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The Report of the Audit Committee
Analysing the trends in South Africa

In an increasingly complex world, the need for the audit committee to be recognised as a bastion of accountability and transparency in the company is paramount. In South Africa, audit committees are highly regarded and regulated with legislation and regulation specifically governing the duties and composition of the committee.

In 2015, Deloitte analysed audit committee reports of the top 50 Johannesburg Stock Exchange ("JSE") listed companies with a primary listing in South Africa, ranked by market capitalisation. We analysed the audit committee reports contained in the latest set of financial results publically available by mid-October 2015. 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 Listings Requirements and the King Report on Governance for South Africa ("King III"). Our study also revealed insights into the composition and meetings of the committee.

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

Composition

The Companies Act and King III require that the audit committee must comprise of at least 3 members. Every member of the committee must be an independent non-executive director.

Size

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Members

Although the statutory requirement for the audit committee is 3 members, the average size of the audit committees we surveyed comprised 4 members. We found that the audit committee size was approximately one-third the size of the full board. A larger audit committee 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.

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.

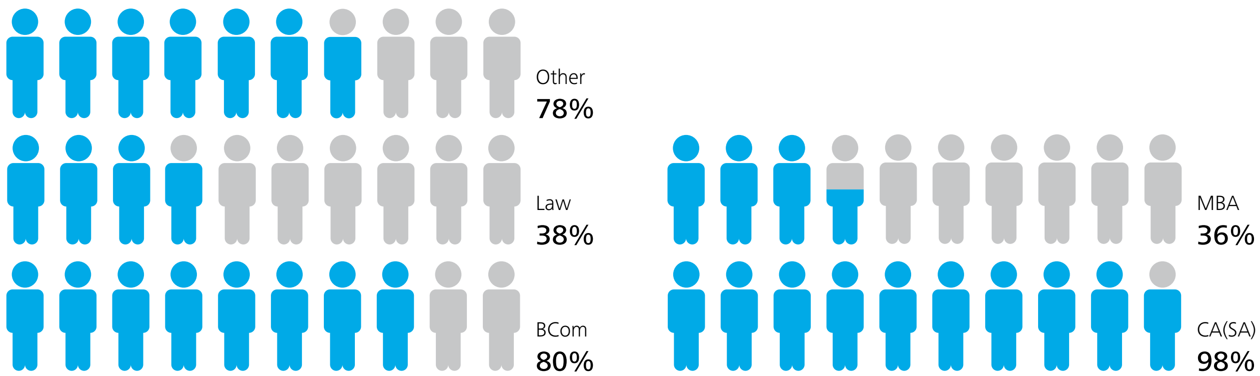
King III provides more direction by proposing that the audit committee as a collective be suitably skilled and recommends that the committee has sufficient qualifications and experience to perform its duties. As such, the specific duties of the committee dictate the required skill and experience.

Skill and experience

All the reports analysed included information on the qualifications and experience of the audit committee members. We found that only 54% of the companies included this information in the audit committee report. Often, this was done by way of reference from the audit committee report to a section in the integrated report which detailed the biographical details of the entire board.

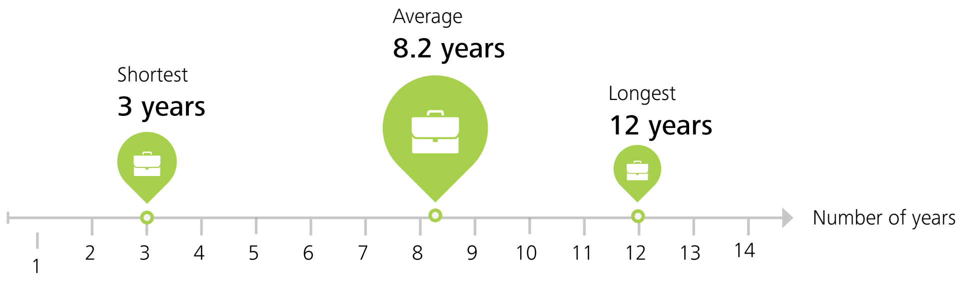
In 98% of the reports, at least one member of the audit committee was a Chartered Accountant (CA(SA)). 36% of the audit committees included at least one member with a Master of Business Administration (MBA) and 38% of the committees included at least one member with expertise in Law. Other expertise 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.

