

# AUDIT COMMITTEES' DUTIES & CONCERNS

## Regulators' powwow with audit committees

A regulatory storm was felt by directors who packed the SGX Auditorium at the inaugural Audit Committee Seminar organised by ACRA, SGX and SID on 7 January 2015.

Most of those present were audit committee (AC) chairs and members and they were jolted by exhortations by the regulators to "Read, Understand and Ask" and take charge of financial reporting. Some sparks flew as directors present lament the increasing work and

regulations, coupled with the limited support they sometimes get from the auditors.

We summarise here the key takeaways from speakers and participants at the event as follows:

- SGX's Regulatory Considerations for Audit Committees
- ACRA's Financial Reporting Surveillance Programme
- Guidebook for Audit Committees in Singapore
- Audit Adjustments
- Overheard at the Seminar

# SGX's Regulatory Considerations for Audit Committees

## Interested Party Transactions (IPTs)

- Scope of IPT General Mandate should not include those of a recurring revenue or trading nature (SGX Listing Rule 920).
- IPT General Mandate should also be limited to specific interested persons and not a generic class of persons.

## Business Expansion

- Acquisition of more than 20 per cent (Rule 1006 figures) is a major transaction and requires shareholders' approval. Exchange may aggregate separate transactions completed within 12 months and treat them as one transaction (Listing Rule 1014 and 1005).
- Those diversifying into Mineral, Oil & Gas (MOG) activities must comply with applicable rules if the MOG activities of the group make up 50 per cent or more of total assets, revenue or operating expenses, or if the group is largest contributor to the MOG assets, revenue or operating expenses. (Practice Note 6.3)
- For business diversification, shareholder circulars should contain sufficient information about proposed new business that are not within the core business.

## Remuneration Disclosure

- Many issuers are not properly complying with Guidelines 9.2 and 9.3 of the Code of Corporate Governance to disclose:
  - o Specific remuneration of directors and CEO on named basis
  - o Remuneration of top five management team in bands of \$250,000
  - o Aggregate sum paid to top five management team



**“Diversified management and board improve company performance in many ways, including reducing the probability of ‘groupthink’ which is associated with less critical endorsement of proposals and a reluctance to adopt innovation.”**

**Mr Magnus Bocker**  
CEO, SGX

“Some issuers are not providing a meaningful explanation for deviating from recommended disclosure. For example, some issuers explain that the reason for not disclosing the remuneration of a director who is a controlling shareholder is due to concerns of poaching.”

**Ms June Sim**  
VP & Head, Listing Compliance, SGX



### Appointment of Auditors

- Audit firm appointed must be suitable and meet Rule 712. They should be registered with ACRA, or otherwise acceptable to SGX.
- Only PRC audit firms on the China Securities Regulatory Commission list of qualified audit firms are recognised.
- AC is encouraged to engage the same audit firm for the company as well its significant foreign-incorporated subsidiaries and associated companies.

### Audit Qualification or Disclaimer

- Where there is a qualification or disclaimer, the announcement must include the board's opinion on whether the issuer is able to operate as a going concern; whether trading can continue in an orderly manner; and the basis of the board's opinion.
- Exchange reserves right to suspend trading under certain conditions.

### Minimum Trading Price (MTP)

- MTP of \$0.20 computed on six-month volume weighted average price will be effective from March 2015, with a 12-month Transition Period, and a 36-month Cure Period.
- Corporate actions to comply can include share consolidation, transfer to catalyst board, restructuring or reverse takeover.

### Sustainability Reporting

- Companies should see sustainability disclosures not as a regulatory burden but an opportunity for them to compete on equal terms with other markets. Approximately US\$13 trillion of assets under management incorporate environmental and social governance in their investment selection processes.
- SGX is working on the steps to advance sustainability reporting in Singapore, whether through 'comply or explain' requirements or other means.

