the focus is on revenue rather than profit.
- **Changing estimates:** Changing estimates to make the numbers is another frequently used method for managing earnings. While changes to estimates may be perfectly acceptable when supported by real economic facts, all too often estimates are altered when the underlying economics of the business do not support the change, and without any disclosure to investors. Investors end up having to make investment decisions based on numbers that lack transparency, consistency and comparability.
- **Abuse of the materiality concept:** Errors may be intentionally recorded under the assertion that their impact on the bottom line is not significant. Even if materiality or significance is sometimes hard to define, the audit committee needs to consider whether and to what extent any identified error represents a threat to the general concept of investor protection or key stakeholder protection, and also therefore a reputation risk for the company.
- **Capitalisation and deferral of expenses:** Costs that should be accounted for as a cost of the period may be capitalised or deferred. The capitalising and deferring of such costs can occur through, for example, ambiguously defined capitalisation criteria for property, plant and equipment and intangible assets, unreasonable amortisation periods, or the capitalisation of costs for which future economic benefits are not reasonably assured.



## Keeping up to date with financial reporting developments

The past few years have been marked by rapid and widespread developments in financial reporting. These developments reflect the increasingly complex and innovative transactions in today's business world, and address the growing information needs of the users of financial statements.

International harmonisation and convergence of accounting standards has brought about radical change to financial reporting by way of International Financial Reporting Standards (IFRS). This is particularly challenging in Luxembourg where certain companies currently have a choice of two financial reporting regimes: Luxembourg GAAP or EU-adopted IFRS.

It has become increasingly difficult for boards to keep up to date with new developments in financial reporting, especially for companies that have additional reporting responsibilities in the US or engage in a wide variety of business transactions. For example, a company faces stringent and complex accounting requirements if it employs stock-based remuneration, engages in derivative or off-balance-sheet transactions, sells products through innovative sales channels or has recently completed one or more business acquisitions.

As part of their oversight responsibilities, audit committees must satisfy themselves that:

- management has sufficient resources devoting appropriate attention to understanding recent developments in financial reporting; and
- the application of new requirements is appropriate in light of the nature of the business and significant transactions.

Audit committee directors must educate themselves to keep their knowledge up to date. Audit committees should ask management and/or the external auditor to describe and explain recent developments in financial reporting. What is required is more than a general update. Audit committee members must clearly understand if and how the developments or changes will affect their particular organisation. Timing can be also critical. The discussion should occur well before any standard comes into effect. Before management has developed the systems to support an accounting standard change, the audit committee needs to have a meaningful discussion of what tough judgements management may have to make in applying the standard.

Audit committee members must also stay abreast of changes in such areas as securities exchange and regulatory matters, corporate law, risk management and business trends. These education needs can be met by attending external courses and conferences, roundtables or discussion forums; through self-study and reading; or by web-based learning.

Audit committees should be equipped to ask probing questions of management as to how new reporting standards influence and affect the financial reporting of the company.







# Chapter 4

Overseeing financial risks  
and internal control processes





## Chapter 4

# Overseeing financial risks and internal control processes



## Relevant extract(s) from the Ten Principles

**Recommendation 9.10:** the audit committee should assist the board at least once a year to review the internal control and risk management systems, with a view to ensuring that the main risks have been correctly identified, managed and disclosed.

Audit committee members must be critically aware of and clearly understand their oversight responsibilities for the organisation's financial risks and internal control processes. Some audit committees find the oversight of this area challenging because it encompasses a broad and difficult subject. In practice, many effective audit committees perform their oversight by demanding relevant, timely and accurate information from senior management, the internal auditor and the external auditor, and by asking direct and challenging questions.

## Responsibilities for risk oversight

The audit committee's role in overseeing financial risks and internal control processes should be established within the context of the overall risk responsibilities of the board of directors and management.

Risk management involves identifying risks that may prevent an organisation from achieving its objectives, analysing those risks, avoiding certain risks, and transferring, mitigating or accepting the risks that remain. An organisation's critical risks can be wide-ranging - including, for example, risks affecting reputation, ethics, technology, health, safety and the environment - not just financial or insurable hazards.

Management is responsible for identifying, assessing, managing and monitoring risk; developing, operating and monitoring the system of internal control; and providing assurance to the board that it has done so.

The board of directors is ultimately responsible for assessing the principal risks of the enterprise, approving the level of risk tolerance and overseeing the management of the risk it faces.

The entire board should participate in active oversight of risk on an enterprise-wide basis. Because some risks are highly technical or complex, boards often delegate the detailed work of overseeing certain risks to specific board committees. In such cases, the board retains overall responsibility for these risks, and must take care to review actively and thoroughly the risk reports.

The audit committee, as a committee appointed by the board of directors, is responsible for assisting the board in fulfilling its oversight responsibilities



The audit committee, as a committee appointed by the board of directors, is responsible for assisting the board in fulfilling its oversight responsibilities. In particular, the audit committee's primary duties and responsibilities are usually to monitor the management of the principal risks that could impact the financial reporting process of the company, monitor the integrity of the system of internal controls regarding financial reporting and accounting compliance, and oversee the internal and external audit processes.

Internal control, however, encompasses not only financial reporting but also compliance with laws and regulations and operational control. The board is responsible for the overall risks and controls of the company and, therefore, has the discretion to give the audit committee responsibility for oversight of compliance with laws and regulations and operational controls.

The board may ask the audit committee to examine objectively:

- the degree to which management has assumed ownership for overall risk management;
- the appropriateness of the risk management strategy and process adopted in addressing this responsibility; and
- the adequacy and effectiveness of systems to support the process.

By asking probing questions about risk management, the audit committee can help bring clarity to the process used to manage risk and the assignment of accountabilities to monitor and react to changes in the organisation's risk profile.

## Identifying and assessing risks

Boards may take several different approaches in identifying and assessing risks. The board may assume that responsibility itself or it may assign selected oversight responsibilities to one or more board committees. It is therefore vital that directors clearly understand the responsibilities of the board of directors, other board committees and the audit committee for overseeing risk management.

Risk management should always be on the board agenda, demonstrating the board's clear ownership of risk management oversight. To fulfil their responsibilities, the board and any board committees need to assess periodically whether they are receiving appropriate risk management information, regularly enough and in a format that meets their needs. They need to evaluate, at least annually, the adequacy and timeliness of management reporting to the board or the committee on financial, non-financial, current and emerging risk trends. By asking probing questions about risk management, the board and its committees can help bring clarity to the processes for managing risk.

It is vital that directors clearly understand the responsibilities of the board of directors, other board committees and the audit committee for overseeing risk management

The audit committee, in particular, needs to discuss financial risk management with senior management and the internal and external auditors. The scope of those discussions should be outlined in the audit committee charter. It is vital that there be an unambiguous understanding of what the audit committee is responsible for.

Appendix 5, Example questions - identifying and assessing risk, contains high level questions that the board or its committees may wish to consider in framing their discussions with management. The list is not exhaustive.

## Setting the appropriate tone



The integrity and attitude of senior management and the board of directors, including its committees, is often referred to as the 'tone from the top'. It is arguably the most important factor contributing to an organisation's effective management of risk. The tone from the top should become the cultural core of the organisation and a model of appropriate conduct for every level.

Organisations normally demonstrate their commitment to organisational integrity by codifying their standards in a code of conduct. An organisation then demonstrates its commitment to its code of conduct by creating systems and procedures to introduce, monitor and enforce its application. But a code by itself is not sufficient. The combination of appropriate systems and procedures can be termed an ethics infrastructure. It helps to ensure that the code influences the daily behaviour of those expected to comply with its content. Such activities include:

- assigning senior individuals to oversee compliance with the code of conduct;
- assessing the integrity of new appointees in the selection and promotion process;
- exercising due care in delegating discretionary authority;
- communicating with and training all employees regarding enterprise values, standards and compliance procedures;
- providing, monitoring and auditing safe systems for reporting unethical or risky behaviour;
- enforcing appropriate discipline with consistency; and
- responding to offences and preventing reoccurrence.

The attention and direction provided by the board helps to set the correct tone from the top and enables the board to lead by example. It is essential that the code of conduct is reflected in the actual behaviour of the board and management.