Audit committee members' qualifications



With regards to company-specific experience, we found that the average tenure on the board for an audit committee member was 8 years, with the shortest tenure being 3 years on average and the longest tenure being 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.

Board tenure

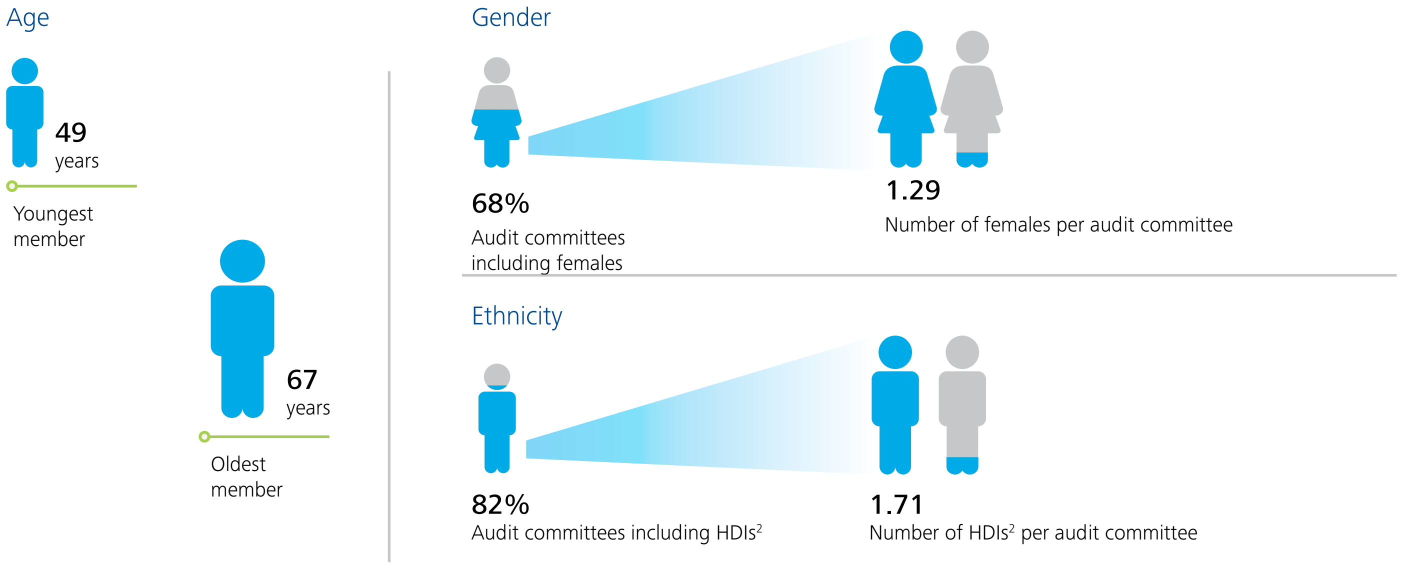


Diversity

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 67 years old and the average age of the youngest member was 49 years old. 68% of the audit committees included at least one woman on the committee. Of the committees which did include women, the average female presence was approximately one member on the committee. 82% of the audit committees included at least one individual from a historically disadvantaged race group[2]. In these cases, such individuals were approximately 2 members of the audit committee on average.

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].

