

APPENDIX D

AUDIT COMMITTEES - RECOMMENDATIONS

1 OBLIGATION TO HAVE A QUALIFIED AUDIT COMMITTEE

A listed company must have a qualified audit committee.

2 OBLIGATION TO HAVE A WRITTEN CHARTER FOR THE AUDIT COMMITTEE

The Board of Directors of a listed company must adopt a written charter to govern the audit committee. The charter must be available to shareholders of the company upon request and the key features of the charter outlined in the Annual Report.

2.1 Specification of scope of audit committee responsibilities

This formal charter must identify and explain the scope of the audit committee's responsibilities and duties. The charter must stipulate matters including:

- the structure of the audit committee;
- the requirements for membership of the audit committee;
- the nature and scope of the audit committee's duties; and
- the processes to be used by the audit committee in discharging its duties.

2.2 Specification of the relationship with the external auditor

The charter must specify that the final responsibility for nominating the external auditor to be proposed for shareholder approval and for evaluating the external auditor will lie with the audit committee and the Board of Directors. It must further outline that the external auditor is ultimately responsible to the audit committee and the Board of Directors, as representatives of the shareholders.

The audit committee is to make recommendations to the Board of Directors on the appointment, remuneration and replacement of the external auditor. If the Board of Directors disagrees with any of those recommendations, it must disclose its decision and reasons in the Annual Report.

2.3 Specification of communications with the external auditor regarding relationships

The charter must stipulate that the audit committee is responsible for ensuring that the external auditor makes required disclosures to the audit committee in a timely fashion and at least annually. These disclosures include a formal written statement covering matters including:

- an account of all relationships between the external auditor and the company; and
- confirmation by the auditor that it is, in its professional judgment, independent of the company.

In addition, the audit committee must engage in active discussions with the external auditor in relation to these disclosed relationships, and their potential impact on auditor independence. The

audit committee is also responsible for recommending that the Board of Directors take any appropriate action, arising as a result of the disclosures by the external auditor, required to satisfy itself of the external auditor's independence.

2.4 Obligation to review adequacy of the written charter

The written charter must specify that the audit committee must review and reassess the adequacy of the formal written charter at least annually.

3 COMPOSITION OF A QUALIFIED AUDIT COMMITTEE

3.1 Independence

The audit committee of a listed company, where market capitalisation of that company exceeds a specified threshold, must consist of at least three directors, and all of the members of the audit committee must meet the relevant definition of 'independent' set out below.

The chairperson of the Board of Directors should not be the chairperson of the audit committee

Listed companies with small capitalisation

A distinction in audit committee independence requirements between small capitalisation and large capitalisation companies exists in the listing rules of major United States stock exchanges. The distinction recognises that requirements for independent directors can be costly and that this cost may be higher for small capitalisation companies than for large capitalisation companies.

A threshold for market capitalisation will be established through negotiations between the Minister and Australian Stock Exchange Limited (ASX). These negotiations will further determine an objective and appropriate mechanism and timing rules for determining when a company crosses this threshold and becomes subject to the larger capitalisation requirements, or vice versa.

Where the market capitalisation of the listed company is below the specified threshold, the audit committee must contain at least one director meeting the independence criteria, instead of all directors of the audit committee being required to meet the independence criteria.

Definition of independent

An audit committee member will only be independent if he or she has no relationship with the company that may interfere with the exercise of independent judgment. The Investment and Financial Services Association (IFSA) has provided a definition of what constitutes an independent director in its Guidance Note No 2.00, *Corporate Governance: A Guide for Investment Managers and Corporations* (1999) as has the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors – Australia, in their publication *Audit Committees: Best Practice Guide* (2nd edition, 2001). The following is a modified version of the IFSA and *Audit Committees: Best Practice Guide* definitions which would be appropriate to apply to audit committee membership:

An independent director is a director who is not a member of management (a non-executive director and who:

- is not a substantial shareholder of the company or an officer of or otherwise associated directly or indirectly with a substantial shareholder of the company;

- has not within the last three years been employed in an executive capacity by the company or a related entity or been a director after ceasing to hold any such employment;
- is not a member of the immediate family of a person who, within the last three years, has been employed in an executive capacity by the company or a related entity or been a director after ceasing to hold any such employment;
- is not a principal of, or consultant to, a professional adviser to the company or a related entity where that professional adviser has provided significant services to the company or a related entity;
- is not a significant supplier or customer of the company or a related entity or an officer of or otherwise associated directly or indirectly with a significant supplier or customer;
- has no significant contractual relationship with the company or a related entity other than as a director of the company;
- is not employed in an executive capacity by another company where any of executives of the company the individual is a director of, are on the other company's remuneration committee; and
- is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.

