

# An Effective Audit and Risk Committee



*The-Panel-from-left-Mr.-Manil-Jayasinghe,-Ms.-Marina-Tharmaratnam,-Desh.-Deva-Rodrigo,-Ms.-Shirani-Jayasekera,-Mr.-Arjuna-Gunaratne-&-Mr.-Sarath-Ganegoda*

The second module of the series of panel discussions organized by the Sri Lanka Institute of Directors on ‘Contemporary Views on Corporate Stewardship & Boardroom Governance’ took place at the Ivy room of the Cinnamon Grand Colombo recently. Titled ‘An Effective Audit & Risk Committee’, it drew a full house despite the torrential rain that inundated the streets of Colombo that day.

The expert panel consisted of very high profile personalities from the accounting and audit fraternity of Sri Lanka. Leading the panel was Deshamanya Deva Rodrigo who is presently an Independent Director of John Keells Holdings PLC, and holds the distinction of being a founder partner and subsequent Senior Partner of Pricewaterhouse Coopers as well as being the former Chairman of the Ceylon Chamber of Commerce. The rest of the panel consisted of Mrs. Marina Tharmaratnam, the Immediate Past President of the Sri Lanka Institute of Directors, and the former CEO and current Independent Director of Union Assurance PLC, Mrs. Shirani Jayasekera, Head of Internal Audit of Carsons Cumberbatch PLC, Mr. Manil Jayasinghe, Senior Partner of Ernest & Young, Mr. Arjuna Gunaratne, Director/CEO of CF Venture Fund Ltd. & Mr. Sarath Ganegoda, Financial Director of Hayleys PLC.



*Ms.-Marina-Tharmaratnam*

When one reflects on the structure of an organization, the audit committee stands out as a primary element on which not only the auditors but also the stakeholders and the entire board relies on with regard to the management. As per the Colombo Stock Exchange Regulatory code, it is compulsory that listed companies include an audit committee but in reality this is applicable to all companies due to the important role that it plays. Usually it is the Board of Directors that appoints the audit committees and according to the code a majority should be independent, non executive directors thus emphasizing the importance of the committee.

## The Purpose



*The-Challenger-Desh.-Deva-Rodrigo*

The Challenger, Desh. Rodrigo kicked off the programme by giving an introduction to the audit committee. “It is a powerful department of any organization which originated during the great depression that hit the globe during the 1930s. Corporate governance became an issue during this period which resulted in the development of the audit committee.

“When we refer to an ‘Audit and Risk Committee’, it is a term which in certain places is simply referred to as ‘Audit Committee’ but will cover the whole area of risk as well” he continued. “Relating to the importance of an audit committee I recall the story on how Sir Henry Benson, a one time accountant who had qualified the accounts of a famous construction company was subsequently requested by the company to change his qualification and thereafter resign. Sir Benson went to the Institute of Chartered Accountants of UK and informed them of the situation he had to face all because he was doing what was considered right. The Council considering this to be an emergency situation investigated the matter and decided to defend an auditor, a member carrying out his professional duty without fear. The Council wrote to all practicing members of the Institute including the ACCA urging them not to accept this audit. This eventually resulted with the said company not being successful in appointing an auditor at their AGM. It has to be said that if the company had an audit committee such a situation would not have arisen.”

Rodrigo further explained “the Audit Committee therefore protects the independence of the auditor. In the past there existed a situation in which the Executive Directors recommended to the shareholders the appointment of the company’s auditors, even though it should be the shareholders who are the final judges in selecting the auditors. This was likened to a thief appointing his own policeman and therefore the economists considered this unsuitable for the

development of any company. Apart from preventing this from occurring there are other functions that an audit committee performs.

“In the modern day, the audit committee is charged with the responsibility of looking after the integrity of financial statements as well as the internal control system. This however does not mean that they have to test it themselves but they have to give assurance to the shareholders that the internal control system is adequately designed and is in place and is operating effectively and also that it gives a true and fair view of the company’s financial standing.

“Ensuring that the external audit is effective involves not only checking on whether they have the right qualifications but beyond that; checking on whether they have the competence, experience and the most important factor being that they are independent. The next function is the performance of the external auditor and the internal auditor and finally the compliance with the rules and regulations of a listed company, the Companies Act and other legislation.”