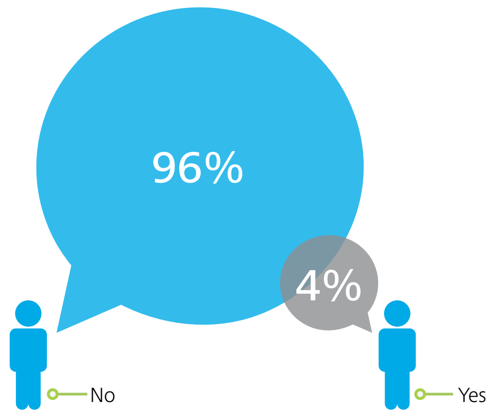


[2] For the purpose of our analysis, we have defined historically disadvantaged race groups as African Black, Coloured and Indian.
[3] For further discussion on the benefits of diversity, see Diversity in the Boardroom on the Deloitte Southern Africa Centre for Corporate Governance website http://www.corpgov.deloitte.co.za/

Chairperson of the board and the audit committee

King III and the JSE Listings Requirements allow for the chairperson of the board to be a member of the audit committee, however he/she cannot chair 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 two of the surveyed companies included the chairperson of the board as a member of the audit committee and in both cases, this individual did not chair the committee.

Is the chairperson of the board a member of the audit committee?



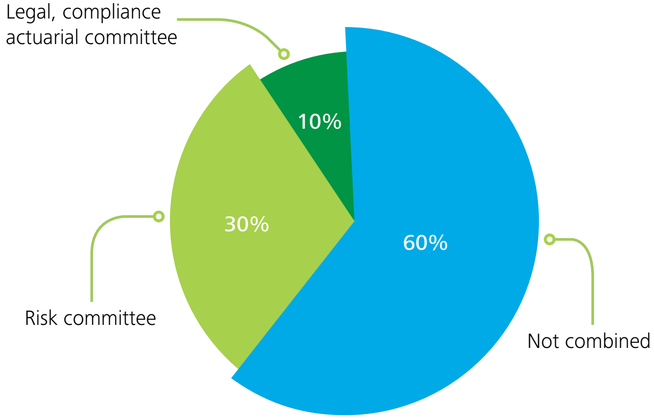
Combination with other committees

The JSE Listings 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 King III i.e. the committee may only comprise independent non-executive directors.

60% of the audit committees in our study were not combined with any other committee. Of the remaining 40%, 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 III assigns a critical role to the CEO in the risk management process. In instances where the audit and risk committees are combined, the CEO as an executive director would not qualify for membership of the combined committee (the audit committee may only comprise independent non-executive directors). Accordingly, although the CEO may be invited to attend meetings, he/she may not vote on matters tabled for decision by the combined committee.

Which other committes is the audit committee combined with?

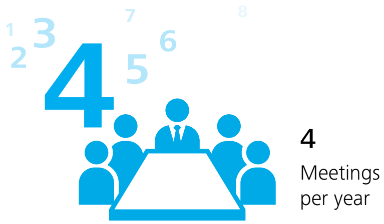


King III recommends that the audit committee should meet as often as is necessary to fulfil its functions, but at least twice a year.