### Diversity

- Boards should have diversity of skills, experience, gender, knowledge of the company and core competencies. ACs should go beyond technical skills such as auditing and finance, to consider soft skills such as independent critical thinking.
- SGX is concerned with low level of gender representation in boards in Singapore which is about half the levels seen in Australia, Europe and US. Expect actions from the Diversity Action Committee in due course.
- SGX has developed the *Investor Guide on Board Diversity*.



# ACRA's financial reporting surveillance



**“Audit Committees have oversight of both management accounting and external auditing. Under ACRA's Practice Monitoring Programme, ACRA inspects audit engagements and assesses the quality of the external auditor's work. By engaging the external auditor on these findings, the AC can make a more informed assessment of the value the auditor brings in ensuring quality corporate reporting for the company.”**

**Mr Kenneth Yap**  
CEO, ACRA

## Directors' Duties

- Directors are responsible for preparing financial statements that are true and fair, and compliant with accounting standards (Section 201 of the Companies Act).
- Fine and imprisonment for breach of duty (Section 204).

## Regulators' Role

- Regulators' role is to protect public interest by ensuring the provision of trusted financial information to investors.
- Accounting standards are enforced via financial reporting surveillance.
- Auditing standards are enforced via inspections of auditors.

## Financial Reporting Surveillance Programme (FRSP)

- FRSP was introduced in 2011 and enhanced in 2014.
- Full review of selective financial statements by ISCA's Financial Statements Review Committee:
  - o Committee comprises about 30 senior and experienced audit partners
  - o Committee only provides the expert opinion, ACRA decides on regulatory outcome
- Selection of accounts based on risk factors:
  - o Those with significant public interests (e.g. listed companies)
  - o Industries susceptible to accounting changes during the year
  - o Qualified accounts
- After each review, there could be first and second enquiry letters from ACRA, followed by interviews with ACRA, as needed.

- Regulatory outcome decided by ACRA can be (in order of severity):
  - o Closure
  - o Advisory letters (not a regulatory sanction, typically issued for less serious breaches)
  - o Warning letters (Directors to announce at his appointment if he has been issued warning by regulatory authority – SGX App 7.4.1 [k])
  - o Composition fines (Listco to announce immediately if sanction is “material information... likely to materially affect price” – SGX Rule 703)
  - o Prosecution
- Up to 31 December 2014, 45 per cent of cases closed with immediate closure or advisory letters after first enquiry. Remaining 55 per cent are proceeding to second enquiry letters due to incomplete or unsatisfactory answers provided.



### Takeaways for Audit Committees

- Ensure rigour of the financial reporting and the audit process.
- Review financial statements thoroughly (Read, understand and ask if the matter is not clear).
- Do not hesitate to question judgmental treatments and disclosures.
- Build a team of competent and well-resourced finance team.
- Appoint individuals with integrity and competence.
- Seek external help where needed.

### Director Financial Training

- All directors, not just AC members, require a minimum level of financial literacy.
- SID and ISCA are jointly conducting a monthly training course, “Director Financial Reporting Essentials” for directors with little financial background.
- ACRA is providing \$1 million in subsidies for the first 3,000 directors to attend the training before March 2016.

**“When Audit Committees receive the enquiry letters, they should get into the details of the findings of the independent third party experts of the Financial Statements Review Committee. They should be leveraging these findings to review and improve the company’s finance function.”**

**Ms Julia Tay**  
Deputy Chief Executive, ACRA

# Guidebook for Audit Committees

### History of Guidebook

- *Guidebook for Audit Committees in Singapore* issued by Working Group established by ACRA, MAS and SGX.
- First edition issued in 2008.
- Second edition issued in 2014 to reflect the changes to corporate legislation and regulations.
- Objective of the guidebook remains the same: Assist AC members with best practices and practical guidance for achieving higher standards of corporate governance.

### What Changed in Second Edition?

- Restructured into six main sections with supporting detailed annexes.
- Updated references to Singapore Companies Act, SGX Listing Manual, Code of Corporate Governance, ACRA Practice Directions and Financial Reporting Standards.
- More practical insights and examples: There are 10 per cent more topics, 24 per cent more FAQs and case studies, and 42 per cent more pages.
- Enhanced guidance all round.