Commenting on the safeguards against the undue removal of auditors that existed prior to the origin of the audit committee, Rodrigo referred to the situation in the USA where a company is required to fill in a form whenever an auditor is changed stating any major disagreements had with the auditor in the past two years. This was made available to all shareholders to determine whether the changing of the auditor was triggered by the disagreement with the management. “Unfortunately” he continued, “such safeguards are still not available in Sri Lanka. The only safeguard lies in the form of an audit committee which comprises independent non executive directors to whom the auditors would be able to voice their concerns over their removals due to unjust reasons.”

Referring to the area of wider risk management, which many consider a responsibility of the audit committee, he was of the view that present day audit committees go beyond internal control and financial reporting to look at the adequacy of the total risk management process of a company. This involves matters such as operational risk, market risk, reputational risk and others that have evolved over the years. Audit committees utilize the audit committee charter to restrict the scope of risk management it is expected to cover during its day to day activities by incorporating the limits it needs to adhere to.

## The Audit Committee Charter:



*Mr.-Manil-Jayasinghe*

The nature and process of the audit committee charter was then succinctly described by Jayasinghe. “It not only contains the functions of the audit committee but also lays down the delegated authority from the Board so that the audit committee can function independently. In short it lays down the composition, the roles and responsibilities of the audit committee whilst ensuring and enhancing the quality of the financial reporting.”

“One of the key areas that the charter will cover” he continued, is the organizational composition; such as how many directors, either independent or executive, should be appointed to an organization and their qualifications. Some of the common requirements would be that all members of the audit committee have to be financially literate and that at least one member of the committee should be a so called ‘expert’ in financial reporting activities such as accounting standards etc. Other aspects cover the composition of the committee, whether there should be three independent directors or four, the number of meetings to be had and the board to be apprised of the functioning of the audit committee.”

Jayasinghe further added that the Charter needed to outline principles relating to audit such as the integrity of the financial statements and the effectiveness of the internal controls. However he was of the view that the extent of internal controls is limited in that it applies only in respect of financial reporting. In addition, compliance with the legal and regulatory requirements comes within the purview of an audit committee and therefore must be included in the charter together with the internal audit functions and the oversight of the external audit functions.

On the subject of risk management, he pointed out that it referred to the financial risk aspect such as market risk, liquidity risk, accounting and financial reporting which have a direct impact on the financial reporting and not the other kinds of risks like operational risk, strategic risk etc which are the others kinds of risk that you may find. Financial reporting can be assessed by quarterly reporting but in reality this needs to be done more frequently in order to perform the auditing function reasonably.

Jayasinghe had the following to say on external audit, another function of the audit committee. “When it comes to external audit it is primarily the oversight role; the appointment, the remuneration or compensation, the retention of auditors and so on, that comes within the purview of the audit committee which is basically delegated by the board. This area sometimes may not be practiced in Sri Lanka, but overseas, they go to the extent of evaluating the competence and performance of the auditors. For example each of the audit firms are supposed to have internal quality controls. In the USA for example they go to that level, but in Sri Lanka I don’t think we have gone that far although I’m sure it will progress towards that.”

Among the other functions of the audit committee, related party transactions, oversight over internal audit, the hiring and removal of the Chief Internal Officer / Internal Audit Director, compliance oversight & code of ethics were mentioned.

With regard to issues of whistle blowing provisions, there needs to be a mechanism to ensure that such complaints and areas that have been raised gets to the audit committee and that there is a proper mechanism for the resolution of these.

The audit charter can be utilized to monitor the performance of the audit committee and in doing so the committee can review their functions and evaluate their relevance in the present day context. Thus self evaluation needs to be implemented on an annual basis. Jayasinghe concluded by pointing out that in keeping with the performance of all of these functions, the audit committee must be given powers to hire or cause any investigation it deems fit to satisfy its objectives. He referred to the system prevalent in the USA where an audit committee calls upon external people to give the different views so that it can decide whether the organization has adopted the right choice.

The next to address the gathering was Tharmaratnam who spoke on the composition and the selection process of the audit committee. As mentioned by her the basic qualities expected of the members of the audit committee can be laid down as follows; independence, knowledge and skills, a financial knowledge and knowledge of the business. An orientation program is required for this purpose where they learn the structure of the business and have regular meetings with the general managers so that they get to understand the business and identify the controls that can be brought in.

A question was raised as to whether the responsibility of financial reporting extends to the point that you would even carry out a review of the information that is presented to the board particularly in terms of risk management. The panelists were of the view that it is the responsibility of the audit committee to drive the risk management process and get that information to the board and that in doing so it needs to take the total business as a whole into consideration. This is so, as the final goal is the sustainability of the business.