Definition of immediate family

Immediate family in relation to an individual means a spouse (or equivalent) or dependent.

Definition of related entity

Where a company:

- (a) is controlled by another entity; or
- (b) controls another entity;

the entity is a related entity of the company.

Definition of control

Control has the meaning contained in section 50AA of the Corporations Act.

3.2 Financial literacy

Financial literacy is an important component of the general standards of care, skill and diligence required of company directors. Courts have imposed an objective standard of skill for all company directors in relation to financial literacy as outlined by Ford, Austin and Ramsay:

'[A] director is obliged to inform himself or herself as to the financial affairs of the company to the extent necessary to form each year the opinion of solvency required for the directors statement under s 295(4), and they cannot avoid liability by claiming that they had never learned to read financial statements: *Statewide Tobacco Services v Morley* (1990) 2 ACSR 405; 8 ACLC 827 affirmed [1993] 1 VR 423; (1992) 8 ACSR 305; 10 ACLC 1233; *Commonwealth Bank of Australia v Friedrich* [(1991) 5 ACSR 115; 9 ACLC 946]...at ACSR 125; at ACLC 955.

Thus it appears that Australian company directors are subject to an objective standard of skill, admittedly minimal, with respect to the financial statements and financial affairs of their companies.’³³⁵

Each member of the audit committee should be financially literate, or made financially literate within a reasonable period of time of appointment. The Board of Directors in its business judgment will determine financial literacy. In making this determination, the Board of Directors will consider that financial literacy includes the ability to read and understand fundamental financial statements including a balance sheet, a profit and loss statement and a cash flow statement.

It is appropriate that members of the audit committee have a range of different backgrounds, skills and experiences. However, financial literacy is an essential skill for audit committee members.

3.3 Accounting expertise

At least one member of the audit committee must have accounting and/or related financial expertise. The Board of Directors in its business judgment will determine accounting and/or related financial expertise. Accounting and/or related financial expertise includes past employment, professional certification or other comparable experience or background.

4 GENERAL REQUIREMENTS

4.1 Meetings

The audit committee should have a regular schedule of meetings with pre-arranged dates. Additional unscheduled meetings from time to time may supplement these meetings, as matters require. The audit committee should put in place a process for arranging these supplementary meetings. In addition, the audit committee should ensure that an agenda for each meeting is prepared.

Structure and agenda for meetings

Meetings of the audit committee should be structured and follow a predetermined agenda. Contributions to this agenda should be sought from both the internal and the external auditors. The chair of the audit committee should review this agenda prior to issuance, and the agenda, along with briefing papers, should be circulated in a timely fashion prior to the meeting.

Attendance at meetings

As far as is reasonable, meetings should be scheduled so that all committee members can attend. Ample time for discussion should be allowed. The audit committee should establish a quorum for meetings, and ensure that this quorum has been met prior to commencing the meeting. In addition to audit committee members, the following persons may attend meetings as provided:

- internal and external auditors, except where a conflict of interest may be perceived; and
- management, only on express invitation by the audit committee requiring their presence.

³³⁵ H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (10th ed, 2001), para [8.340].

Records of meetings

Minutes should be taken at all audit committee meetings, and these should be signed by the chair of the committee.