For the audit committee, tone from the top provides the foundation for the organisation's control environment. It can significantly affect internal controls, including those surrounding the financial reporting process. The audit committee should annually evaluate whether management is setting, documenting and communicating the appropriate tone. To facilitate its review, the committee should obtain periodic updates and briefings from management and others as to how they are achieving compliance with ethical policies and other relevant company procedures.

## Overseeing financial risks and internal control over financial reporting

The process for identifying and managing the organisation's risks, as a part of its overall control environment, influences the identification and management of financial risks that can affect its financial reporting.

The audit committee is responsible for assisting the board in fulfilling its oversight responsibilities. Typically, the audit committee's duties and responsibilities may include:

- monitoring the management of principal risks that could impact the financial reporting process;
- monitoring the integrity of the financial reporting process and system of internal control over financial reporting;
- overseeing the external and internal audit processes; and
- monitoring the organisation's compliance with applicable legal and regulatory requirements affecting financial reporting.

## Understanding the risk environment

By understanding the environment and the pressures the organisation and its management are facing, the audit committee can evaluate whether risks are being identified and, most importantly, being mitigated. Such an approach enables the committee to exercise its responsibilities in an active rather than a reactive manner, and reduces surprises.

By understanding the environment and the pressures the organisation and its management are facing, the audit committee can evaluate whether risks are being identified and, most importantly, being mitigated

Every organisation is different and will be subject to its own risks. Several basic factors drive the risks. The interaction of many elements - the organisation's control environment (including the tone from the top); management's capabilities; the industry, market conditions and expectations; the organisation's operating and financial stability; and the nature of its assets - all contribute to a unique risk profile. This profile directly affects the audit committee's core responsibilities - assessing the company's processes relating to its financial risks and control environment, overseeing its financial reporting and evaluating its internal and external audit processes.

### Industry factors

Companies may operate in one or several industries. The more diverse the company, the more attuned the audit committee should be to different industry risks, accounting practices, laws, regulations, and reporting and disclosure requirements.

Understanding the industry and the organisation will enable an audit committee member to identify and react to industry-specific requirements such as those in banking institutions, investment companies, insurance companies or other Professionals of the Financial Sector (PSF). In regulated industries, for example, audit committees should be familiar with the scope of the regulation and the authority of the regulators. They should understand the demands that regulators place upon the business, management's attitude toward the regulators and the nature of the relationship between management and the regulators.

The audit committee must consider management's response to the risks inherent in specialised industries and incorporate this perspective into its agenda. While the core responsibilities described in this publication are relevant to many organisations, the audit committee should tailor its specific activities and the manner of their execution to meet the needs of each specific industry.

## Identifying indicators of financial risk

Companies may operate in one or several industries. The more diverse the company, the more attuned the audit committee should be to different industry risks, accounting practices, laws, regulations, and reporting and disclosure requirements

Members of the audit committee should identify some financial risk indicators because of their position as directors. To facilitate identifying risk indicators, the company's senior executives should regularly report to the board to keep the directors informed of the risks and exposures facing the company.

In addition, senior management should brief the board on the company's strategic objectives, procedures for achieving them, and evaluations of the progress toward meeting them. Such meetings should take place at full board level.

When appropriate, audit committees should request additional meetings to obtain a more detailed understanding or to address issues of particular importance to their responsibilities. The audit committee should also solicit the comments of the internal and external auditors, and draw upon the committee members' own business acumen.

Every organisation is unique, and each board should be alert to its own risk warning signals.

Managing risk is about much more than managing the risk of business failure. Maintaining and regularly reviewing a list of warning signals can be a useful oversight tool.

## Considering the effect of current and emerging issues

Because both regulators and the public have intense interest in the financial reporting process, prudent audit committees are sharpening their focus on current and emerging issues and responding accordingly

An audit committee must monitor what is happening within the organisation now and, at the same time, what may happen in the future. In today's global economy and formidable business environment, being prepared, and staying ahead of the curve, is a major ingredient for success.

While the issues, including their nature and relative importance, vary by entity, questions like the ones that follow should be considered by every audit committee. Because both regulators and the public have intense interest in the financial reporting process, prudent audit committees are sharpening their focus on current and emerging issues and responding accordingly.

The following questions may help identify current and emerging issues that should shape the audit committee's agenda:

- Is the board of directors adequately overseeing management's process for identifying and assessing principal business risks? What risks are acceptable? Through what process are risks being managed?
- Do the processes and controls adequately support the organisation's complexity and international reach?
- Are controls and systems keeping pace with the organisation's growth?
- Have the control implications for enterprise-wide solutions been adequately addressed?
- Have controls been enhanced through the introduction of new systems?
- Has management addressed specific industry regulations and requirements?
- Does the audit committee tailor its responsibilities to reflect specific industry considerations?
- How does the audit committee contribute to a 'no surprises' environment? Is the audit committee alert to the indicators contributing to the organisation's risk profile?
- Have management and the audit committee remained abreast of recent developments in financial reporting and recent regulatory actions? Have the complexities of new financial reporting requirements been fully understood and evaluated in the context of the business and any unusual transactions?
- Is management reporting the company's operations in a clear and responsible way? Could the company satisfactorily respond to an inquiry into earnings management from an exchange or from a regulator?



- How are the board and audit committee assessing the tone from the top?
- Are any dominant executives adequately governed?
- Are members of the audit committee fulfilling their responsibilities as directors and thereby mitigating potential liability?
- Is the audit committee alert to factors increasing the risk of fraud and illegal acts? Does the audit committee understand how to minimise the risk of loss arising from fraud?



The audit committee should question whether management has considered those risks likely to have the greatest financial, reputational or regulatory impact on the business

## Addressing the risk of fraud and illegal acts

The nature of fraud risk is expanding. Technological advances have changed the speed and ways of recording business transactions; these advances have enhanced opportunities for fraud and have greatly increased the potential quantum of losses arising from fraud. Globalisation can also create risks. Management may find they are doing business with people they do not know, in countries they have never visited, employing cultural standards they do not understand.

The following factors are, among others, sometimes seen as symptomatic of a potential for fraud to occur:

- an overly dominant chief executive officer with unfettered powers;
- frequent changes in finance or other key employees, the auditor or other professional advisers;
- implausible explanations as to the source of profits or projections that are too good to be true;
- individuals who have expensive lifestyles or habits that are potentially at variance with the compensation they receive from the company; and
- overly complicated corporate structures involving havens of secrecy.

The audit committee should question whether management has considered fraud risks likely to have the greatest financial, reputational or regulatory impact on the business. The assessment should include identifying fraud risks and a rigorous assessment of any relevant internal controls and their ability to prevent and/or detect fraud.

Because the audit committee is not involved in day-to-day management, it is therefore removed from the detail in matters related to fraud and unethical activities. It can, however, usefully focus attention on the need for proper policies and procedures to help prevent fraud and unethical activities. The committee should question whether policies are appropriate and effective, and whether they have been adopted by all relevant business units.

## Overseeing internal control processes

The board of directors, management, the internal auditor, external auditor, and the audit committee each have a role in helping to ensure that an effective control environment exists



As part of its assessment, the audit committee should consider requesting from management an overview of the risks, policies, procedures and controls relating to the integrity of financial reporting

An effective control environment needs more than good controls; it needs competent oversight. The board of directors, management, the internal auditor, external auditor, and the audit committee each have a role in helping to ensure that an effective control environment exists.

The board is ultimately responsible for overseeing risk management and the entity's internal control processes. The board has the discretion, however, to assign a board committee, such as the audit committee, the responsibility for overseeing compliance with applicable laws and regulations and/or specific aspects of internal control. The audit committee usually covers this point by overseeing the work of internal audit which includes compliance with legal and regulatory requirements as part of its audit plan, taking note of the recommendations issued by the external auditor, and taking note of relevant reports from the compliance officer. The results of the audit committee's work should, however, be reported to and considered by the board, prior to the board reaching its own conclusions.

Management is responsible for designing and implementing an effective system of internal control. The audit committee must determine that management has implemented policies that help to ensure that:

- risks around financial reporting (and, where applicable, the wider sphere of business risk) are identified; and
- controls are adequate, in place and functioning properly.

