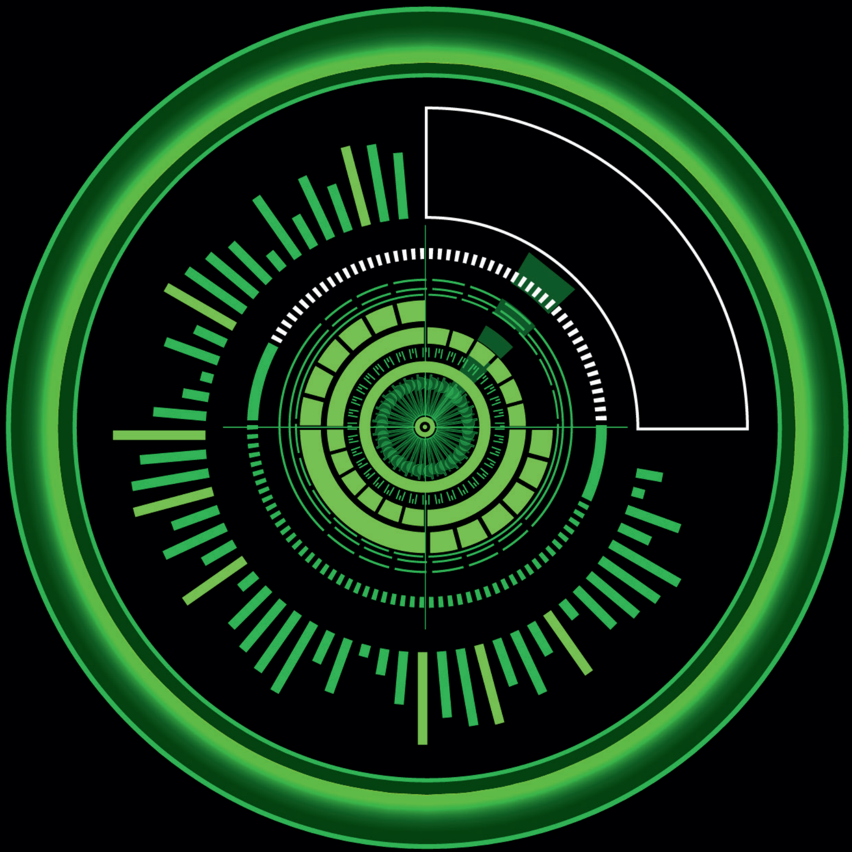


The Audit Committee Report

Analysing the trends in
South Africa

2018

Introduction

In an increasingly complex business environment, the need for effective governance is paramount. More and more investors and other stakeholders turn to the audit committee to ensure accountability and transparency. In South Africa, audit committees are highly regarded and regulated with legislation specifically governing the duties and composition of the committee. King IV confirms the central role of the audit committee and proposes a number of specific disclosures. These disclosures are intended to provide stakeholders with relevant information and comfort in the oversight function of the audit committee.

Deloitte analysed a selection of the audit committee reports of the top 50 Johannesburg Stock Exchange (JSE) listed companies with a primary listing in South Africa, ranked by market capitalisation. The selection included 34 audit committee reports contained in the latest set of financial results publicly available by mid-October 2017. Based on our reading of the integrated reports[1] and the annual financial statements, we gleaned trends regarding the compliance of the audit committee reports contained therein with certain provisions of the Companies Act of South Africa (Companies Act), the JSE Listing Requirements and the King Report on Corporate Governance for South Africa (King IV). Our study also revealed insights into the composition and meetings of the committee.

Certainly one of the most interesting findings in our analysis was that hardly any audit committee report expressly addressed company specific matters. Most reports are generic in nature, and do not refer to the company by name.

