From Compliance to Governance:

Evolution of the Audit Committee

Many audit committees are playing a more vital role since Sarbanes-Oxley, especially in risk management. The maturation process demands training, succession planning and a significant commitment from members, writes **Zena Olijnyk**.

THE PAST DECADE HAS SEEN a tremendous evolution in how audit committees perceive their role in the corporate governance process, and how that role is viewed by management, shareholders and other stakeholders. From a "tick the boxes" approach towards regulatory compliance, audit committees are maturing into bodies where they see themselves in a crucial role that reaches far beyond simple oversight of the external auditors and signing off on the financial statements.

"The thinking behind what an audit committee does has moved from a pass-fail model to one where there's now good discussion among committee members, management and auditors on audit risks, how they've been mitigated, and whether the financial statements accurately reflect the operations of the organization," says Brian Hunt, CEO of the Canadian Public Accountability Board.

It's not so much that the duties of the audit committees have changed. The main job of the committee has been, and still is, to provide oversight of the organization's financial statements and evaluate the management of risk. However, audit committees today that are considered to have the

"best practices" see themselves as vital players in the risk management process itself.

"The role of the audit committee has not changed from that of ensuring the integrity and soundness of financial controls, financial disclosure and ultimately the soundness of financial statements," says Victor Young, audit committee chair at Royal Bank of Canada. "It's still all about ensuring proper disclosure and working with the external auditor to see that this proper disclosure happens."

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What has changed, Young says, is the manner in which the role is carried out. "It is now predominantly seen through a 'risk lens'. Committee discussions now revolve around areas that demand more scrutiny." Much of this, of course, dates back to the fallout from the Enron scandal and the introduction of Sarbanes-Oxley rules in the United States that were designed to ensure better risk management of the auditing process.

Brian Hunt

Kathleen O'Neill

Kathleen O'Neill, who chairs the audit committees of several companies, including Finning International Inc., ARC Resources Inc. and Cadillac Fairview Corp. Ltd., says expectations of audit committees have increased to focus more on risk management and interaction with the external and internal audit process. Of course, there's also increasing scrutiny by regulatory bodies and the professional associations to which the auditors belong.

"The amount of effort required has grown, and the challenge is to keep focused on the critical risk areas," she says.

"Different organizations will be at different stages of this evolution from compliance to governance", says Hunt. Smaller organizations, for example, may not have the same ability to immediately attract board members who each have all the required skills. Even larger organizations face a similar challenge. It goes without saying that there needs to be at least a few members on the committees with auditing and financial skills, Hunt says, but they

also have to understand how those factors play out within the organization's business and the sector it is in.

The need for management of any organization — whether public, private or not-for-profit — also goes far beyond choosing the "right" audit committee members. It's about laying the groundwork for providing the education and training necessary to keep up with what is happening in financial risk management, corporate governance and the sector the organization operates in, Hunt says.

That includes management providing specific education on the organization from its own team. But O'Neill adds that major accounting firms typically provide materials on how to be an effective audit committee member, and bodies such as the Institute of Corporate Directors provide regular seminars, including one that she teaches on audit committee effectiveness.

What also needs to be considered, Hunt says, are issues such as succession planning for members of the audit committee, and how the meetings of committee members can be organized and prepared for in order to achieve maximum effectiveness.

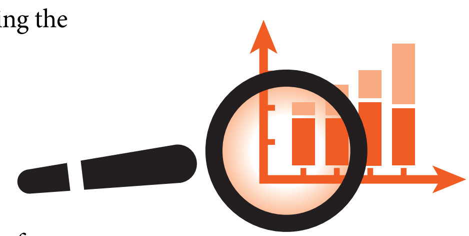
On succession issues, Hunt says it is vital the audit committee members, especially the chair of the committee, work with management and the larger board in choosing and preparing the next audit committee head for what is seen as a challenging, but ultimately rewarding, role. "Thinking about succession issues about a year in advance of any changes would be considered a best practice", Hunt says.

As well, this succession planning process should not just apply to picking the next chair. Good governance practices on when to rotate auditors and how long audit committee members should remain together also needs to be considered. Too short a time, and there's a lack of cohesion. Too long a time frame, and committee members can get "burnt out" from the workload.

O'Neill says that while the audit committee can sound daunting, she believes it is actually a good place for new board directors to cut their teeth on learning the company and the business it is in. "The chair has to be prepared to provide guidance, and the new board member must be willing to take on the work, but it's a great place for new board members to start," she says.

As for the meetings, Hunt, Young and O'Neill all agree an audit committee's duties should require members meet more frequently than the few regularly scheduled sessions each year.

For example, along with sending out materials for the meeting far enough in advance to prepare audit committee members, it's a common practice to have "pre-meetings" prior to the regular meeting with management, the internal auditor and the external auditor, O'Neill says. "The expectation is that there is a clear understanding among everyone involved of areas of emphasis and areas of concern, and that those can be cleared up before the regular meeting."



WHAT AUDIT COMMITTEE MEMBERS SHOULD BE ASKING THE EXTERNAL AUDITOR

What are the business and industry risks our company is facing that may affect financial reporting?

What are you doing to assess our risk management processes that could affect financial reporting?

Do you plan any significant changes to the scope of the audit compared with the previous year. If so, what could prove to be the high-risk areas and how would you approach to them?

How will you mitigate risk associated with company operations in foreign jurisdictions?

What areas represent the company's significant tax exposures and are there any jurisdictions where our tax rate is so abnormally low that it could cause reputational risk?

Which areas of the company's operations do you believe are particularly susceptible to fraud, and how have you modified your audit approach to address this risk? How will this approach determine whether any illegal payments are being made?

How do you rate our IT controls and how would you address any IT risks?

In what areas are you maximizing collaboration with our internal auditors to fully utilize their knowledge of our risk and operating environments?

How would you characterize the company's accounting policies compared to its peers in the industry (aggressive or conservative)?

- Source: CPAB

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Young notes it is critical that committee members know about any potential risk-related issues that come up between meetings. "We all have to be on the same page, and kept up to date, in case something is important enough to warrant a special meeting."

There's also more emphasis on viewing this work through the "risk lens" — with expectations that audit committee members ask questions of management, as well as the internal and external auditors.

As Young puts it: "If there are no probing, challenging questions asked by audit committee members during a meeting, then the audit committee chair and management should be scratching their heads."

The increasing role of audit committees to "challenge" has meant the increased significance of in camera sessions, Young says, so that no issues of concern can be "smouldering in an environment of uncertainty."

The areas most likely to need this "frank discussion" include: the quality and integrity of the financial statements; the robustness of controls; the fullness and timeliness of financial disclosure, and identifying and preparing for emerging control or auditing risks.

In the end, Young says "transparency has become paramount to ensuring a no surprises environment."

Zena Olijnyk is a Toronto-based business writer and television producer.