As part of its assessment, the audit committee should consider requesting from management an overview of the risks (such as a risk cartography depicting the main risk exposures), policies, procedures and controls relating to the integrity of financial reporting. The committee should request, however, that the information it receives is manageable; it should not be so voluminous as to deter a proper understanding of the key risks. It is more important that the audit committee gains meaningful insight into the key sources of risk and how such risks are managed, rather than being presented with a long list of every imaginable risk facing the business.

The audit committee should supplement representations received from management with further information and assurances from the internal and external auditors.



## Whistle-blowing procedures

When reviewing whistle-blowing procedures, the audit committee may consider the following:

- Are whistle-blowing procedures documented and communicated throughout the organisation?
- Does the policy make clear that it is both safe and acceptable for employees to raise concerns about wrongdoing?
- When employees raise concerns, are they responded to within a reasonable timeframe?
- Are there procedures to help ensure all reasonable steps are taken to keep the identity of whistle-blowers confidential?
- Has a senior person been identified to whom employees can disclose confidential concerns? Does this person have the authority and determination to act if concerns are not raised with - or properly dealt with - by immediate line management?
- Is there a reporting to the audit committee of all whistle-blowing concerns that have been initiated?



# Chapter 5

Overseeing the external  
and internal audit processes





## Chapter 5

# Overseeing the external and internal audit processes

## Relevant extract(s) from the Ten Principles

### Recommendation 9.11:

The internal and external auditors should, in addition to maintaining an effective working relationship with management, have free access to the board. To this end, the audit committee should act as principal contact point. The internal and external auditors may at all times approach the chairman of the audit committee or the chairman of the board directly. The audit committee should receive timely information regarding any issue raised by the internal or external auditor.

### Recommendation 9.12:

The audit committee should be informed of the internal auditor's work programme and should receive periodic summaries of his work.

It may make recommendations regarding the internal auditor's work programme. It should monitor the effectiveness of the internal audit function and make sure that the internal auditor has adequate resources for the performance of the tasks entrusted to him. In the event of the resignation of the internal auditor it should investigate the issues leading to this and make recommendations concerning any measures that are needed.

### Recommendation 9.13

The audit committee should be informed of the external auditor's work programme and receive a report from the auditor describing all existing relationships between the external auditor on the one hand and the company and its group on the other hand. It may make recommendations regarding the external auditor's work programme. The audit committee should make recommendations to the board regarding the selection, appointment, reappointment and removal of the external auditor and, in addition, the terms and conditions of their remuneration. It should monitor the independence and objectivity of the external auditor, in particular by monitoring the rotation of the partners of the audit firm. It should examine the nature and scope of non-audit services provided, with a view to avoiding any conflict of interest. To this end, the audit committee should establish an official policy specifying which non-audit services shall be (a) prohibited (b) authorized after consideration by the committee and (c) authorized ex officio without the need for consultation of the committee.

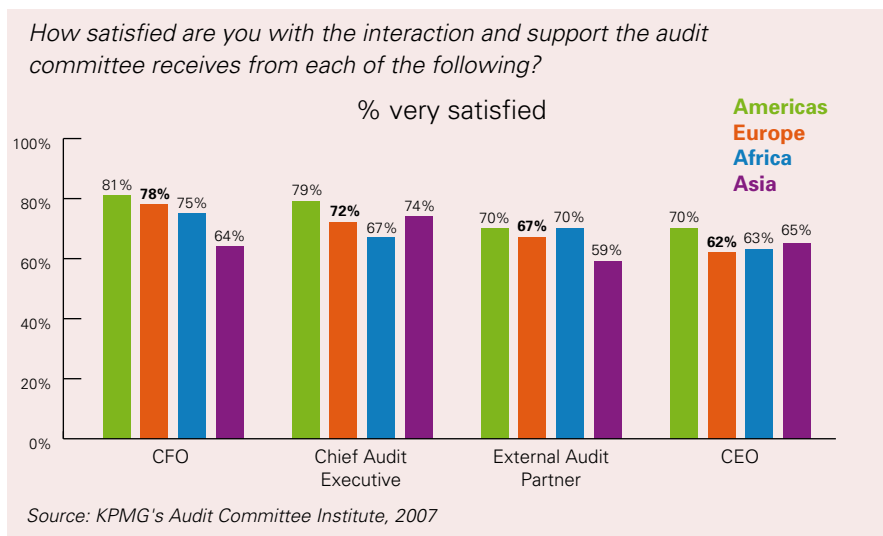
In addition, the audit committee should monitor the effectiveness of the external audit process and check that the executive management acts on the letter of recommendations submitted to it by the external auditor. In the event of the resignation of the external auditor, it should investigate the issue leading to this and make recommendations concerning any measures that are needed.

The audit committee is responsible for overseeing the external and internal audit processes. Several key elements in the relationship between the auditors and the audit committee require active oversight by the audit committee including appointing the auditors, maintaining their independence, understanding their approach to the audit and the outcomes from their work, and regularly assessing their performance.



## Overseeing the external auditor

In a recent ACI global survey respondents were asked to indicate who identifies and communicates the most constructive suggestions to improve the audit committee’s organisation and activities. Respondents were asked to select one of the following: board of directors, external auditor, chief finance officer, general counsel, internal auditor, chief executive officer, governance officer or corporate secretary, audit committee chairman, audit committee, and other. The board of directors came first with 37 percent of the votes and the external auditor came second with 20 percent of the votes.



### Maintaining an effective relationship

First and foremost, the external auditor and audit committee should have a strong and candid relationship - anything less may limit the committee’s effectiveness in achieving its oversight responsibilities. The audit committee should establish that the auditor is directly accountable to the audit committee and, through it, to the board of directors and ultimately the company’s shareholders. The audit committee should make sure its actions and communications with the auditor are consistent with this accountability. The audit committee should also be sure to communicate its expectations to the auditor, and that both parties understand and have agreed to those expectations.

The chairman of the audit committee should communicate with the audit partner prior to each audit committee meeting. This step allows the chairman and the audit partner to review agenda items and should reduce any surprises arising at the audit committee meeting. Of course, if particularly controversial or difficult items are identified, the chairman should also discuss those issues with management and consider the need to give advance warning to the other members of the audit committee.

The audit committee should make recommendations to the board regarding the selection, appointment, reappointment and removal of the external auditor and, in addition, the terms and conditions of their remuneration  
(Extract from recommendation 9.13 LSE)

### **Selecting, appointing and removing the auditor**

Making recommendations to the board on the appointment, reappointment and removal of the auditor is an important audit committee responsibility. The audit committee's recommendation to the board should be based on its assessment of the qualifications, expertise and resources, and independence of the auditor and the effectiveness of the audit process. If the audit committee recommends considering selecting a new appointee as the auditor, it should oversee the selection process.

The audit committee should approve the terms of engagement and recommend the compensation to be paid to the auditor in respect of audit services provided. In doing so, it should satisfy itself that the level of fees in respect of the audit is appropriate and that an effective audit can be conducted for such a fee.

If the auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

### **Safeguarding auditor independence**

The audit committee should, at least annually, consider the external auditor's independence and carry out procedures to help ensure the auditor's independence and objectivity, taking into consideration relevant Luxembourg professional and regulatory requirements. For its part, the audit firm should have internal policies and procedures in place, which are properly monitored, to establish that the audit firm and its individual members are independent from the company.

In considering matters that may bear on the auditor's independence, both the auditor and the audit committee should consider whether conflicts exist, such as:

- the auditor holding a financial interest, either directly or indirectly, in the company;
- personal and business relationships of the auditor's immediate family, close relatives and partners with the company;
- the nature of the relationship between the audit partner and the CEO and/or the CFO;
- economic dependence by the auditor through its relationship with the company; and
- the nature and extent of services provided by the auditor in addition to the audit engagement.

The audit committee should monitor the independence and the objectivity of the external auditor  
(Extract from recommendation 9.13 LSE)

Each year the audit committee should obtain from the audit firm information about policies and processes for maintaining independence and monitoring compliance with relevant requirements.

The audit committee should develop a policy on the provision and pre-approval of all non-audit services

## Communications from external auditors

The International Standards on Auditing 260, Communications of Audit Matters with those Charged with Governance (ISA 260), formalises auditors' communication with those charged with governance in respect of the financial reporting process. For listed companies, this will usually be the audit committee.