On the matter of the ultimate objective of the audit committee; whether it is limited to considering whether it is going to be a growing concern or extends to determining whether the strategies and objectives of the organization have been realized, Jayasinghe was of the view that even though

this aspect is debatable, technically risk is the responsibility of the board. He also made the point that in the event that an audit committee takes over all of the responsibilities there would be no need for a board. It must be born in mind that the audit committee is after all a sub committee of the board and does what the board delegates it to do.

### **Internal & External Auditors**

The audit committee has to review the independent external auditor's qualifications, their independence, ability to perform and the appointments and reappointments of independent auditors. They also need to maintain free communication with the internal as well as the external auditors preferably in the form of meetings without the presence of the management.

Commenting on the similarities between the roles and the working relationship between the internal and external auditors, Jayasekera had the following to say. "Both parties should be independent, objective and have input integrity in that if there is something to be reported on, it has to be done even if it is very sensitive. The internal audit must approach the audit committee and discuss it and see how to deal with it. External auditors however have a different responsibility. In other matters both must be presented with the audit plan, they should challenge it, appraise it and give their input by way of clear and concise reports. The action plan to control those weak areas should be agreed and accepted by both parties; the management as well as the audit.

Concentrating on the differences, external audit deals in areas such as true and fair reviews whereas internal audit is more of the business part of it such as delivering corporate objectives. Also the independence of the external auditor is generally higher than the internal auditor. Hence in external audit, partner rotation is required every 5 years even though it is not mandatory for internal auditors. It is important for internal auditors to have a good understanding of the business which can be done by getting people from the business to work with internal audit for short periods which will enable them to get insights in to what is required by way of internal controls."

## Internal Control & Risk Control



*Mr.-Arjuna-Gunaratne*

In their pursuit of success, organizations are faced with varying types of risks, both external and internal. It is needless to say that a better managed company will handle these risks efficiently within a framework of corporate governance.

Commenting on this subject, Gunaratne referred to the internal control framework as the backbone of a company in handling these matters. Internal controls make sure that the company gains reliable financial information and that it has an efficient and robust operational procedure which lays down formal policy guidelines and defines accountabilities and responsibilities. It will also make sure that the company complies with the various regulatory requirement and legislations in place.

How does an organization make sure that this internal control framework is effective? The board itself can set the tone for a control conscious environment at the top by showing that the governance structure is strong and that it believes in integrity and values by showing that compliance is taken seriously with repercussions in force if control mechanisms are not adhered to. Gunaratne expressing his views said “Very often companies tend to look at the growing of the business at the expense of controls. That mindset must be brought in and it must be ensured that the audit committee sets the right controls and that this should not be considered as an impediment to the speed of business, but as a very important part of the business itself.”

“Audit committees also need to pay special attention towards matters such as the methodology with regard to these controls, their proper functioning and the availability of the right kind of information systems which do the reporting and highlight when things are not falling into place.” He singled out IT operations as one of the common segments to which organizations should concentrate more in relation to control framework. With the expansion of business transactions and the complexities of business systems taking place, companies are faced with more risks which require expert and careful handling.



## Risk Management.



*Ms.-Shirani-Jayasekera*

Jayasekera began her discussion by explaining briefly the terms of risk and control. She described risk as anything that comes between a person and his/her objective and control as anything done in the process of managing that risk. Risk has been defined as ‘any event, situation or circumstance which if occurred would adversely affect the achievement of objectives including the failure to capitalize on the opportunities.’ Using the example of a man climbing a mountain, she impressed upon all that, as process owners people are responsible for meeting their objectives i.e. reaching the peak of the mountain, for identifying the risks i.e. having the proper climbing equipment, and finally, being in control. The auditors will thereafter overview, review and give an opinion on whether or not he has managed his controls, but that will be done only after the event. Therefore the process owner is responsible for his own actions and responsible to meet his own objectives. She also pointed out that risk management is not about putting too much of controls so that you become risk averse but about balancing your internal controls and being proactive rather than being reactive.

On the subject of best practices, she touched upon the COSO Enterprise Risk Management, a process that an entity’s board of Directors and management applies in strategy setting as well as across the enterprise in order to identify potential events and to manage those events to be within the risk appetite. “Risk appetite can be defined as the amount of risk that an entity is willing to accept at a broad level in pursuit of value. An example would be a multinational company that

states that its risk appetite is to grow profits and cash flow at the rate of 18 – 25% but which eventually rises to 30% within the year. That might be too much and they may need to look and review the level of risk they are willing to take - in other words, its risk appetite.” Jayasekera also pointed out that the risk appetite of a company must be uniform and should not take the form of a yo-yo over the years.