4.2 Systems of Reporting

Reporting to the Board of Directors

Following each audit committee meeting, the chair should furnish a formal report at the next meeting of the Board of Directors. This report should cover issues including but not limited to:

- the minutes of the committee and any formal resolutions;
- information about the audit process including the results of internal and external audits;
- any determination by the audit committee relating to the independence of the external auditor;
- any other matters that in the opinion of the audit committee should be brought to the attention of the board, and any recommendations requiring board approval and/or action; and
- at least annually, a review of the formal written charter and its continuing adequacy, and an evaluation of the extent to which the committee has met the requirements of the charter;

Reporting in the external reports

Membership of the audit committee must be disclosed in the Annual Report. In addition, the Board of Directors must disclose whether or not the company complies with the ASX Guidance Note on audit committees, and if not, why not.

The audit committee must ensure there is disclosed in the Annual Report a statement regarding non-audit service (NAS) provision by the external auditor. In this statement, the audit committee must outline whether or not it believes the level of NAS provision by the external auditor is compatible with maintaining auditor independence, and should include reasons where appropriate.

Where the Board of Directors disagrees with a recommendation by the audit committee relating to the external auditor, it must disclose its decision and reasons in writing in the Annual Report.

The audit committee must include further information about its activities in the Annual Report, and, where appropriate, in any interim report. This information must include:

- a summary of the audit committee's main rights, responsibilities and duties;
- biographical details of audit committee members, including expertise, appointment, dates and terms of appointment;
- member and related party dealings with the company;
- details of meetings, including the number of meetings held during the relevant period, and the number of meetings attended by each member;
- details of any change to the independent status of each member during the relevant period, if applicable; and
- details of any determination by the audit committee regarding the external auditor's independence.

5 DUTIES AND RESPONSIBILITIES OF A QUALIFIED AUDIT COMMITTEE³³⁶

To the extent that the following functions exist, an audit committee should follow the guidance outlined below in relation to performing its duties and responsibilities.

5.1 External reporting

The audit committee should review and assess the external reporting of the company. In particular the audit committee should:

- Review and assess the appropriateness of the company's accounting policies and principles. Any significant changes to the company's policies and principles should also be reviewed and assessed by the audit committee. To ensure that the audit committee can carry out this duty effectively, management should inform the audit committee of:
 - Any changes in accounting policies or their application during the reporting period;
 - Whether the methods chosen by management are consistent with Accounting Standards, Accounting Concepts and Urgent Issues Group (UIG) Consensus views; and
 - The methods used to account for unusual transactions for which there may be no specific accounting standard, including management's reasoning in determining that method.
- Review and assess any significant estimates and judgments in financial reports. To ensure that the audit committee can carry out this duty effectively, management should inform the audit committee of:
 - The method and process used in making material estimates and judgments, including management's reasoning in determining that method.
- Upon receipt of information from management relating to accounting policy choice or method for making significant estimates and judgments, seek the opinion and views of both internal and external auditors in relation to that choice or method. This opinion should include the appropriateness, and not just the acceptability of that choice or method.
- Review and assess the processes used by management to monitor and ensure compliance with laws, regulations and other requirements relating to external reporting by the company of financial and non-financial information. These include, but are not limited to:
 - Australian Accounting Standards;
 - Corporations Act;
 - Listing Rules of ASX, including but not limited to:
 - : The existence of an appropriate procedure for meeting the company's continuous disclosure obligations;
 - : Reviewing for completeness and accuracy the disclosure of the company's main corporate governance practices; and
 - Where applicable, requirements of other countries.
- Review and assess information from internal and external auditors that may affect the quality of financial reports.

³³⁶ These principles have been developed from international reports, best practice guides and standards. Particular reliance has been placed upon the Blue Ribbon Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (1999); the New York Stock Exchange, *NYSE Listed Company Manual: 303.01 Audit Committee*; and the Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors - Australia, *Audit Committees: Best Practice Guide* (2nd edition, 2001).

- Review and assess documents and reports to regulators and make recommendations to the Board of Directors on their approval or amendment.
- Based on the assessment by the audit committee, recommend to the Board of Directors whether the financial and non-financial statements should be signed.
- Where management does not offer information required to make any of the reviews or assessments required under this section, ensure that the audit committee acquires that information from management.

5.2 Related party transactions

The audit committee should review and monitor related party transactions and assess their propriety.