### Qualitative aspects of financial reporting

(ISA 260.11) The auditor should consider audit matters of governance interest that arise from the audit of the financial statements and communicate them with those charged with governance. Ordinarily such matters include:

- 1 The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
- 2 The selection of, or changes in significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
- 3 The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
- 4 Audit adjustments, whether or not recorded by the entity that have, or could have, a significant effect on the entity's financial statements;
- 5 Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- 6 Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report (these communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter);
- 7 Expected modifications to the auditor's report;
- 8 Other matters requiring attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management; and
- 9 Any other matters agreed upon in the terms of the audit engagement.



### Employment of former employees of the external auditor

The audit committee may agree on a policy for the employment of former employees of the external auditor, taking into account the relevant independence guidelines governing the accounting profession. Particular attention should be paid to those individuals who were part of the audit team and moved directly to the company.

### Pre-approving non-audit services

To help ensure that non-audit services provided by the auditor do not impair, or appear to impair, the auditor's independence or objectivity, the audit committee should develop a policy on the provision and pre-approval of all non-audit services. In determining the policy, the audit committee should consider the skills and experience of the audit firm, the potential threats to the auditor's independence and objectivity, and any controls put in place by the company and the auditor to mitigate such threats. In principle, the audit committee may not agree to the auditor providing a service if the result is that:

- the audit firm or a member of the engagement team has a financial or other interest that might cause him or her to be reluctant to take action that would be adverse to the interests of the audit firm or a member of the engagement team (self-interest threat).
- the results of the non-audit service performed by the audit firm may be included in the company's accounts, and thus not subject to proper audit review (self-review threat).
- the auditor undertakes work that involves making judgements and taking decisions that are the responsibility of management (management threat).
- the audit firm undertakes work that involves acting as advocate for the company and supporting a position taken by management in an adversarial context (advocacy threat).
- the auditor is predisposed, for example because of a close personal or family relationship, to accept or not sufficiently question the company's point of view (familiarity threat); or
- the auditor's conduct may be influenced by fear or threats (intimidation threat).

The audit committee should examine the nature and scope of non-audit services provided, with a view to avoiding any conflict of interest

*(Extract from recommendation 9.13 LSE)*

## Understanding the audit cycle

### Timing considerations

Sufficient time should be allowed to enable the audit committee to complete its review and engage in an appropriate dialogue with the auditor. An appropriate timetable should be agreed upon by the board, management and the auditor.

### Reviewing the audit plan

The committee needs to understand the scope of the audit and how it is to be approached. An effective way to achieve this understanding is to hold a meeting with the auditor prior to the auditor's finalising the audit plan. A discussion may uncover areas where the audit committee assumes work is done but it is not, and other areas where audit effort is directed but of which the audit committee may not be aware. This discussion should also focus on what the auditor considers to be the significant accounts and transactions posing the most risk.

The committee should determine that an appropriate audit plan is in place. It should carefully consider and discuss whether the business risks identified by the auditor are the only business risks or whether, because of the audit committee's own knowledge of the organisation's risk environment, other risks should also be taken into account. This focus applies both at a strategic level, those risks that are fundamental to the achievement of the entity's strategy, and at the more detailed operational level, those risks that affect day-to-day operations, the recognition of revenue and costs, the custody and value of assets, and the completeness of recognition of liabilities.

In general terms, the audit committee should understand the areas where the auditor intends to perform detailed substantive testing and those areas where the auditor intends to rely on internal control. The audit committee should also understand the auditor's materiality for planning purposes. At the completion of the audit, the audit committee should review the reporting materiality threshold with the auditor.

The committee should also be concerned, for example, that branches or subsidiaries receive adequate coverage, particularly those that are remote either geographically or culturally. It should understand whether other audit firms are involved in auditing specific geographic locations.

At the pre-audit planning meeting, the committee may determine that the external auditor should be performing additional work to satisfy the needs of the company, such as increased internal control testing.



## Reviewing the audit findings

The audit committee should check that the executive management acts on the letter of recommendations submitted to it by the external auditor  
*(Extract from recommendation 9.13 LSE)*

Moving to the end of the audit cycle, the audit committee should review the audit findings, including any changes in audit approach or any modification to the auditor's report. The issues to be discussed will depend on individual company and audit circumstances. Nevertheless, the audit committee should:

- discuss with the external auditor major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved;
- review any problems detected in internal control;
- review key accounting and audit judgements; and
- review levels of errors identified during the audit, obtaining explanations from management, and where necessary the external auditor, about why certain errors might remain uncorrected.

While it may seem strange to review issues that have subsequently been resolved and uncorrected misstatements that are not material, such issues can suggest weaknesses in the design or operation of internal control, or be indicative of management's approach to the preparation and presentation of financial information (e.g., earnings management).

### Reviewing the auditor's management letter

Where the audit team identifies significant deficiencies or material weaknesses in either accounting or internal control systems during their audit, they should report these findings in a 'Management letter'. As part of the ongoing monitoring process, the audit committee should review the management letter and also review and monitor management's responses to the auditor's findings and recommendations.

## Assessing the auditor's performance

The audit committee should monitor the effectiveness of the external audit process  
*(Extract from recommendation 9.13 LSE)*

The audit committee has primary responsibility for selecting, evaluating, and, if need be, replacing the auditor. The committee's evaluation should consider the auditor's competence, the quality and efficiency of the audit, whether the audit fee is appropriate in relation to size, complexity, and risk and control profile of the company to ensure that the company's audit is not compromised.

The Ten Principles recommend that the audit committee should review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process.



## Overseeing the internal auditor



The audit committee should make sure that the internal auditor has adequate resources for the performance of the tasks entrusted to him  
(Extract from recommendation 9.12)

### Reviewing the need for an internal audit function

Companies need to weigh the potential benefits and costs of internal control processes. One such decision relates to the need or desirability of having an internal audit function. The Ten Principles recommend that an independent internal audit function should be established, within the company's resources and skills. Designed and deployed effectively, internal audit can have a very positive impact on the control environment of an organisation and the effective design and operation of internal control.

### Establishing and maintaining an effective internal audit function

Internal audit can be resourced either through an in-house function or an external service provider. The decision as to the appropriate sourcing for the company will usually be driven by the availability of appropriate skills and the breadth and depth of experience to cover the company's business operations adequately. The cost implications of each approach may differ significantly. A mixed approach can also work, with assignments requiring specific skills (e.g. information technology audits) to be sourced to a service provider.

Where an internal audit function exists, the audit committee may participate in the appointment, promotion or dismissal of the chief internal auditor, and help determine required qualifications, reporting obligations and compensation. The audit committee may also help to ensure access to all necessary contacts both at the board level and within the organisation.

The audit committee should also be satisfied that the internal audit function has adequate resources. Today's internal audit function generally applies a risk-based methodology and often needs to have access to the specialised skills necessary to deal with complex treasury, technology and operational strategies being employed by the organisation.

### Supporting internal audit's independence

A significant challenge for internal audit is understanding its responsibility to both the audit committee and management. The internal auditor is employed by management and yet reviews management's conduct; in addition the internal auditor reports to the audit committee and yet is not directly employed by the audit committee (although they do have some say at the employment and dismissal stages).

Managing the relationship between the audit committee, internal audit and management can be difficult.

### Clear lines of communication

It is very important that internal audit retains a degree of independence from management so that it may carry out its function impartially. It is key therefore that whilst the head of internal audit reports directly into the board and executive management, i.e. to the CFO or the CEO, they also have a clear line of responsibility to the audit committee.

The audit committee should have processes in place to facilitate confidential exchanges with the internal auditor, with regular meetings scheduled between the audit committee and the chief internal auditor.

**Responsibility for performance evaluation**

The audit committee may participate in the appointment, promotion, or dismissal of the head of internal audit. These decisions should not be made by management alone. Indeed the contribution of the audit committee is essential to the stages of promotion and dismissal as it is responsible for monitoring and reviewing the effectiveness of the company's internal audit function. It is therefore reasonable for the process of performance evaluation which would precede promotion or dismissal to be carried out jointly by management and the audit committee.

In practical terms the 'terms and conditions' of the working relationship between these parties should be set down in writing and discussed regularly.