“Be it departmental, corporate or individual, any person can identify their objectives and assess the risks involved” she continued. “If you find that certain tolerances are going beyond your estimated level, then such tolerance would be considered as a risk and you will need to draw up a risk response which should preferably be within the risk appetite. Presently there is an ISO 31000:2009 standard which sets down guidelines on how to manage risks. This contains 11 principles on risk management, some of which are as follows; Risk management should create value, it should be an integral part of an organization’s processes and it must be part of decision making.” Hence she went on to clarify “it may not be a separate meeting on risk but a normal business process with risk embedded in it.”

Jayasekera concluded her discussion by stating that risk management can be a very important business driver and also that the tone at the top which drives that risk management is important in making the strategic plans come alive right down to all levels of your business.

### **Compliance with Legislation**

Since the audit committee is a specialized body appointed by the board to perform certain specialized tasks, compliance with laws and regulations becomes part of its mandate. Commenting on this compliance Jayasinghe stated that it is not all rules and regulations, but those that have a direct significance to these tasks. He took the audit committees in the West that focuses primarily on financial reporting as an example.

Basing his views on the subject of internal controls, the distinction between financial controls and operating controls for financial reporting and also the controls on the overall risk area, Jayasinghe had the following to say. “If for example you take a product, you might have controls to minimize the product rejects in the production line. From a financial reporting point of view that process might not get evaluated. But once the reject happens, the capture of such occurrence and it being accounted for will be evaluated. In other words it is trying to distinguish between operating controls and financial reporting controls. In my view it is the latter that comes within the purview of audit committees and not necessarily to see whether you have the necessary checks and balances in the production flow which is an operational control.”

“Non compliance, with regulations has an impact not only on the financial statements but also on the company, its reputation and also the reports that the company presents. Therefore you cannot have deviations from regulations’ concluded Jayasinghe.

## Communication and Reporting



*Mr.-Sarath-Ganegoda*

Internal controls, risk management, risk control, checks, balance and procedures, all of the above are means used to ensure that business is run well in order to achieve its objectives. Apart from these, it also needs to be ensured that no fraudulent or unethical practices take place during this process and that the results of the business are accurately and timely reported. These results are then communicated to the stakeholders through financial statements.

Speaking on the above Ganegoda stated that it is mandatory that listed companies issue quarterly statements and annual financial statements; balance sheet, P&L, cash flow and various other information so that the stakeholders get a good view on what is going on with regards to the company. Likewise even large unlisted companies have audit committees that meet and discuss these reports in detail before the board adopts the quarterly and annual financial statements, which is another method used in order to ensure that the correct statements are issued to the stakeholders.

Internal audit which is based on the COSO method is used by companies to establish a direct communication with the audit committee. The committee meets with the internal auditors prior to the audit committee meeting and gets feedback on these matters which are then discussed in detail during the audit committee meetings. The minutes of this meeting is then made available to the Board of Directors. Therefore this mechanism ensures that financial statements are adopted by a company's board based on the recommendations of the audit committee. This can be adopted for any price sensitive information and is not necessarily limited to financial statements. Hence an effective audit committee in reality makes the life of Directors much easier. Since the members of the audit committee are Non Executive Directors who possess very limited amount of information pertaining to the day to day business activities, it is very important that this communication link is established between the audit committee and the internal auditor.

A question was raised by a participant as to the ability of the audit committee to perform all of the said functions during its limited time capacity which is four meetings a year. Answering the above, Jayasinghe stated that the quarterly meeting procedure was a result of the mandatory requirement of quarterly reporting. However, the audit charter can lay down the frequency of audit committee meetings depending on the size and complexity of the organization.

The frequency of meetings may also depend on the scope of COSO, of strategic oversight and risk. Unlike in the past, today the engagement between the audit committee and the internal audit is far too strong making the controls more proactive rather than reactive. This is a good policy to adopt. Also apart from the standard audit committee meetings, the members of the committee can also set up informal meetings with the Management in order to review the controls.