5.3 Internal control and risk management

The audit committee should review and assess internal processes for determining, monitoring and assessing key risk areas. In particular, the audit committee should consider:

- non-compliance with laws, regulations, standards and best practice guidelines;
- important judgments and accounting estimates;
- litigation and claims;
- fraud and theft; and
- any other business risks that are not dealt with by a specific board committee.

In relation to these risk areas, the audit committee should ensure:

- that the company has an effective risk management system in place, including for macro risks, and that the committee assesses this system;
- that the company has an effective internal control system in place, and that the committee assesses this system;
- that the company has a system in place for unusual and/or high risk transactions and that the committee assesses this system;
- that the company has a clear policy and procedure for reporting, actioning and documenting breaches of laws, including fraud and theft;
- that it receives from management reports on all actual and suspected breaches of laws, including fraud and theft; and
- that it meets periodically with management, and external and internal auditors to discuss the company's control environment, including the processes for improvement in place.

5.4 External audit

The audit committee should review and assess key areas relating to the external audit of the company. In particular the audit committee should:

- make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness, and independence of the external auditor;
 - as outlined in section 4.2, if the Board of Directors disagrees with any of these recommendations, it must disclose its decision and reasons in the Annual Report;
- review and assess the independence of the external auditor, including but not limited to any relationships with the company or any other entity that may impair or appear to impair the external auditor's judgment or independence in respect of the company;

- review and assess any prospect of auditor replacement and/or tender suggested by management. Before any decision is made, the audit committee should report the results of its investigation to the Board of Directors and make recommendations;
 - where the decision for replacement or a new tender is made, this tender should then be conducted by the audit committee;
 - as outlined in section 4.2, if the Board of Directors disagrees with any of these recommendations, it must disclose its decision and reasons in the Annual Report;
- review and agree on the terms of engagement for the external auditor at the start of each audit;
- review the scope of the external audit with the external auditor including identified risk areas and any additional agreed-upon procedures;
- review and assess non-audit service (NAS) provision by the external auditor, with particular consideration given to the potential for the provision of these services to impair or appear to impair the external auditor's judgment or independence in respect of the company;
 - as outlined in section 4.2, the audit committee must disclose in the Annual Report whether or not it believes the level of NAS provision by the external auditor is compatible with maintaining auditor independence, and should include reasons where appropriate;
- review the external auditor's audit fee, and be satisfied that an effective, comprehensive and complete audit can be conducted for that fee;
 - in addition to reviewing the audit fee, the audit committee should review and assess total fees paid to the external auditor, considering in particular fees paid for NAS provision, and these fees as a proportion of total fees;
- review and monitor management's responsiveness to the external auditor's findings and recommendations;
- review with the external auditor any significant disagreements between the external auditor and management, irrespective of whether they have been resolved;
- review all representation letters signed by management, and be satisfied that the information provided is complete and appropriate;
- monitor the number of former employees of the external auditor currently employed in senior positions in the company and assess whether this impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether taken as a whole, the various relationships between the company and the external auditor impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether the compensation of the individuals employed by the external auditor who are performing the audit of the company is tied to the provision of non-audit services and, if so, consider whether this impairs or appears to impair the external auditor's judgment or independence in respect of the company;
- review the economic importance of the company (in terms of fees paid to the external auditor for the audit as well as fees paid to the external auditor for the provision of non-audit services) to the external auditor and assess whether the economic importance of the company to the external auditor impairs or appears to impair the external auditor's judgment or independence in respect of the company; and
- at least annually, meet with the external auditor without the presence of management.

5.5 Internal audit

The audit committee should review and assess key areas relating to the internal audit of the company. In particular the audit committee should:

- review the internal auditor's mission, charter and resources;

- communicate the audit committee's expectations to the internal auditor in writing;
- review and assess the scope of the internal audit and the internal auditor's audit plan and work program, as well as the systems in place to monitor and evaluate the effectiveness of the internal auditor;
- monitor and assess the progress of the internal audit and any implications that may arise for the control environment;
- review and monitor management's responsiveness to the internal auditor's findings and recommendations;
- oversee the co-ordination of the internal and external auditors;
- ensure that the internal auditor reports directly to the managing director and the audit committee; and
- at least annually, meet with the internal auditor without the presence of management.