The Companies Act requires the audit committee to prepare a report, to be included in the annual financial statements for that financial year describing how the audit committee carried out its functions, stating whether the audit committee is satisfied that the auditor was independent of the company, and commenting in any way the committee considers appropriate on the financial statements, the accounting practices and the internal financial control of the company. The JSE Listings Requirements requires a specific statement confirming that the audit committee is satisfied with the appropriateness of the expertise and experience of the financial director.

In order to enhance accountability and transparency and to provide the reader with relevant information, King IV requires a number of additional disclosures. Since the reports analysed were not (yet) subject to the provisions of King IV, we found that some companies already included some (but not all) of these proposed disclosures. The disclosures as proposed by King IV are:

- A statement as to whether the audit committee is satisfied that the external auditor is independent of the organisation. Although this disclosure in itself is not new, King IV does point to a number of considerations which the audit committee should account for in their independence inquiry. The disclosure should specifically address:
  - the policy and controls that address the provision of non-audit services by the external auditor, and the nature and extent of such services rendered during the financial year
  - the tenure of the external audit firm (this should also be disclosed by the external auditor in the audit report),
  - the rotation of the designated external audit partner (as required in terms of section 92 of the Companies Act), and
  - significant changes in the management of the organisation during the external audit firm's tenure which may mitigate the attendant risk of familiarity between the external auditor and management
- Significant matters that the audit committee has considered in relation to the annual financial statements, and how these were addressed by the committee
- The audit committee's views on the quality of the external audit, with reference to audit quality indicators such as those that may be included in inspection reports issued by external audit regulators
- The audit committee's views on the effectiveness of the chief audit executive and the arrangements for internal audit

[1] For the purpose of our analysis, the term "integrated report" has the same meaning as "annual report" or "annual integrated report".

- The audit committee's views on the effectiveness of the design and implementation of internal financial controls, and on the nature and extent of any significant weaknesses in the design, implementation or execution of internal financial controls that resulted in material financial loss, fraud, corruption or error
- The audit committee's views on the effectiveness of the CFO and the finance function
- The arrangements in place for combined assurance and the committee's views on its effectiveness.

For purposes of this document, we focused on statutory requirements.

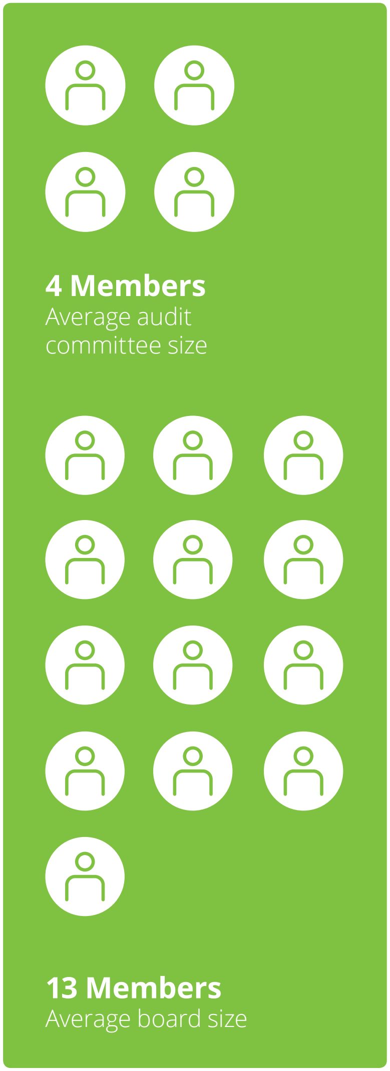
Composition

Size

The Companies Act and King IV require that the audit committee must comprise at least three members. Every member of the committee must be an independent non-executive director.

Although the statutory requirement for the audit committee is three members, the average size of the audit committees we surveyed comprised four members. We found that the audit committee size was approximately one-third the size of the full board.

Since the statutory requirement is to have a committee comprising at least three members, a slightly bigger audit committee allows for effective succession planning and rotation, and prevents a statutory vacancy where one member resigns or is removed from the committee. A committee with less than three members does not meet the requirements of the Companies Act and as such is not regarded as an audit committee as defined. A larger audit committee also provides access to a deeper pool of skill and experience for the committee as a collective, and inevitably enhances the quality of the discussions and decisions.