Commenting on whether the audit committee has the ability to perform all of the said duties, a participant made the following observation. It is the management that must perform these duties and the audit committee must ensure that the management actually does so. "I don't think an audit committee is there to check on all the nitty gritty, they have to be savvy enough with their own knowledge and the right indicators to know whether the management that has been selected to run that organization, whose skills on which the stakeholders depend on, those directors are doing everything that was covered from risk management to ensuring that the internal controls are there, the checks and balances, proper reporting, ethical behaviour, professional conduct and setting the standards all of which should be done."

Another view that was observed by yet another participant was that risk management which actually does not form part of the operational activities of the business, must be taken into the strategic planning process and thereafter driven in the implementation stage. By doing so, risk management can be more effective and supportive towards the achievement of goals.

Rodrigo added that the audit committee must have the finesse and experience to ask the right kind of questions in order to make sure that what they hear are actually being done. This can be applied in with regard to discussions with the auditors as well, whereby asking the right questions and being answered clearly will grant much more comfort to the audit committees as regards the running of the business.

In reply to a query from a participant as to whether the concepts of residual risks and risk management could be embedded into the organizational structures of insurance companies Mrs. Tharmaratnam made the following observation. "Most companies today have begun to include reputational risk, market risk and many other kinds of risks into the area of risk management. Anything can be insured, but it can be done so at a cost. The audit committee may look at whether the risks have been assessed correctly, the impacts of the risk and also whether the management doing the right job but ultimately the board is responsible for entire gamut of responsibilities which were mentioned above. The committee in turn is delegated with the task of reviewing the management and correctly identifying the risks because the management has far more expertise to identify the risks. With regard to risk mitigation strategies the audit committee is expected to look at it and decide if the risk mitigation strategy is adequate. So it is the risks which are at a very high level that the audit committee will look at and not each and every risk that may come within the entire gamut of risk."

Rodrigo used the following example to impress upon those present on the management of risk and risk appetite. "If we could consider the business practices of 3 companies, one company 'A' might prefer not to take any credit risk and therefore have all of its sales on a cash basis. Another company 'B' who will be confident of collecting the debts might be willing to take the risk of sale

on credit. Likewise a third company 'C' might be willing to deliver goods on credit but might do so on a bank guarantee. Given the situation that all of the above companies operate in the same market we could assume that people may go to the company dealing on the basis of credit rather than cash because of the convenience involved. Hence even though there might be a price difference with regard to the issuance of goods on credit that company will decide to forego it maybe by giving a discount on it. However a cleverer company will even without a bank guarantee, have other mechanisms to ensure that the credit and the self image of the company have all been recovered. Therefore it can be said that ultimately, it is the fact that it is better managed and not the total avoidance of risk that proves a company's standing in business."

Rodrigo recalled an auditing book that he read in which he said "Accounting had been defined as the process by which you capture millions of complex transactions accurately and completely and then through a mode of classification, whether it is a sale, a rent payment or an asset or liability, you summarize those complex transactions into highly significant account balances which get reported in the balance sheet and income statement. This involves the application of the right accounting policy, the measurement criteria and revenue recognition.

"Internal control on the other hand is the method by which all of these transactions are processed, giving a complete and authorized product. Risk management is an aspect that is even beyond that and under which insurance is usually included. Some might consider the internal control to include the insurance policies that you take and the decisions as to whether all of the aspects carrying an insurable risk such as safety, health and injury... etc are all insured.

"What ultimately must be perceived is that risk management is a very extensive area and whether the audit committee should go into its entire depth of it depends on the normal of the 5 objectives of the audit committee, mentioned in the audit charter of which one is the internal control over financial reporting and not beyond."

Rodrigo got the participants actively involved in the discussion, and judging by the questions asked and the feed back given, this was yet another very successful session of the Contemporary Views on Corporate Stewardship and Boardroom Governance series conducted by the Sri Lanka Institute of Directors.



*The-Participants*

The next module in this series is scheduled for Thursday 13<sup>th</sup> January on “An Efficient Nomination and Remuneration Committee” at the Ivy Room of the Cinnamon Grand. This will be lead by the prominent banker Mr Rajendra Theagarajah CEO/MD HNB of Bank PLC, and ably supported by the top most rung of senior corporate directors of the caliber of Dr. Anura Ekanayake Chairman of the Ceylon Chamber of Commerce, Mr. Preethi Jayawardena MD/CEO of Chemanex PLC, Mr. Asite Talwatte Country Manager/ Partner Ernest & Young and Ms Sithie Tiruchelvam Senior Partner, Tiruchelvam Associates.