



AUDIT COMMITTEE INSTITUTE

Five Guiding Principles for Audit Committees

KPMG INTERNATIONAL

Those seeking to strengthen corporate governance and enhance audit committee oversight often look for (and recommend) “leading” or “best” practices—and with good reason: they suggest processes, policies, or approaches that “work.” Yet, practices that work best for one organization may not be ideal for another—especially in a corporate governance environment where corporate culture, financial reporting risks, and governance needs can vary dramatically from company to company.



Communicating with
audit committee members
since 1999

KPMG’s Audit Committee Institute (ACI) believes, however, that certain guiding principles underlie the effectiveness of every audit committee. Even as specific oversight practices evolve to address changing risks, regulatory requirements, and corporate governance needs, the right principles can help ensure that practices are applied effectively—that is, by the right people with the right information, processes, and perspectives.

To this end, we offer five guiding principles for audit committees and corporate leaders to consider when developing, evaluating, and refining the audit committee’s oversight processes and practices:

1. Recognize that one size does not fit all.
2. Have the “right” people on the committee.
3. Monitor and insist on the right “tone at the top.”
4. Ensure the oversight process facilitates the committee’s understanding and monitoring of key roles, responsibilities, and risks within the financial reporting environment.
5. Articulate and exercise the committee’s direct responsibility for the external auditor.

The first four principles have long been important to audit committee effectiveness; the fifth, which was mandated by the Sarbanes-Oxley Act of 2002 (S-O), is vital to the independence, objectivity, and integrity of the financial reporting process.

Refocusing on the Basics

With compliance processes related to S-O widely in place, many audit committees are refocusing their agendas on other matters they believe are most critical to the integrity of the financial reporting process—from critical accounting judgments and estimates to internal audit resources to the oversight of risk management.

Given the demands of the new corporate governance environment, this “back to basics” focus presents its own challenges. The complexity of accounting issues, increased oversight responsibilities, and unprecedented expectations of shareholders and regulators require audit committees to be more focused than ever on enhancing their efficiency and effectiveness, including improving the committee’s interaction with management, internal audit, and external auditors.

In tackling these and other challenges, ACI encourages corporate leaders to consider the five guiding principles presented here. We believe they can provide a strong foundation and framework for audit committees to develop their own “leading practices”—and, ultimately, to be effective in their oversight of the financial reporting process.



FIVE GUIDING PRINCIPLES FOR AUDIT COMMITTEES

1. One size does not fit all: When delegating oversight responsibilities to the audit committee, recognize that the needs and dynamics of each company, board, and audit committee are unique.

In general, audit committees are responsible for oversight of the company’s financial reporting process, including related risks and controls as well as the company’s internal and external auditors. In delegating these and other oversight responsibilities to the audit committee, however, each board should factor in the unique needs, dynamics, and culture of the company and the board.

The responsibilities of the audit committee should be clearly communicated and precisely defined; and its workload and agenda should be appropriately limited and focused on essential issues, activities, and responsibilities.

Once delegated, the activities of the audit committee—including appropriate management interaction—should have the ongoing support of the full board.

2. The board must ensure the audit committee comprises the “right” individuals to provide independent, objective, and effective oversight.

Members of the audit committee should be independent and financially literate, and have the personal and professional characteristics necessary to be effective

committee members. As a body, the audit committee should be “informed, vigilant, and effective overseers of the financial reporting process.”¹

To this end, each audit committee member should have:

- A general understanding of the company’s major economic, operating, and financial risks.
- A broad awareness of the interrelationship of the company’s operations and its financial reporting.
- An understanding of the difference between the oversight function of the committee and the decision-making function of management.²

To use this knowledge effectively, audit committee members must have the ability to ask probing questions about the company’s financial reporting process and a willingness to challenge management’s assertions when necessary. Asking the “hard questions” and effectively evaluating the answers to them requires intelligence, diligence, a probing mind, and financial literacy.³

Perhaps the most important characteristic of an effective audit committee member is a willingness to challenge management; this is the essence of independence.