Skill and experience

The Companies Act requires at least one–third of the members of a company's audit committee to have academic qualifications or experience in economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management.

King IV provides more direction by proposing that the members of the audit committee should, as a whole, have the necessary financial literacy, skills and experience to execute their duties effectively.

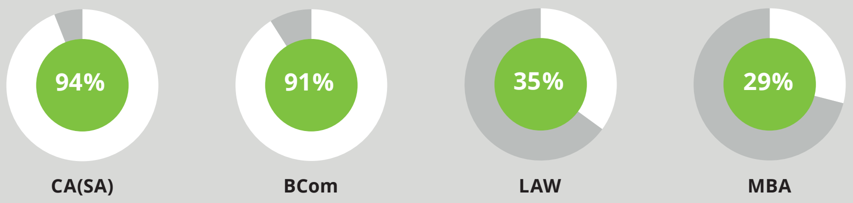
All the reports analysed included information on the qualification and experience of the audit committee members.

In 94% of the reports, at least one member of the audit committee was a Chartered Accountant (CA(SA)). 29% of the audit committees included at least one member with a Master of Business Administration (MBA) and 35% of the committees included at least one member with expertise in Law. 91% of the committees had at least one member with a BCom degree. Other expertise noted ranged from engineering, information systems and actuarial science to human resource management and economics. We found that in many cases, these other areas of expertise aligned to the industry in which the company operates in.

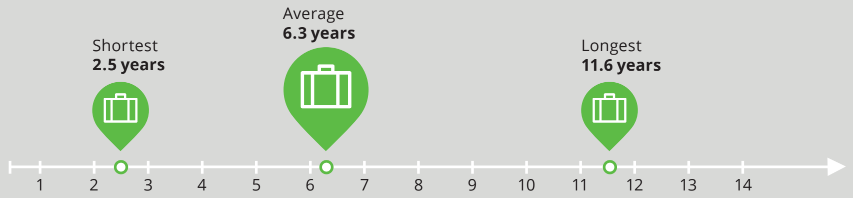
With regard to company-specific experience, we found that the average tenure on the board for an audit committee member was just over six years, with the shortest tenure being two and a half years on average and the longest tenure being approximately 12 years on average. In many cases, we found that the most experienced directors served on the audit committee which acknowledges the significance of the committee in the overall governance framework of these companies.

King IV indicates that once a director has served for nine consecutive years, the Board has to pay special attention to the independence of the director in question. The Board should, on an annual basis consider the director's independence. The independence test should ascertain whether there is any interest, position, association or relationship which, when judged from the perspective of a reasonable and informed third party, is likely to influence unduly or cause bias in decision-making.

Spread of qualifications on audit committees

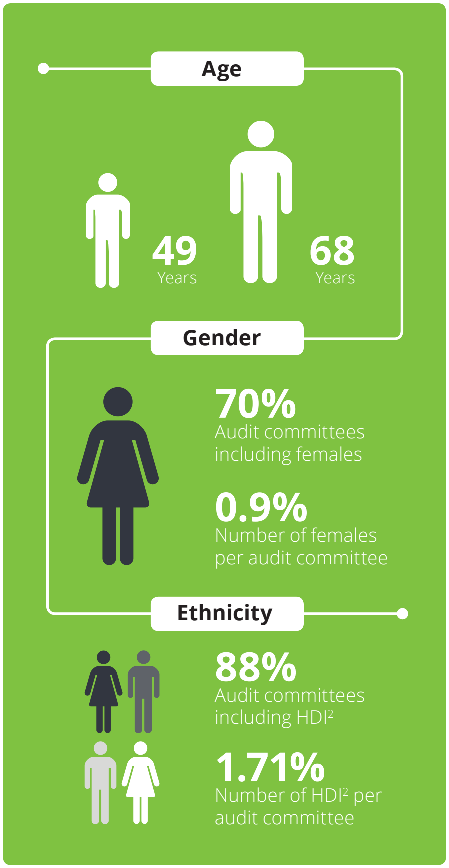


Average board tenure of audit committee members



Diversity

Diversity is a multi-faceted concept which includes skill and experience, age, gender, ethnicity, geography and culture. In our analysis of the composition of the audit committees, we focused specifically on the elements of age, gender and ethnicity.