Summary of changes between Edition 1 and 2 of Guidebook

| 2008 Guidebook for ACs   | 2014 Guidebook for ACs                           | Level of Change |
|--|--|-----------------|
| AC Composition   | Section 1: AC Composition                        | MODERATE        |
| Section VI:<br>Other Duties and Responsibilities<br>A. Interested Person Transaction<br>B. Conduct of Meetings<br>C. Performance Assessment<br>D. Whistle-blowing<br>E. Training | Section 2: AC Agenda                             | MODERATE        |
| Section I: Internal Controls<br>Section II: Risk Management  | Section 3: Risk Management and Internal Controls | SIGNIFICANT     |
| Section III: Internal Audit  | Section 4: Internal Audit                        | MINIMAL         |
| Section IV: Financial Reporting  | Section 5: Financial Reporting                   | MINIMAL         |
| Section V: External Audit  | Section 6: External Audit                        | MINIMAL         |

Source: KPMG Risk Consulting, Singapore

## Highlights of Specific Changes in Second Edition

- AC Composition
  - Enhanced sample terms of reference (TOR)
  - New TOR for Audit and Risk Committee (where the AC has responsibility for risk governance)
- AC Agenda
  - Guidance on minuting of dissenting views
  - New AC self-assessment guide
  - Revised guideline for IPTs, and differences between IPT and related party transactions (RPT)
  - More examples of indicators of RPT fraud
- Risk Management & Internal Controls
  - AC to adopt higher standard of revised Code on adequacy and effectiveness of risk management and internal controls
  - Adoption of an ERM framework (e.g. COSO)
  - New FAQs for risk oversight of small and large companies
  - New guidance on “risk-aware” culture, data analytics, control deficiencies considerations and evaluation, and due diligence of CEO/ CFO assurance
- Internal Audit
  - Revised comparison of IA sourcing options
  - Revised IA activity charter, measurement criteria and evaluation
- Financial Reporting
  - New guidance on due diligence by AC on financial statement and management remedial actions to regulatory matters
  - New recommendation on anti-bribery and anti-fraud laws of all applicable jurisdictions, and on exit interviews of key management personnel
- External audit
  - New recommendation for external auditor (EA) to define materiality
  - List of questions to ask EA in private session, and sample checklist for evaluation of EA



“AC members often struggle with how the risk appetite and tolerance levels are articulated and operationalised in the organisation. Having this well understood is key to the board's and AC's ability to opine on the adequacy and effectiveness of internal controls and risk management.”

**Ms Emilie Williams**  
**Director of Risk Consulting, KPMG Singapore**

## What Should AC Members Do?

- Read the guidebook.
- Attend a briefing on the new guidebook to share insights. (Several of the public accounting firms are conducting such sessions, or ask your external auditor to do one for your AC).
- Review whether your AC's current terms of reference reflect actual and expected AC's roles and responsibilities.
- Validate that the mechanisms and processes in your company exist to provide the timely, accurate and complete insights into the risk management and internal controls systems.

# Audit adjustments

## The Study

- Study conducted by SMU, commissioned by ACRA.
- Reviewed accounts of listed companies for financial year ended 31 December 2013 from seven audit firms.
- Audit adjustments are accounting adjustments proposed by auditors before issuing audit report. They indicate gap between unaudited financial statements prepared by management and what is required under accounting standards.

## Findings

- Total of 3,222 sets of adjusting entries adding up to \$33.9 billion in 257 listed companies (market cap of \$288 billion or 31 per cent of SGX's total market cap).

- Quality of financial statements varies: Average adjusting entry per company was 12, median was five.
- The majority of adjustments came from minority of companies: 13 per cent contributes \$24.7 billion (73 per cent) of the adjustments, with more than 20 adjustments each.
- By type of adjustments: The majority were factual (36 per cent by value) and misclassifications (51 per cent). Nine per cent were judgemental.
- By accounts: The most frequently adjusted were expenses (26 per cent of lines but 10 per cent of value), and the most by amount were revenue and payables (23 per cent of lines but 47 per cent of value).