**Overseeing the interface between internal and external audit**

If an organisation has an internal audit function, that function and the external audit firm both execute its audit coverage. Each has unique responsibilities:

- The external auditor is generally responsible for auditing and attesting to the company's financial statements and, in certain circumstances, management's assessment of internal control over financial reporting. For regulated entities, the external auditor is also responsible for verifying compliance with relevant laws and regulations and reporting findings to the regulator.
- The internal auditor is responsible for monitoring the performance of the company's internal controls.
- The external auditor should identify the internal audit activities that are relevant to planning the external audit.

The audit committee should determine that these audit functions complement each other, that where appropriate they coordinate their audit efforts, and that they communicate effectively with one another.

The audit committee should stay up to date on the scope and results of internal audit's operations and management's responses to its recommendations. Internal audit's objectivity and independence of judgement should be periodically evaluated. The audit committee should monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system and, in particular, determine that internal audit's involvement in the financial reporting process is appropriate.

The audit committee should also consider the following questions as it oversees the internal audit function:

- How does internal audit best add value to the business model?
- How effectively does the company use internal audit to evaluate management's response to its strategic, financial, technological, security and operational risks?
- Should the internal audit function be monitoring process improvements and sharing strong practices? And is it?



The audit committee should monitor the effectiveness of the external audit process (Extract from recommendation 9.13 LSE)

- Does internal audit have the resources and appropriate expertise to satisfy its responsibilities?
- What are the results of any assessment of internal audit?
- What is the relationship between the internal audit function locally and at group level and between internal audit, compliance and risk management.

**Assessing internal audit's performance**

Self-assessment by the head of internal audit is an effective assessment tool, but it should not be the sole means of assessing the effectiveness of internal audit. The audit committee should draw its own conclusions based on its experience and contact with internal audit. In evaluating the work of internal audit, the audit committee should review the annual internal audit work plan, receive periodic reports on the results of the internal auditor's work and monitor management's responsiveness to the internal auditor's findings and recommendations.





# Chapter 6

The wider picture





## Chapter 6

# The wider picture

Many countries in Europe, and the rest of the world have their own set of corporate governance rules. It would be too lengthy to discuss the requirements of each individual country here; however, companies should ensure that they are aware of the requirements of any country they operate in. Two of the greatest sources of governance practice and regulation which serve to inform and influence the activities of audit committees in Europe are the European Commission (EC) and the US (more specifically the Sarbanes Oxley Act).

The key difference between the US and Europe is style: prescriptive versus 'comply or explain', and it is this that attracts much comment amongst regulators and audit committee members alike.

## Europe

In 2004, the EC issued two corporate governance-related Recommendations and proposed changes to its accounting directives.

### The Recommendations

In September 2004, the EC formally invited member states, through two Commission Recommendations<sup>1</sup>, to:

- reinforce the presence and role of independent non-executive directors on listed companies' boards; and
- encourage listed companies to disclose their policy on directors' remuneration and ensure shareholders are given adequate control over these matters and over share-based remuneration schemes.



### Amendments to the accounting directives

To enhance confidence in the financial statements and annual reports published by European companies, the Fourth and Seventh Accounting Directives have been amended to require companies whose securities are traded on a regulated market to include a new corporate governance statement in their annual reports. This statement will have to refer to the corporate governance code applied by the company and explain whether and to what extent the company complies with that code. Also, it will have to include, inter alia, a description of the company's internal control and risk management system and information on the composition and operation of the board and its committees.

<sup>1</sup> Commission Recommendation (2005/162/EC) On the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.  
Commission Recommendation (2004/913/EC) Fostering an appropriate regime for the remuneration of directors of listed companies.



### **Amendments to the Statutory Audit Directive**

The majority of the EU 8th Directive is concerned with clarification of the duties of statutory auditors, provision for auditor independence and ethical standards, the introduction of a requirement for external audit quality assurance and the provision for public oversight and improved cooperation between EU oversight bodies.

Article 41 of the Directive, however, effectively mandates audit committees for EU-listed companies and public interest entities. There is an exemption, however where the company has a body performing equivalent functions to an audit committee, established under national law. Article 41 goes on to say that the statutory auditor should 'report to the audit committee on key matters arising from the statutory audit, in particular on material weaknesses in internal control in relation to the financial reporting process'.

## Sarbanes Oxley

As a result of the Sarbanes-Oxley Act, NYSE rules require foreign companies to make their US investors aware of the significant ways in which their corporate governance practices differ

The Public Company Accounting Reform and Investor Protection Act of 2002 (otherwise known as the Sarbanes-Oxley Act) implemented radical reforms to US corporate governance practice following the collapse of Enron and other major corporate failures.

The intention of standard setters was to reduce the risk of the likes of Enron and Worldcom happening again, and to reassure the investment community that it was safe to invest.

The key provisions of the act relate to:

- integrity and completeness of company financial reports;
- non-interference of company directors and officers in the audit process;
- establishment of a Public Company Accounting Oversight Board (PCAOB) with responsibility for registration, inspection and disciplinary of public and accounting firms and the establishment of audit regulations;
- audit independence, i.e., partner rotation and non-audit fees;
- the maintenance of company records - it is now a criminal offence for anyone knowingly to destroy, alter or falsify a document;
- whistle-blower protection; and
- codes of ethics for senior financial officers.

As a result of the Sarbanes-Oxley Act, the New York Stock Exchange (NYSE) rules require foreign companies with US listings to make their US investors aware of the significant ways in which their corporate governance practices differ from those required of domestic companies.

**Different approaches**

Many of the elements of the Sarbanes-Oxley Act have been reflected in corporate governance codes in other countries. However, many countries have avoided the prescriptive approach of the legislation and have adopted the 'comply and explain' regime.

A key example of the way the regulator in the US approach governance is the regulation that governs internal controls over financial reporting.

In the US, section 404 of the Sarbanes Oxley Act requires that management assess the effectiveness of the company's internal control over financial reporting and then report on that assessment at the close of its fiscal year. The Act also requires a company's external auditor to attest to and report on the assessment made by management.



# Appendix





## Appendix 1

# Audit committee terms of reference

**Membership**

The board shall appoint the committee. All members of the committee shall be independent non-executive directors of the company. The committee shall consist of not less than three members. A quorum shall be two members. The board shall appoint the chairman of the committee from amongst the independent non-executive directors.

One member of the audit committee should have recent and relevant financial experience.

**Secretary**

The secretary of the company shall be the secretary of the committee.

**Attendance at meetings**

No one other than the audit committee members shall be entitled to attend audit committee meetings.

The chairman, other non-executive directors, CEO, finance director, head of internal audit, representatives of the external auditors or other persons shall attend meetings at the invitation of the committee.

There should be at least one meeting a year, or part thereof, where the audit committee meets the external and internal auditors without executive board members present. This need not be the same meeting.

**Frequency of meetings**

Meetings shall be held not less than two times a year.

External auditors or internal auditors may request a meeting if they consider that one is necessary.

**Authority**

The committee is authorised by the board to:

- investigate any activity within its terms of reference;
- seek any information that it requires from any employee of the company and all employees are directed to cooperate with any request made by the committee; and
- obtain outside legal or independent professional advice, at the company's expense, and secure the attendance of outsiders with relevant experience and expertise if it considers this necessary.

**Duties**

The duties of the committee shall be:

*Financial reporting*

- to review, and challenge where necessary, the actions and judgements of management, in relation to the company's financial statements, operating and financial review, interim reports, preliminary announcements and related formal statements before submission to, and approval by, the board, and before clearance by the auditors. Particular attention should be paid to:
  - critical accounting policies and practices, and any changes in them,
  - decisions requiring a significant element of judgement,
  - the extent to which the financial statements are affected by any unusual transactions in the year and how they are disclosed,
  - the clarity of disclosures,
  - significant adjustments resulting from the audit,
  - the going concern assumption,
  - compliance with accounting standards,
  - compliance with stock exchange and other legal requirements, and
- to consider other topics, as defined by the board.

*Internal control and risk management*

- to review the company's procedures for detecting fraud and whistle blowing and ensure that arrangements are in place by which staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or any other matters;
- to review management's and the internal auditor's reports on the effectiveness of the systems for internal financial control, financial reporting and risk management;
- to monitor the integrity of the company's internal financial controls;
- to review the statement in the annual report and accounts on the company's internal controls and risk management framework; and
- to assess the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non-financial risks. [Note: the board retains responsibility for the review of the effectiveness of the system of internal control and must form its own opinion despite aspects of that review being delegated to the audit committee.]