We found that the average age of the oldest member of the audit committee was 68 years old and the average age of the youngest member was 49 years old.

70% of the audit committees included at least one woman on the committee. This is up from 68% compared to the analysis done in 2015. Of the committees which did include women, the average female presence was approximately one member on the committee. The number of audit committees which include at least one individual from a historically disadvantaged race group[2] has increased from 82% to 88% over the past 3 years.

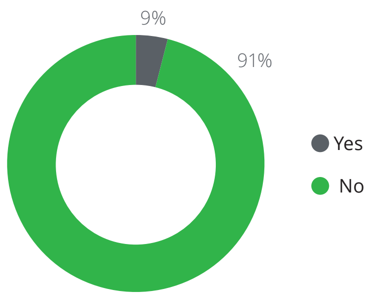
Diversity promotes the consideration of various perspectives which in turn facilitates robust discussions and effective decision-making. The results of our study evidence a slow rate of transformation and it appears that many companies have yet to fully embrace and acknowledge the clear benefits of diversity in the governance of companies.[3]

Chairperson of the board and the audit committee

Until recently the JSE Listings Requirements allowed for the chairperson of the board to be a member of the audit committee, however he/she was not permitted to chair the audit committee. The amended JSE Listing Requirements prescribe that the composition of board committees must comply with the Companies Act (as applicable) and should be considered in accordance with the recommended practices in the King Code on an apply and explain basis. King IV recommends that the chair should not be a member of the audit committee.

From our study the large majority of companies elected not to appoint the chairperson of the board to the audit committee. Only three of the surveyed companies included the chairperson of the board as a member of the audit committee and in each case, this individual does not chair the committee.

Chairperson of the board appointed to the audit committee



With regard to the Lead Independent Director (LID) we found that in 18% of cases the LID is a member of the audit committee.

[2] For the purpose of our analysis, we have defined historically disadvantaged race groups as African Black, Coloured and Indian.
[3] For further discussion on the benefits of diversity, see Duties of Directors on the Deloitte Southern Africa Centre for Corporate Governance website http://www.corpgov.deloitte.co.za/

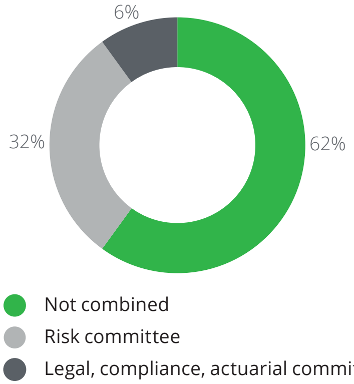
Combination with other committees

The JSE Listing Requirements allow for the audit committee to be combined with the risk committee, however, the composition of the combined committee must meet the more stringent independence criteria of the audit committee as set out in the King Code i.e. the committee may only comprise independent non-executive directors.

62% of the audit committees in our study were not combined with any other committee. Of the remaining 38%, three-quarters of the audit committees were combined with the risk committee and the remainder were combined with either a legal, compliance or actuarial committee. In our view, it is preferable not to combine the audit committee with other committees as it dilutes the effectiveness of the decision-making. For example, King IV suggests that the risk committee should have executive and non-executive members, with a majority being non-executive members of the governing body. In instances where the audit and risk committees are combined, the executive directors would not qualify for membership of the combined committee (the audit committee may ONLY comprise independent non-executive directors). Accordingly, although the executive directors may be invited to attend meetings, he/she may not vote on matters tabled for decision by the combined committee.