**“Companies must take more responsibility for their financial statements. The fewer adjustments there are, the higher is the quality of the financial statements.”**

**Dr Themis Suwardy**  
Associate Professor of Accounting, SMU



- By industry: Manufacturing companies (32 per cent of population) accounted for 59 per cent of proposed adjustments. Its proportion of factual and misclassifications was higher than other industries.
- By size: Growing companies should expand accounting capacity and capability; Companies with market caps of \$100 to \$500 million (32 per cent of population) accounted for 65 per cent of proposed adjustments.
- Accepted adjustments: Approximately 65 per cent of proposed accounting entries representing 89 per cent of value were accepted and adjusted in the final audited financial statements. Auditors should continue to hold their line.

### Implications for Boards and ACs

- Tone from the top is important.
  - o Ensure that company has an effective finance function and internal control systems allowing for high quality financial reporting with minimal audit adjustments
  - o Support CFOs and finance teams in receiving cooperation from other parts of the organisation
- Set realistic targets.
  - o Set targets to reduce number of proposed audit adjustments over time, especially factual differences and misclassifications
  - o Investigate the root causes of all proposed adjustments and adjust internal processes to prevent recurrence
- Take more ownership of accounting.
  - o Stay abreast of financial reporting developments to be able to understand and discuss issues
  - o Relying fully on finance team's or auditor's representation does not relieve directors of fiduciary duties



**“External auditors will report and review the unadjusted audit differences with the ACs. They often do not, but should share also the adjusted audit differences that have been already agreed with management because this presents a more complete picture of the state of financial reporting in the company.”**

**Mr Kyle Lee**  
Chairman and Member of  
several audit committees

# Overheard at the seminar

## The AC is critical

“Audit Committees play a central role in governance... A successful committee must include leadership, vision and discipline, as well as the courage to ask tough questions.”

Mr Magnus Bocker  
CEO, SGX



“The Audit Committee is arguably the most important and difficult of the board committees.”

Ms Poh Mui Hoon  
Council Member, SID

## The AC's job is meant to be tough

“AC Members should firstly read, secondly understand, and thirdly ask questions of the company's financial statements ...”

Ms Julia Tay  
Deputy Chief Executive, ACRA

“And when you ask, please ask the management first, rather than your auditor. The financial statements are prepared by the management and not the auditor.”



Mr Chaly Mah  
CEO, Deloitte Asia Pacific

“And if you don't ask questions of the financial statements that should be asked, the regulator will ask you those questions ...”

Ms June Sim  
VP & Head, Listing Compliance, SGX

## The regulator's job is also tough

“We hear the ground concerns that compliance requirements can be time-consuming and costly. However, some measure of preventive medicine and tough love is necessary to ensure financial stability and market protection. Where we may differ is the right balance between reducing risk and encouraging growth.”

Mr Kenneth Yap  
CEO, ACRA



## It does not seem so tough for the auditor



"Although there has been a heightened awareness of the responsibilities of directors in relation to financial statements and internal controls of their companies, we should guard against the pendulum of responsibility swinging too much from the external auditors to directors. In my

opinion, the Audit Committee should see auditors as an integral part of a company's controls in depth. The first layer of defence is the business, the second is the finance function, the third is the internal audit and, last but not least, the fourth is the external auditor."

Mr Yap Chee Keong  
Chair and Member of several audit committees



"In the aftermath of Enron and other major accounting scandals, the auditors

have been fairly successful at ringfencing their exposure and liability, but it also raises questions on the value of the audit report."

Mr Willie Cheng  
Chairman, SID

## Those who need to, are not here



"The people who should be here are not, and for those who are here - we are preaching to the converted."

Mr Irving Low  
Head of Risk Consulting, Partner, KPMG



"Seminars like this should be organised for owner-chairman and directors of family-owned businesses. They, more than most other directors, need to appreciate the importance of good corporate governance."

Mr Rodolfo Balmater  
Independent director

