

# The Issues and Challenges for Audit Committees in 2007 and Beyond

Navin Pasricha & Seow Mei Ling

The authors can be contacted at [navin@cct-global.com](mailto:navin@cct-global.com) and [meiling@cct-global.com](mailto:meiling@cct-global.com).

**Tan Sri Dr. Hadenan A. Jalil, former Auditor General of Malaysia, left a legacy of greater accountability and transparency in Malaysia. He talks here about one of the cornerstones of good corporate governance: The Audit Committee (AC).**



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**Q: Tan Sri, Malaysia was one of the first in the world to make Audit Committees mandatory for listed companies through the Bursa's listing rules. What do you feel has been achieved since 1994, the year when ACs were made compulsory for listed companies?**

A: There are some very tangible things I have noted with the setting up of ACs. Firstly, significant accounting and financial issues have found themselves on the Board Agenda, much more readily than during the time before AC's.

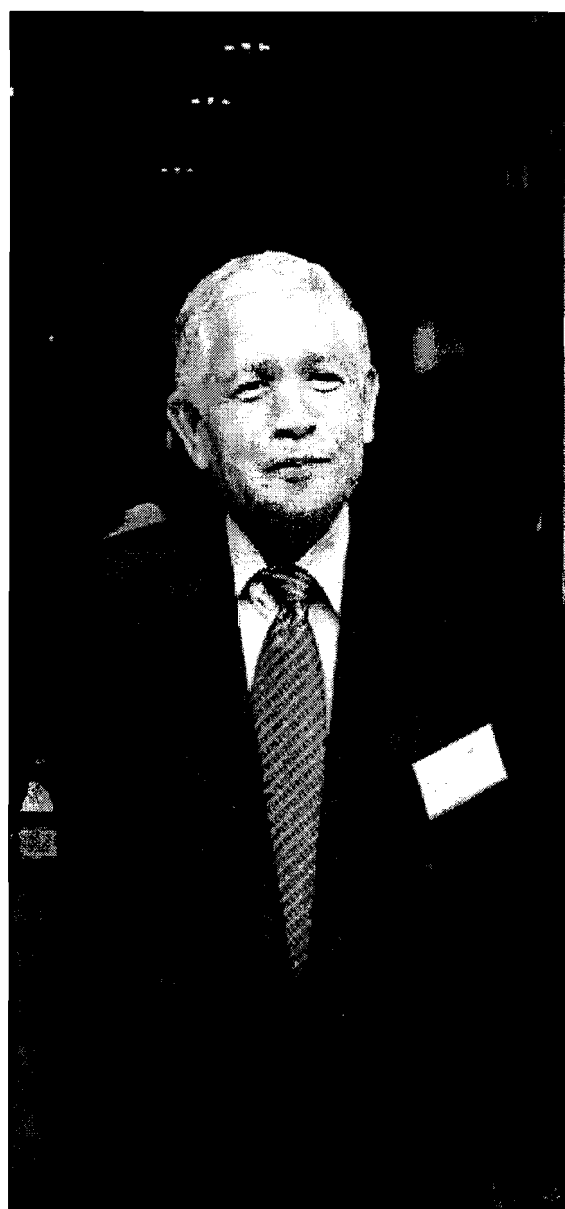
The presence of ACs has also improved the status of internal audit within listed companies. Company disclosure, particularly in respect of related party transactions and director's remuneration has improved. The quality of external audit has also been put under scrutiny by ACs and there is no doubt that standards have improved. There are very significant gains that ACs here delivered.

**Q: Clearly, you believe that many of the objectives which were in mind when ACs were introduced have been met. What of the future?**

A: Corporations of the 21st Century will be facing a changed and more challenging environment, arising not only from demands from within but more so from external sources. The management and Board, including the AC of corporations, are currently facing a paradigm shift in corporate responsibility and behaviour. Corporations are to adhere and comply with new standards for reporting of internal control effectiveness and they must adopt the practice and culture of accountability at all levels in the organisation structure. There is the growing demand for corporations to be managed in the spirit of transparency towards shareholders. Good corporate governance will be the guiding principle for corporations, demanding a more transparent process in the whole operation and people with integrity to run corporations for better public trust. It is not surprising that people have concluded that the 21st Century will be the "Century of Corporate Integrity".

**Q: Do you consider there are some specific risks that will emerge for ACs?**

A: It is an expected phenomenon, in the years to come, that management of corporations and the Board will be facing continuous and ever increasing regulatory and monitoring regimes from the various regulating bodies. The Chairman and members of the AC will be looked upon as the watchdog for the



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shareholders and the other stake holders. It is timely for AC members to realise and recognise that they are facing risks from two aspects. Firstly, risks associated with their own performance. These include:

- not fulfilling its audit charter obligation,
- not recognising failure of the internal control system,
- not understanding the implications of restatement of financial accounts,

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- miscommunication and independence failure with the external auditor,
- failing to comply with key laws and regulations.

In the effort to mitigate those risks and to ensure that ACs are able to perform their duties and carry out their responsibilities effectively, the AC must be supported by an efficient dynamic and energetic internal audit unit. As one writer puts it, "A close relationship between audit committee and internal audit isn't optimal, it is the lynchpin of an organisation's safety and soundness". Others refer to internal audit as an ART; "love them or hate them but you need them". So, it is a continuing risk for ACs if their internal audit unit is not at world class standards.

