



## To Audit Committee Members and Other Participants in the Financial Reporting Process:

During the last few months, the issue of corporate governance—and especially the role of the audit committee—has been dominated by reactions to three major events: the collapse of Enron and other high-profile financial restatements, new risk perceptions due to the tragic events of September 11, and the 2001 economic downturn and its impact on financial reporting. Each of these events has resulted in significant shareholder interest in the audit committee and how it might be improved to minimize similar risks at their companies. These events have also been a focus of the media, regulators, legislators, and other groups interested or involved in corporate governance.

In response, audit committee members have been more focused than ever on enhancing both the effectiveness and efficiency of their audit committees, including improving the interaction of the audit committee with management, internal audit, and the external auditors. The importance of a dynamic audit committee process was one of the primary messages heard from the approximately 1,600 attendees at KPMG's Audit Committee Roundtable Spring 2002.

Much of the current debate and dialogue offers recommendations and “best practices” for improving the effectiveness of the audit committee in overseeing a company's financial reporting process. While such advice is well intentioned, KPMG's Audit Committee Institute (ACI) urges caution in attempting to adopt each and every generic “best practice.”

ACI encourages corporate leaders to consider these Basic Principles for Audit Committees, which we believe provide the foundation for, and the framework within which, each audit committee develops and adopts its own “best practices” that support its independent and objective oversight of the financial reporting process.



The Audit Committee Institute Web site at [www.us.kpmg.com/auditcommittee](http://www.us.kpmg.com/auditcommittee) contains more depth of coverage on many of the issues addressed by the Basic Principles for Audit Committees. As you review this document, please feel free to share with us any comments or suggestions you may have on these basic principles or for making our Web site, *Audit Committee Quarterly*—or the Institute—better. Please fax your comments or suggestions to KPMG's Audit Committee Institute at 201-505-2284, or e-mail them to [auditcommittee@kpmg.com](mailto:auditcommittee@kpmg.com).



Basic  
Principles  
for Audit  
Committees

# BASIC PRINCIPLES FOR AUDIT COMMITTEES

## **1 Recognize that the dynamics of each company, board, and audit committee are unique—one size does not fit all.**

The organization and operational approach followed by any audit committee should take into account the unique aspects of the organizational and governance structures of the company that the committee serves.

In addition, the delegation of responsibilities to an audit committee by the board of directors must be explicit and responsive to the needs and culture of the company and the board as a whole.

The basic responsibilities of an audit committee are to oversee the financial reporting process of the company as implemented and maintained by management, including risks and controls related to that process, and the internal and external auditors' roles and responsibilities within the financial reporting process. The audit committee should not be overloaded with activities or the committee may (1) lose sight of its major objectives or (2) perform its duties superficially.<sup>1</sup>

Once delegated, the ongoing support of the board for the activities of the audit committee, including appropriate management interaction, is critical.

## **2 The board must ensure the audit committee comprises the “right” individuals to provide independent and objective oversight.**

It is the responsibility of the board of directors to ensure that audit committee members are independent, financially literate, and have the characteristics to serve as effective audit committee members.

<sup>1</sup> Frank M. Burke and Dan M. Guy, *Audit Committees: A Guide for Directors, Management, and Consultants*, 2nd edition (New York: Aspen Law & Business, 2002), p. 117.

The 1987 “Report of the National Commission on Fraudulent Financial Reporting” (known as the “Treadway Commission Report”) captured the basic attributes that every audit committee should possess. The audit committee must be **informed**, **vigilant**, and **effective** overseers of the financial reporting process. To have those attributes, the individual members of the committee must possess certain characteristics. First, the individual should have a general understanding of the company's major economic, operating, and financial risks. In addition, the individual should have a broad awareness of the interrelationship of the company's operations and its financial reporting. Further, the audit committee member should understand the difference between the oversight function of the committee and the decision-making function of management.

Audit committee members must have the ability to formulate and ask probing questions about the company's financial reporting process. According to the 1999 Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Blue Ribbon Committee), a member's ability to ask and intelligently evaluate the answers to the necessary questions hinges on intelligence, diligence, a probing mind, and financial literacy. In fact, perhaps the most important characteristic of a good audit committee member is a willingness to challenge management when necessary. This is the essence of independence.

## **3 The board and audit committee must continually assert that, and assess whether, the “tone at the top” embodies insistence on integrity and accuracy in financial reporting.**

The company must have the “right tone at the top.” What is the right tone at the top from the perspective of the audit committee and its oversight of the financial reporting process?

The audit committee, as a check and balance on management, is the guardian of the company's financial reporting integrity. Thus, in establishing the “right tone,” according to

# A FRAMEWORK FOR YOUR “BEST PRACTICES”

Michael R. Young, a litigation partner of Willkie Farr & Gallagher and counsel to the American Institute of Certified Public Accountants, the company must have an unrelenting insistence:

- On accuracy in financial reporting
- That numbers and financial statements not be massaged or manipulated
- On truthfulness as the foremost objective of the company

Young says, “It is a tone that makes financial misreporting unthinkable.”<sup>2</sup>

## **4 The audit committee must demand and continually reinforce the “ultimate accountability” of the external auditor to the board and audit committee as representatives of shareholders.**

The ultimate accountability of the external auditor to the board and the audit committee must be more than words in the audit committee charter. The audit committee, external auditor, and senior management must all acknowledge this reporting relationship and “allegiance” by their actions and deeds.

## **5 Audit committees must implement a process that supports their understanding and monitoring of the:**

- **Specific role of the audit committee in relation to the specific roles of the other participants in the financial reporting process (oversight)**
- **Critical financial reporting risks**
- **Effectiveness of financial reporting controls**
- **Independence, accountability, and effectiveness of the external auditor**
- **Transparency of financial reporting**

The audit committee process provides a framework for coordinating the activities of, and information provided by, the participants in the financial reporting process that support the audit committee’s understanding, and monitoring, of the “key risks and controls” related to the company’s financial reporting process. A strong audit committee process allows a company, including its shareholders, to benefit from the collective insight and experience of each member of the committee.

The Blue Ribbon Committee described the participants in the financial reporting process as a “three-legged stool of responsible disclosure and active oversight.” The three legs are (1) management, including internal audit, (2) the independent external auditor, and (3) the audit committee. The audit committee must not only understand the specific and unique roles that each “leg” plays in the financial reporting process but also hold these participants accountable to the board and the audit committee.

When a company establishes an audit committee and the board delegates oversight of the financial reporting process to the committee, implicit in that delegation decision is that the audit committee is thereby assigned oversight responsibility for financial reporting risks (including fraud risks) and controls related to those risks. Therefore, the audit committee must have an understanding of (1) significant risks related to financial reporting reliability and (2) the controls that the company has established to address those risks.

With a well-defined **process** predicated on an understanding of the specific roles of management, including the internal auditor and the external auditor, the audit committee will have established the framework within which to *exercise effective oversight—listen, ask, assess, and challenge*.

<sup>2</sup> Michael R. Young, *Accounting Irregularities and Financial Fraud*, 2nd edition (New York: Aspen Law & Business, 2002), p. 231.



KPMG's Audit Committee Institute (ACI) has been communicating with audit committee members since our formation more than three years ago. Our programs have allowed us to meet directly with thousands of directors and officers. ACI's initiatives include semiannual Roundtables, publication of *Audit Committee Quarterly*, conference and board presentations, a toll-free hotline (**877-KPMG-ACI**), periodic distribution of time-sensitive information, and our Web site, [www.us.kpmg.com/auditcommittee](http://www.us.kpmg.com/auditcommittee).

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