*Internal audit*

- to consider annually whether there is a need for an internal audit function where no such function exists;
- to review the internal audit programme and ensure that the internal audit function is adequately resourced and has appropriate standing within the company;
- to ensure that the internal auditor has direct access to the board chairman and the audit committee and is accountable to the audit committee;
- to receive a report on the results of the internal auditors' work on a periodic basis;
- to review and monitor management's responsiveness to the internal auditor's findings and recommendations;
- to monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system;
- to appoint or dismiss the head of internal audit.

*External audit*

- to oversee the company's relations with the external auditor;
- to consider, and make recommendations on the appointment, reappointment and removal of the external auditor;
- to approve the terms of engagement and the remuneration to be paid to the external auditor in respect of audit services provided;
- to assess the qualification, expertise and resources, effectiveness and independence of the external auditors annually. Steps to consider include:
  - seeking reassurance that the auditors and their staff have no family, financial, employment, investment or business relationship with the company (other than in the normal course of business),
  - seeking from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff,
  - monitoring the external audit firm's compliance with applicable ethical guidance relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, office and partner and other related regulatory requirements,
  - agreeing with the board and monitoring the company's policy for the employment of former employees of the external auditor;

*External audit (continued)*

- to discuss with the external auditor, before the audit commences, the nature and scope of the audit;
- to review with the external auditors, the findings of their work, including, any major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved; key accounting and audit judgements; levels of errors identified during the audit, obtaining explanations from management and, where necessary the external auditors, as to why certain errors might remain unadjusted;
- to review the audit representation letters before consideration by the board, giving particular consideration to matters that relate to non-standard issues;
- to assess, at the end of the audit cycle, the effectiveness of the audit process by:
  - reviewing whether the auditor has met the agreed audit plan and understanding the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks,
  - consideration of the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committees, and in their commentary, where appropriate, on the systems of internal control,
  - obtaining feedback about the conduct of the audit from key people involved;
- to review and monitor the content of the external auditor's management letter, in order to assess whether it is based on a good understanding of the company's business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon;
- to develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor and ensure that the provision of such services does not impair the external auditor's independence or objectivity. In doing so, the audit committee should;
  - consider whether the skills and experience of the audit firm make it a suitable supplier of the non-audit services,
  - consider whether there are safeguards in place to ensure that there is no threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor,
  - consider the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit fee,
  - consider the criteria that govern the compensation of the individuals performing the audit; and

- set and apply a formal policy specifying the types of non-audit work: from which the external auditors are excluded; for which the external auditors can be engaged without referral to the audit committee; and for which a case-by-case decision is necessary.

#### *Reporting*

The secretary shall circulate the minutes of meetings of the committee to all members of the board, and the chairman of the committee shall, as a minimum, attend the board meeting at which the accounts are approved.

The audit committee shall annually review its terms of reference and its own effectiveness and recommend any necessary changes to the board.

The audit committee shall prepare a report on its role and responsibilities and the actions it has taken to discharge those responsibilities for inclusion in the annual report and accounts. Such a report should specifically include:

- a summary of the role of the audit committee;
- the names and qualifications of all members of the audit committee during the period;
- the number of audit committee meetings and attendance by each member; and
- the way the audit committee has discharged its responsibilities.

Where disagreements between the audit committee and the board cannot be resolved, the audit committee shall report the issue to the shareholders as part of the report on its activities in the company's annual report.

If the board does not accept the audit committee's recommendation regarding the appointment, reappointment and removal of the external auditors, the audit committee shall include a statement explaining its recommendation and reasons why the board has taken a different stance in the annual report.

The audit committee chairman shall attend the AGM and shall answer questions, through the chairman of the board, on the audit committee's activities and their responsibilities.

## Appendix 2

# Example audit committee Agenda



Our experience suggests that the following topics deserve consideration when establishing the detailed agendas for the audit committee meetings during the year.

### **Risk Assessment**

- Risk management process and control (particularly financial reporting risks);
- Operating reviews;
- Budget reviews;
- Industry and market updates;
- Review financial community and regulatory expectations;
- Information technology changes;
- Legal briefings;
- Understand senior management compensation programs;
- Executive sessions with appropriate senior management;
- Current and emerging risk issues.

### **Assess Processes Relating to the Company's Control Environment**

- Compliance with code of ethical conduct;
- Control policies and procedures (including earnings management, error and fraud);
- Management's assessment of key third-party providers;
- Internal and external auditor internal control observations and recommendations;
- Compliance with specific industry regulations.

**Oversee Financial Reporting**

- Financial statements and earnings releases;
- Recommend approval of financial statements to board of directors;
- Periodic reports and filings;
- Management overview of financial results for quarter/year;
- Critical accounting policies (including appropriate application of GAAP);
- Significant and unusual transactions and accounting estimates;
- Current developments in auditing, accounting, reporting, and tax matters;
- Executive session with senior management.

**Evaluate the Internal and External Audit Processes**

- Coordination of the internal and external audit effort and definition of responsibilities;
- External auditors
  - Engagement letter
  - Audit engagement team
  - Independence letter
  - Consider all significant non- audit services to be performed by the external auditor - scope, procedures, and timing
  - Audit results
  - Audit reports
  - Quarterly review results
  - Meeting with external auditors
  - Management's responsiveness to audit results - assess effectiveness;
- Internal Audit Department
  - Assess need for internal auditing
  - Mandate and objectives scope, procedures, and timing of the audits
  - Audit results
  - Audit reports
  - Meeting with internal auditors
  - Management's responsiveness to audit results
  - Assess effectiveness;
- Audit Committee Structure
  - Update mandate
  - Assess audit committee performance.

## Appendix 3

# Example audit committee meeting agenda for the year

This example relates to an organisation with a December year end and four audit committee meetings held in a year.

Scheduled meetings				
April/ May	July/ August	October/ November	January/ February	
				<b>Constitution</b>
■				Review audit committee's terms of reference
				Review code of conduct
				Assess independence, financial literacy, skills and experience of members
■				Establish number of meetings for the forthcoming year
■				Audit committee chair to establish meeting agenda and attendees required
■				Enhance financial literacy - update on current financial events
				<b>Assessment of financial information</b>
				(discuss with management and external auditors where applicable)
				Review and recommend approval of annual financial statements
■				Review and recommend approval of half year financial statements
■				Review and recommend approval of quarterly financial information
				<b>External auditors</b>
■				Recommend appointment and review performance
■				Approve audit fees and terms of engagement
■				Consider policy in relation to non-audit services
■				Consider objectivity/independence and obtain confirmation from auditor
■				Review audit plan and scope of audit work
■				Review external audit findings
■				Discuss appropriateness of accounting policies, estimates and judgements
■				Discuss external auditors views on control environment including fraud risk management
■				Discuss with auditor in absence of executives and management
■				Ongoing communication (written/oral) of external auditor with audit committee
				<b>Internal auditors</b>
■				Where no internal audit function, consider the need for an internal audit function
■				Recommend appointment and review performance
■				Review internal audit plan and its progress
■				Review significant internal audit reports and findings
■				Review progress on actions taken in response to the committee's representations
■				Discuss issues with auditor in the absence of executives and management
				<b>Other responsibilities</b>
■				Consider financial risks and internal controls (and other controls if applicable)
■				Review progress on actions taken in response to the representations of the auditors
■				Review whistle blowing arrangements
■				Review legal and compliance developments
■				Review report to shareholders on role and responsibilities of the committee
■				Perform self-assessment of audit committee performance
■				Review financial personnel succession planning
■				Review director and officer expenses and related party transactions
■				Conduct special investigations and perform other activities as appropriate
■				Maintain minutes and report to the Board

■ Recommended timing  
 ■ As required

## Appendix 4

# Audit committee self-assessment



The self-assessment has been prepared on the basis that each audit committee member will complete it independently. The audit committee chairman would then lead discussion on the results of the questionnaire, focusing on those areas which clearly need improvement or where there is great variation in answers. Alternatively, the self assessment could be undertaken as a facilitated group activity led by the audit committee chairman or an external party.