¹ “Report of the National Commission on Fraudulent Financial Reporting” (Treadway Commission Report), 1987

² Frank Burke and Dan Guy, *Audit Committees: A Guide for Directors, Management, and Consultants*, Third Edition (New York, Aspen Law & Business, 2004), p. 81

³ Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 1999

3. The board and audit committee must continually assess whether—and insist that—the “tone at the top” sets an expectation of integrity and accuracy in financial reporting.

In establishing the “right tone,” the company’s leaders—from the CEO, CFO, and other senior management to line management across the enterprise—should be unequivocal in their insistence on accuracy and transparency in financial reporting. They must set the expectation that all financial numbers and statements represent the actual financial performance of the company.

The audit committee, as part of a system of checks and balances on management and the guardian of shareholder interests, should continually assess whether management has set the “right” tone and whether that tone is reaching the rest of the organization.

To help maintain the right tone at the top—and throughout the company—the audit committee should insist that management “talk the talk” (verbalize the company’s standards and expectations at every opportunity) and “walk the walk” (put its ethics policies into everyday practice).⁴

4. The audit committee’s oversight process should facilitate its understanding and monitoring of key roles, responsibilities, and risks within the financial reporting environment.

An effective oversight process—encompassing people, policies, and practices—provides the framework for the audit committee to carry out its oversight

responsibilities by helping the committee understand and monitor:

- The company’s critical financial reporting (and related) risks
- The effectiveness of financial reporting controls
- The role and effectiveness of the audit committee (vis-à-vis the roles of the full board, management, and external auditors)
- The independence, accountability, and effectiveness of the external auditor
- The transparency of financial reporting and disclosures.

Developing an effective oversight process requires the active participation of the audit committee, management (including internal audit), and the external auditor—collectively, the “three-legged stool” of financial reporting. To this end, the audit committee should understand the specific and unique role that each “leg” plays in the financial reporting process and must hold each participant accountable to the board and the audit committee.

An effective oversight process also is predicated on the audit committee having an understanding of the company’s financial reporting risks (and the controls related to those risks) as well as appropriately communicating and coordinating its responsibilities and activities with other committees of the board in areas of oversight that may overlap (e.g., risk management and compensation). Ultimately, an effective oversight process is one that is well defined, clearly articulated, and driven by informed and persistent listening, questioning, assessing, and challenging on the part of the audit committee.

⁴ “Tone at the Top: Getting It Right,” speech by Stephen Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, at Second Annual General Counsel Roundtable, December 3, 2004

⁵ The Sarbanes-Oxley Act of 2002, section 301



5. The audit committee must continually reinforce its “direct responsibility” for the external auditor, as required under Sarbanes-Oxley.⁵

One of the most significant changes to come out of the S-O reforms is the audit committee’s “direct responsibility” for the external auditor—specifically, its appointment, compensation, evaluation, and retention. To ensure the auditor’s true independence from management, however, the audit committee’s direct oversight responsibility for the auditor must be more than just words in the audit committee’s charter or items on its agenda. All parties—the audit committee, external auditor, and senior management—must acknowledge and continually reinforce this direct reporting relationship in their everyday interactions, activities, communications, and expectations.

Independence, Diligence, and Integrity

Returning to guiding principle number one: each audit committee faces unique oversight challenges and corporate governance needs and must therefore determine which processes, policies, and practices work best. By applying the guiding principles discussed here, however, all audit committees can help advance their common goal of providing effective financial reporting oversight with independence, diligence, and integrity.

To Learn More

In-depth commentary and analysis on these and other audit committee issues are provided at www.kpmg.com/aci. Feel free to contact the ACI with any comments or questions at 1-877-KPMG-ACI (1-877-576-4224) or auditcommittee@kpmg.com.

About ACI

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