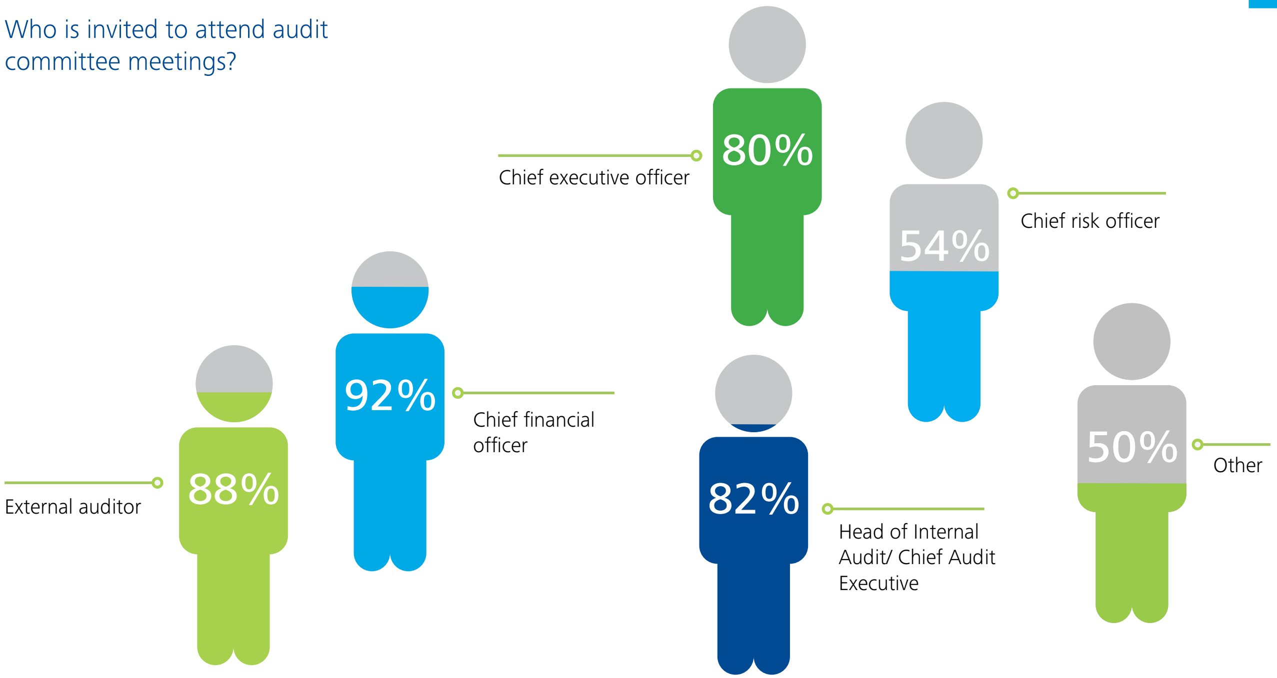
Meetings

Our analysis revealed that audit committees meet on average 4 times a year, which is well above the minimum recommendation. 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 (for e.g. Nominations and Social & Ethics Committee), company secretaries, and professional advisors.



Who is invited to attend audit committee meetings?



Percentage of companies where the above party was an invitee to the meeting of the audit committee as evidenced in the integrated report.

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

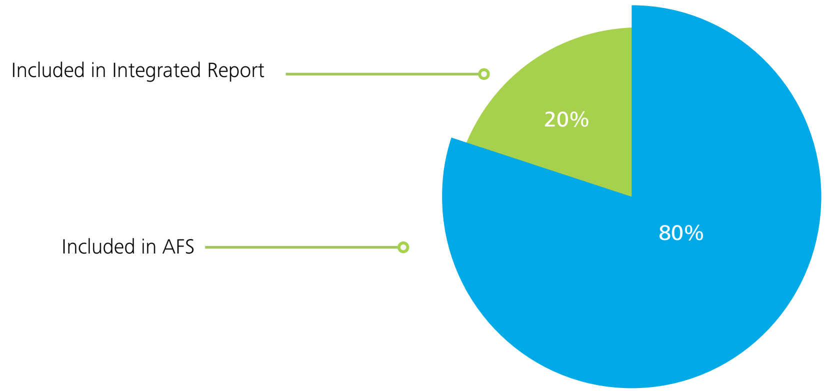
Disclosure

Statutory disclosures as required by the Companies Act

The Companies Act requires that the audit committee report 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.