Audit committee chairman may wish to give more weight to some aspects of the self-assessment than others. Appropriate weighting will be influenced by a number of factors including, but not limited to:

- the committee's charter;
- the organisation's strategies and risk assessments;
- its control environment;
- the outcomes of previous self-assessments;
- the stage of maturity of the audit committee;
- the views of stakeholders on the organisation's corporate governance performance; and
- current and emerging business and economic factors.

The results of the self-assessment and any action plans arising should be reported to the board after discussion with the chairman of the board. The board should also make its own assessment of the performance of audit committee's effectiveness on an annual basis.

Yes / No / N/A	Rating					Comment
	Excellent				Poor	
	1	2	3	4	5	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

## Terms of reference

Have the audit committee’s terms of reference been approved by the board?

Does the audit committee annually review its terms of reference and recommend any necessary changes to the board?

Do the terms of reference (audit committee charter) include:

- monitoring the integrity of the financial statements;
- reviewing the company’s internal financial control system;
- unless addressed by another board sub-committee or by the board itself, reviewing the company’s risk management systems;
- monitoring and reviewing the effectiveness of the company’s internal audit function;
- recommending to the board the appointment of the external auditor and approving their remuneration and terms of engagement following appointment by the shareholders at the AGM;
- monitoring the effectiveness of the external auditor’s performance and their independence and objectivity;
- developing and implementing a policy on the engagement of the external auditor to supply non-audit services?

Yes / No / N/A	Rating					Comment
	Excellent				Poor	
	1	2	3	4	5	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

## Membership and appointments

Does the audit committee consist of independent non-executive directors?

Is the board chairman excluded from audit committee membership?

Are audit committee members appointed by the board on the recommendation of the nomination committee (where there is one) in consultation with the audit committee chairman?

Is audit committee membership restricted to a term no longer than three years (extendable by no more than two additional three year periods)?

	Rating					
	Excellent					Poor
Yes / No / N/A	1	2	3	4	5	Comment

## Meetings

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee meet regularly (at least three times a year to coincide with key dates in the financial reporting and audit cycle)?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Are audit committee meetings well attended?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Do audit committee meetings allow sufficient time for discussion and questions?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Are meeting agendas and related background information circulated in a timely manner to enable full and proper consideration to be given to the issues?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Is sufficient time allowed between audit committee meetings and board meetings to allow any work arising to be carried out and reported to the board as appropriate?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee invite non-members to attend meetings where necessary? (Only the audit committee members should be entitled to attend audit committee meetings.)

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Are arrangements in place for the audit committee to meet with external and internal auditors during the year without the presence of management?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee chairman, and to a lesser extent the other members, keep in touch on a continuing basis with the key people involved in the company's governance e.g., the board chairman, the chief executive, the finance director, the external auditor and the head of internal audit?

	Rating					
	Excellent					Poor
Yes / No / N/A	1	2	3	4	5	Comment

## Training and resources

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee have sufficient skills, experience, time and resources to undertake its duties?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does at least one audit committee member have recent and relevant financial experience?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Is an induction programme (covering the role of the audit committee, its terms of reference and expected time commitment by members; an overview of the company's business; and the main business and financial dynamics and risks) provided for new audit committee members?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Do audit committee members receive relevant training in financial reporting and related company law on an ongoing and timely basis?

Yes / No / N/A	Rating					Comment
	1	2	3	4	5	

## Training and resources (continued)

Do audit committee members have the opportunity to attend formal courses and conferences, internal company talks and seminars, and briefings by external advisers such as the company’s auditors and lawyers?

Does the audit committee have access to the services of the company secretary and staff?

Are funds available to enable the audit committee to take independent legal, accounting or other advice when it reasonably believes it necessary to do so?

Yes / No / N/A	Rating					Comment
	1	2	3	4	5	

## Financial reporting

Does the audit committee review the significant financial reporting issues and judgements made in connection with the preparation of the company’s financial statements, interim reports, preliminary announcements and related formal statements?

Where an accounting treatment is open to a different approach, does the audit committee consider whether the company has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgements?

Does the audit committee review the clarity and completeness of disclosures in the financial statements, interim reports, preliminary announcements and related formal statements?

Where, following its review, the audit committee is not satisfied with any aspect of the proposed financial reporting, does it report such views to the board and seek changes?

Yes / No / N/A	Rating					Comment
	1	2	3	4	5	

## Internal financial controls and risk managements systems

Does the audit committee monitor the integrity of the company’s internal financial controls?

Does the audit committee assist in the boards assessment of the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non-financial risks?

Yes / No / N/A	Rating					Comment
	1	2	3	4	5	

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

In carrying out such an assessment, does the audit committee receive and review reports from management on the effectiveness of the systems they have established and the results of any testing carried out by internal and external auditors?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee review and approve the statements included in the annual report in relation to the process for managing risk and the boards review of the adequacy of that process?

Yes / No / N/A	Rating					Comment
	1	2	3	4	5	

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

## Internal audit process

Where no internal audit function exists, does the audit committee annually consider whether there is a need for one and make a recommendation to the board?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee review and approve the appointment or termination of the head of internal audit?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee review and assess the independence and objectivity of the internal audit function?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee review and approve the internal audit function's remit?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee ensure that the internal audit function has the necessary resources and access to information to enable it to fulfil its mandate?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee review and assess the annual internal audit work plan?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee receive a report on the results of the internal auditors' work on a periodic basis, and monitor management's responsiveness to the internal auditor's findings and recommendations?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee meet with the head of internal audit at least once a year without the presence of management

Yes / No / N/A	Rating					Comment
	1	2	3	4	5	

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

## Internal audit process (continued)

Does the audit committee monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee make appropriate enquiries about the coordination and cooperation between internal and external audit?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee ensure that the internal audit function follows the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors?

Yes / No / N/A	Rating					Comment
	1	2	3	4	5	

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

## External audit process

Is the audit committee responsible for overseeing the external auditor?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee make recommendations to the board (and thence to shareholders) on the appointment, reappointment and removal of the external auditors?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee annually assess the qualification, skills and resources, effectiveness and independence of the external auditors?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee annually assess the procedures in place to ensure the independence and objectivity of the external auditor?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee seek reassurance that the external auditors and their staff have no family financial, employment, investment or business relationship with the company (other than in the normal course of business)?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee regularly seek information from the external auditor about its policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Did the audit committee agree with the board the policy for the employment of former employees of the external auditor, and does the audit committee monitor application of that policy (including the number of former employees of the external auditor currently employed in senior positions in the company)?

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
--------------------------	--------------------------	--------------------------	--------------------------	--------------------------	--------------------------

Does the audit committee monitor the external audit firm's compliance with applicable ethical guidance relating to the rotation of audit partners, the level of fees that the company pays in proportion to the overall fee income of the firm, office and partner and other related regulatory requirements?

Yes / No / N/A	Rating					Comment
	Excellent				Poor	
	1	2	3	4	5	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Does the audit committee develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Does the audit committee have a policy specifying non-audit work: from which the external auditors are excluded; for which the external auditors can be engaged without referral to the audit committee; and for which a case-by-case decision is necessary?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Does the audit committee keep the nature and extent of non-audit services provided by the auditors under review?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Does the audit committee review and agree the engagement letter issued at the start of each audit and, where necessary, ensure that it has been updated to reflect changes in circumstances arising since the previous year?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Does the audit committee satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective audit can be conducted for such a fee?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	At the start of each annual audit cycle, does the audit committee consider whether the auditor's overall work plan, including planned levels of materiality, and proposed resources to execute the audit plan appears consistent with the scope of the audit engagement, having regard also to the seniority, expertise and experience of the audit team?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Does the audit committee: discuss with the external auditor major issues that arose during the course of the audit; review key accounting and audit judgements; review levels of errors identified during the audit, obtaining explanations as to why certain errors might remain unadjusted?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	Does the audit committee review the audit representation letters before signature by management?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	At least annually, does the audit committee meet with the lead audit partner, and other members of the audit team as necessary, without the presence of management, to discuss issues arising from the audit, and any other matters that the auditor might wish to raise with the audit committee and vice versa?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	As part of the ongoing monitoring process, does the audit committee review the management letter (or equivalent) and monitor management's responsiveness to the external auditor's findings and recommendations?
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	At the end of the annual audit cycle, does the audit committee assess the effectiveness of the audit process?