King IV also proposes that if the committees for audit and risk are separate, the governing body should consider letting one or more members have joint membership of both committees for more effective functioning.

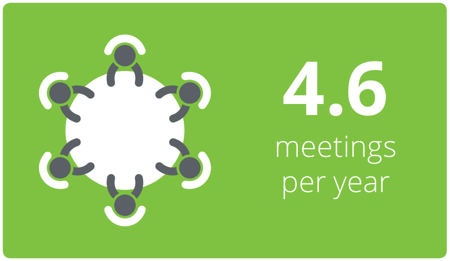
Which other committees is the audit committee combined with?



Meetings

Our analysis revealed that audit committees meet on average 4.6 times a year. This is an increase from an average of 4 meetings per year in 2015. Although we did not interrogate the reason for the increase in the number of audit committee meetings, it may be assumed that the increase is as a result of a more complex business environment.

With regard to attendees, it appears to be general practice for a wide range of role players to be invited to audit committee meetings. The reports evidenced that invitees included members of the C-suite, internal audit and external audit. Other individuals invited to audit committee meetings included chairpersons of other board committees (e.g. Nominations and Social & Ethics Committee), company secretaries, and professional advisors.



Invitees

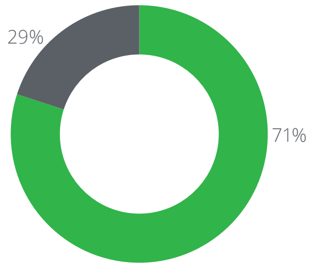
88% Chief financial officer	**65%** Head of internal audit/Chief audit excutive
82% Chief executive officer	**56%** Chief risk officer
79% External auditor	**21%** Other

Disclosures

Statutory disclosures as required by the Companies Act

In terms of the Companies Act, the audit committee report must be included in the annual financial statements of a company.

Is the audit committee report included in the"annual financial statements"?



Included in Integrated Report
Included in AFS

The Companies Act requires the audit committee report to be included in the annual financial statements of a company. This requirement is aimed at enhanced accountability and transparency and specifically requires the audit committee, as a statutory committee, to report not only to the board but also directly to the shareholders in the annual financial statements.

We analysed whether the required statutory disclosures were included in the audit committee reports located in the annual financial statements. Surprisingly, only 71% of our sample complied with this statutory requirement by including the audit committee report in the annual financial statements. The remaining 29% did not include the report in the annual financial statements but rather elsewhere in the integrated report. Inclusion of the audit committee report in the body of the integrated report does not constitute compliance with the Companies Act requirements. Interestingly, some companies included an audit committee report in both the annual financial statements as well as in the integrated report (usually within the 'governance report').

Of the companies that did include the audit committee report in the annual financial statements, not all complied with the specific disclosures required in terms of the Companies Act.

The Companies Act requires disclosure to be made in the audit committee report stating whether the committee is satisfied that the auditor was independent of the company.

Looking at the functions of the audit committee as set out in the Companies Act, the principal function of the committee is to confirm and guarantee the independence of the external auditor. As such, the Companies Act requires a specific statement to this effect in the audit committee report.

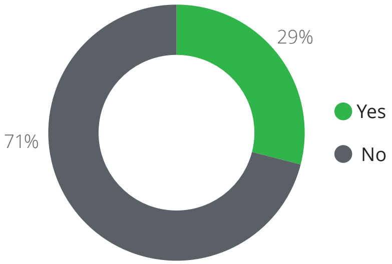
Pursuant to the role of the audit committee to guarantee auditor independence, one of the functions of the audit committee is to pre-approve non-audit services provided by the auditor. 94% of the reports provided some level of detail regarding the approval of non-audit services, although in most cases, this detail was fairly generic.