It is beyond any doubt that a company's internal auditors continue to face challenges and must have the courage to confront issues related to management's integrity, value and ethics within the company and not forgetting transparency. Good reporting is expected from an effective internal audit, and will in turn provide meaningful input to the work of the AC. The AC's work will only be effective if it is given the right information from the right party, in the right context and at the right time.

However, these are by and large everyday issues that all ACs face and they generally do it very well. Unfortunately, people do not remember that there are thousands of ACs around the world that have been doing a good, diligent job of discharging their duties effectively. Instead, they will remember only the Enron's and Worldcom's. As such, efforts must be taken to ensure that such reputation issues do not surface in the future.

**Q: You mentioned there are two classes of risk for ACs. Would you like to elaborate on the second?**

A: Yes. The first types of risk I have talked about are perennial. Then there are more topical issues of the day if you like. While AC members continue to deal with the traditional issues, new technical challenges have surfaced. The introduction of new accounting standards has tested the accounting staff and the ACs to the limit. New guidance on corporate governance and risk management continue to emanate from regulators such as Bursa Malaysia and the Securities Commission that must be complied with. For those industries that are related to finance, there are more stringent requirements in respect of anti-money laundering.

The internationalisation of the Malaysian economy is also an added audit challenge. There are a number of Malaysian companies that are doing extremely well in overseas markets and a number of them have already been listed on overseas stock exchanges or at least have a strategy to do so. This indicates that members of the AC need to be conversant not only with local laws and conventions but also with overseas

jurisdictions. ACs need to be aware that sometimes these overseas jurisdictions have entirely different ways of doing business that they need to be familiar with.

For instance, a number of Malaysian companies have been successful in the construction market in India. In that country, labour is still largely paid in cash. Very often materials are also purchased in cash. The control issues involved can often be a real challenge for the AC which is more familiar with the use of plastic money and direct credits in workers bank accounts. Basic issues such as the impairment of assets and valuations become quite problematic for ACs to assess properly when the assets are overseas in areas sometimes where there are large political issues. So, the twin issues of the new accounting standards and globalisation have added a tremendous technical burden on the independent directors who are members of the AC.

**Q: What are your thoughts on the broader issues of corporate governance?**

A: The whole issue of the quality of corporate governance is one that needs to be taken to the next level of debate. There have been a number of studies done in the recent past which indicate that Malaysian companies have a high level of compliance with the corporate governance requirements in the listing rules and in other guidance. For instance, bankers have additional requirements contained in the Basel guidance and Islamic banks have still further guidelines.

However, there is a need to recognise that compliance to a guideline does not mean that the spirit or even the essence of corporate governance has been adopted. ACs can assist to ensure there is tangible improvement in corporate governance by insisting upon greater transparency in focal documents and statements such as the corporate governance statement required in the annual report of our listed companies.

**Q: Do you believe that AC members are equipped to handle the significant challenges you have outlined?**

A: Now, that's a difficult question. As the watchdog for shareholders, it is recognised that directors do not need to be experts in every area. Instead, they need sufficient

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knowledge to be able to access pertinent information; ask the right question and assess the answers they receive. The skill, experience and training of independent directors is therefore a continuing challenge for ACs. A few years ago, it was not unusual to hear that there was a shortage of independent directors. I do not believe that this is now the case because one of the things that have been a benefit of the requirements in respect of independent directors is that Boards have been forced to look beyond their old school networks to find independent directors; this has certainly brought a breath of fresh air to many Boards. The question now is not that of a shortage of independent directors, but whether those independent directors can keep up with the technical changes that happen and the growing demands on them to act as the cornerstone of good corporate governance within companies. I believe only time will tell.

**Q: What do you see as the way forward in terms of AC quality?**

A: It cannot be stressed enough that the way forward for ACs in the Malaysian scenario is to bring the status and reputation of the committee to a level of the developed economies. There is a need for an evaluation and assessment be made of the performance of ACs. AC Chairmen need to be a little more proactive. They need to be taking some positive steps to bolster the reputation of ACs. One of the things that can be done is to take very seriously, the requirement in the listing rules, to periodically review the performance and effectiveness of all Board Committees. The AC should, by its nature, be the first to volunteer to be put under scrutiny to assess its effectiveness.

It makes sense that such assessments should be external and independent. Only then will the results of an assessment carry

adequate credibility. The results need to be acted upon and there will be a resultant improvement in standards and the transparency involved in the process will enhance the reputation of the AC as a whole.

A review of available literature points to the fact that effectiveness and efficiency of an AC needs commitment and contribution by its members. As such, AC best practices may include some of the following features:

- to meet compliance requirement, members of the AC must understand and respond to the legal and regulatory requirements,
- committees must be made up of qualified directors who are able to devote the necessary time,
- the AC in its deliberation must insist on continuous improvement of disclosure controls and internal controls over financial reporting,
- the AC should expect reliable financial reporting,
- the AC should encourage auditors to increase the effectiveness of the audit process by encouraging variation in the audit plan each year and with less input from management,
- the AC should establish and increase the focus on the internal audit function.

Whilst Malaysian companies have achieved credible levels of compliance to corporate governance standards, the AC is one of the bodies expected to take the lead in ensuring the spirit of corporate governance is also adopted wholeheartedly in companies. These are significant challenges that need discussion and exploration for solutions. ■