		Rating					
		Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	Comment	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

## Whistle-blowing

Does the audit committee review the arrangements by which staff may raise concerns in confidence about possible improprieties in matters of financial reporting, financial control or related matters.

		Rating					
		Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	Comment	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

## Relationship with the board

Does the audit committee report to the full board after each meeting?

		Rating					
		Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	Comment	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

Where there is disagreement between the audit committee and the board, is adequate time set aside for discussion of the issue with a view to resolving the disagreement?

		Rating					
		Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	Comment	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

Where disagreements between the audit committee and the board cannot be resolved, does the audit committee have the right to report the issue to shareholders?

		Rating					
		Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	Comment	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

## Communications with shareholders

Does the audit committee ensure that a report on its role and responsibilities, and the actions taken to discharge those responsibilities is included in the annual report and accounts? Does such a report provide sufficient detail to enable shareholders to understand how the audit committee has discharged its duties?

		Rating					
		Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	Comment	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

Does the report on the audit committee's activities provide sufficient detail to enable shareholders to understand how the audit committee has discharged its duties?

		Rating					
		Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	Comment	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

If the board did not accept the audit committee's recommendation regarding the appointment, reappointment or removal of the auditors, did the audit committee ensure the annual report and accounts included a statement explaining its recommendation and the reasons why the board took a different stance?

		Rating					
		Excellent		Poor			
Yes / No / N/A	1	2	3	4	5	Comment	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

Does the chairman of the audit committee attend the AGM and, where necessary, answer questions on matters within the scope of audit committee's responsibilities?

## Recommendations for improvement

How can the audit committee improve its performance?

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## Appendix 5

# Example questions - identifying and assessing risk



In view of the different approaches boards may take in referring powers to the audit committee in respect of risk management and the control framework, it is vital that there is an unambiguous understanding of what the board of directors, other board committees and the audit committee are responsible for in this important area of corporate governance. The audit committee's responsibilities should be reflected in its terms of reference.

So as to meet its responsibilities under its terms of reference, the audit committee needs to assess whether it is getting appropriate risk management information regularly enough and in a format that meets the needs of members. It needs to evaluate at least annually the adequacy and timeliness of management reporting to the committee on financial, non-financial, current and emerging risk trends. The audit committee needs also to discuss risk management with senior executives, internal and external audit. The scope of those discussions should have reference to the audit committee terms of reference.

The following are high-level questions the audit committee may like to consider in framing discussions with management. The list is not exhaustive and will require tailoring based on the audit committee's terms of reference as well as the particular circumstances of the organisation.

Risk management framework	Evaluation of risk management framework
<p><b>Risk management framework</b>  <b>Risk strategy: the approach for associating and managing risks based on the organisation's strategies and objectives.</b></p>	<ul style="list-style-type: none"> <li>• What are the risks inherent in our business strategies and objectives?</li> <li>• How is our risk strategy linked to our business strategy?</li> <li>• Is our risk management policy clearly articulated and communicated to the organisation? If not, why not? If yes, how has this been achieved?</li> <li>• Is our risk appetite (the amount of risk the organisation is willing to take) clear? How is it linked to our objectives?</li> <li>• How has the board's perspective on risk permeated the organisation and culture?</li> </ul>
<p><b>Risk structure: the approach for supporting and embedding the risk strategy and accountability.</b></p>	<ul style="list-style-type: none"> <li>• Is there a common risk management language/terminology across the organisation? If not, why not?</li> <li>• Is accountability for risk management transparent at the management level? If not, why not? If yes, describe how this has been achieved.</li> <li>• Are risk management activities/responsibilities included in job descriptions?</li> </ul>
<p><b>Measuring and monitoring: the establishment of Key Performance Indicators (KPIs) and continuous measuring and improving of performance.</b></p>	<ul style="list-style-type: none"> <li>• How do our performance management and incentive systems link to our risk management practices?</li> <li>• Are risk owners clearly identified? If not, why not. If yes, How?</li> <li>• Are there systems in place for measuring and monitoring risk?</li> <li>• How are risks, including suspected improprieties, escalated to the appropriate levels within the organisation?</li> <li>• How is the risk management framework linked to the organisation's overall assurance framework?</li> </ul>

Risk management framework	Evaluation of risk management framework
<p><b>Portfolio: the process for identifying, assessing and categorising risks across the organisation.</b></p>	<ul style="list-style-type: none"> <li>• Does a comprehensive risk profile exist for the organisation? If not, why not?</li> <li>• Does the risk profile evidence identification and evaluation of non-traditional risk exposures?</li> <li>• Are the interrelationships of risks clearly identified and understood?</li> </ul> <p><b>Operational risk</b></p> <ul style="list-style-type: none"> <li>• What are the risks inherent in the processes chosen to implement the strategies?</li> <li>• How does the organisation identify, quantify and manage these risks given its appetite for risk?</li> <li>• How does the organisation adapt its activities as strategies and processes change?</li> </ul> <p><b>Reputation risk</b></p> <ul style="list-style-type: none"> <li>• What are the risks to brand and reputation inherent in the way the organisation executes its strategies?</li> </ul> <p><b>Regulatory or contractual risk</b></p> <ul style="list-style-type: none"> <li>• Which financial and non financial risks are related to compliance with regulations or contractual arrangements?</li> </ul> <p><b>Financial risk</b></p> <ul style="list-style-type: none"> <li>• Have operating processes put financial resources at undue risk?</li> <li>• Has the organisation incurred unreasonable liabilities to support operating processes?</li> <li>• Has the organisation succeeded in meeting measurable business objectives?</li> </ul> <p><b>Information technology risk</b></p> <ul style="list-style-type: none"> <li>• Is our data/information/knowledge reliable, relevant and timely?</li> <li>• Are our information systems reliable?</li> <li>• Do our security systems reflect our reliance on technology, including our e-business strategy?</li> </ul>

Risk management framework	Evaluation of risk management framework
<b>Portfolio: continued.</b>	<b>New risks</b> <ul style="list-style-type: none"><li data-bbox="584 349 1461 450">• In a business environment that is constantly changing, are there processes in place to identify emerging risks? If not, why not? If yes, describe.</li><li data-bbox="584 490 1461 622">• What risks have yet to develop? These might include risks from new competitors or emerging business models, recession risks, relationship risks, outsourcing risks, political or criminal risks, financial risk disasters such as rogue traders, and other crisis and disaster risks.</li></ul>
<b>Optimisation: balancing potential risks and opportunities based on the appetite to accept risk.</b>	<ul style="list-style-type: none"><li data-bbox="584 696 1461 797">• Does the risk approach include a regular search for new markets, partnering opportunities and other risk optimisation strategies? If not, why not? If yes, how is this achieved?</li><li data-bbox="584 837 1461 898">• Is risk a priority consideration whenever business processes are improved? If not, why not? If yes, describe how this is achieved.</li></ul>

## About the Audit Committee Institute

Recognizing the challenges that audit committees face in meeting their demanding responsibilities, KPMG created the Audit Committee Institute (ACI) to serve as a resource for audit committee members and senior management. Our primary mission is to communicate with audit committee members to enhance their awareness of, commitment to, and ability to implement effective audit committee processes.

Wholly sponsored by KPMG International, the ACI provides complimentary guidance and engages in a variety of initiatives to assist audit committee members. Board members can turn to the Institute at any time for help and advice or to share knowledge.

Since ACI was first launched in the United States in 1999, more than 25 other KPMG member firms have established similar initiatives, including those in Luxembourg, United Kingdom, Germany, France and Belgium. The strength of this network allows us to more closely monitor international trends and issues affecting audit committees.

In Luxembourg, ACI collaborates actively with the Luxembourg Institute of Directors (Institut Luxembourgeois des Administrateurs - ILA) via the ILA working group on Audit Committees.

**Web links:**

[www.auditcommittee.lu](http://www.auditcommittee.lu)

[www.kpmg.com/aci](http://www.kpmg.com/aci)

[www.ila.lu](http://www.ila.lu)

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