94%
of reports provide detail on approval of non-audit services

In terms of the Companies Act, the audit committee is responsible for determining the fees of the external auditor.

Although there is no disclosure requirement in this regard, we believe that it is appropriate for the audit committee to disclose the fee. Of the reports analysed, only 29% made this disclosure. It will be interesting to see if this type of disclosure will become more common, seeing that investors and shareholders have taken a keen interest in the fees paid to the external auditor.

Disclosure of audit fees



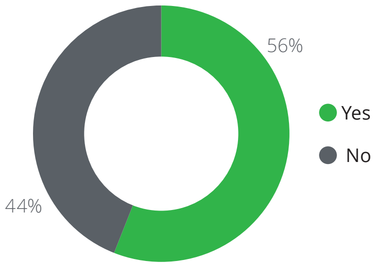
Non-statutory disclosures

King IV suggests that the audit committee must disclose any significant matters that the audit committee has considered in relation to the annual financial statements, and how these were addressed by the committee.

The committee needs to exercise judgement in deciding which of the issues it considered in relation to the financial statements were significant. The audit committee should aim to describe the significant issues in a concise and understandable form while reporting on the specific circumstances of the company. When reporting on the significant issues, the audit committee would not be expected to disclose information which, in its opinion, would be prejudicial to the interests of the company (for example, because it related to impending developments or matters in the course of negotiation).

Where an audit committee discloses the significant matters in relation to the financial statements, it provides an ideal opportunity to respond to the key audit matters raised by the external auditor in their report. 56% of companies surveyed disclosed significant matters pertaining to the financial statements.

Disclosure of significant matters related to the annual financial statements



The external auditor is required to disclose the length of audit firm tenure in the audit report. There is no requirement for the audit committee to make any disclosure in this regard. King IV proposes that the length of audit firm tenure should be one of the factors the audit committee has to consider when evaluating the independence of the external auditor.

We have found that close to **40%** of audit committee reports disclosed the length of audit firm tenure

In addition to the disclosures discussed above, we noted that some audit committee reports included detailed commentary on risk management, the committee's assessment on going concern and additional responsibilities assigned to it by the board. We found that those reports that included robust disclosure and discussion on the entire range of functions and activities of the committee during the year were more insightful than those that applied a "tick-box" approach by merely including statutory disclosures. In the case of one report, the audit committee included a list of the actual reports and information that the audit committee reviews on a quarterly basis. This level of transparency increases the level of trust and confidence in the audit committee among shareholders.

King IV recommends that the finance function is reviewed annually by the audit committee. Our analysis revealed that 94% of the reports included such disclosure.

Furthermore, in terms of the JSE Listing Requirements, the integrated report must confirm that the audit committee is satisfied with the appropriateness of the expertise and experience of the financial director. All the reports we assessed included this confirmation.

Assessment of the finance director: **100%**

Conclusion

Audit committees today face a host of competing priorities in an ever-changing regulatory and governance landscape. As such, it becomes increasingly important for the committee to consider how enhanced transparency with regard to their role, composition and oversight of the external auditor can enhance marketplace confidence.

It is clear from the survey results that the audit committees appreciate their role and function, as well as the need for proper disclosure and transparency. It is however somewhat surprising that, given the maturity of these committees, not all audit committee reports comply with the statutory and governance requirements. Given the level of reliance on the audit committee by the market, shareholders and other stakeholders (including regulators), it is important that audit committees constantly evaluate the quality and efficacy of their reports. Clear, concise and thorough disclosures of how the committee performed its activities help provide investors with insight into the role of the committee in protecting their investment. Equally, other stakeholders derive value and comfort from clear and comprehensive reporting. As such, audit committees may wish to consider their current audit committee reports to determine whether additional disclosures may be useful to the broad spectrum of the company's stakeholders.

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For further information, visit the Deloitte Africa Centre for Corporate Governance http://www.corpgov.deloitte.co.za/

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