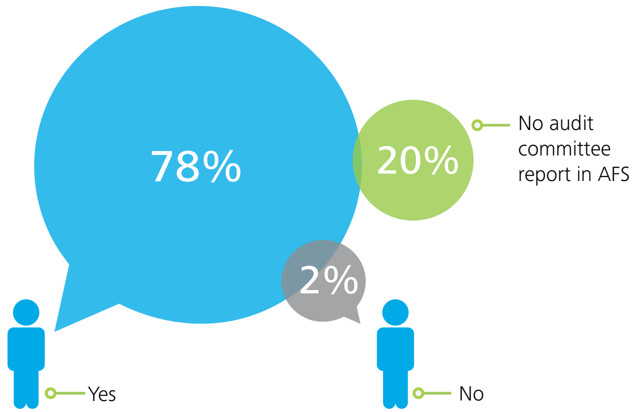
We analysed whether the required statutory disclosures were included in the audit committee reports located in the annual financial statements. Surprisingly, only 80% of our sample complied with this statutory requirement by including the audit committee report in the annual financial statements. The remaining 20% 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').

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

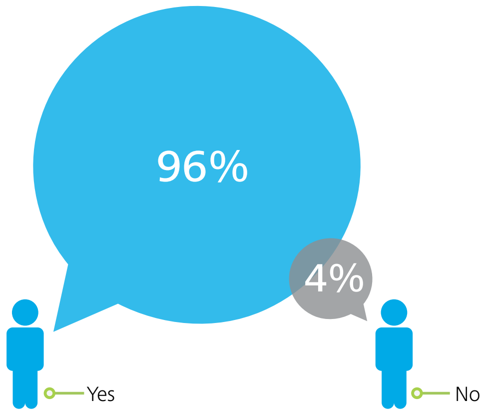


Of the companies that did include the audit committee report in the annual financial statements, not all complied with the specific disclosures required in terms of the Companies Act.

Does the audit committee report in the AFS disclose whether the committee was satisfied that the external auditor was independent of the company?



Does the audit committee report provide any details pertaining to the approval of non-audit services?



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.

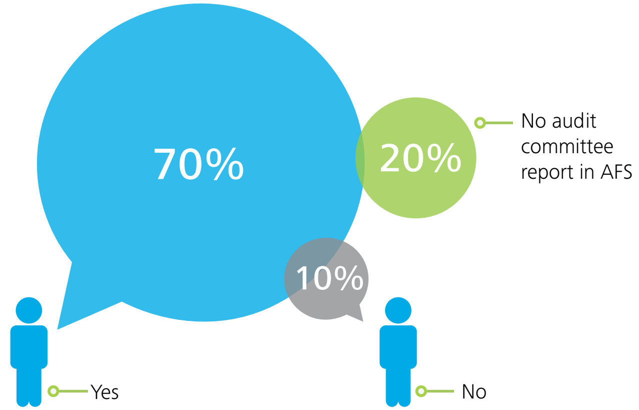
Looking at the functions of the audit committee as set out in the Companies Act, the principal function of the committee is to confirm and guarantee the independence of the external auditor. As such, the Companies Act requires a specific statement to this effect in the audit committee report. We found that of the companies that did include the audit committee report in the annual financial statements, only one company failed to include this disclosure.

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. 96% of the reports provided some level of detail regarding the approval of non-audit services, although in most cases, this detail was fairly generic.

The Companies Act requires disclosure to be made in the audit committee report describing how the committee carried out its functions.

The Companies Act requires the audit committee to explain to shareholders how it carried out its functions. This provides the audit committee with the ideal opportunity to communicate with the users of the financial statements. Ideally, the committee may provide detail on the processes followed and the interactions with experts, executives and other board committees in the carrying out of the committee's various functions. In our analysis, we found that 10% of the reports did not include adequate disclosure. These reports either included no disclosure or merely included a statement *that* the functions of the committee were performed, rather than explaining *how* these functions were performed.

Does the audit committee report in the AFS describe how the committee performed its functions?



The Companies Act requires disclosure to be made in the audit committee report commenting in any way the committee considers appropriate on the financial statements, the accounting practices and the internal financial control of the company.

Although 72% of the reports included commentary on accounting practices and the internal financial control of the company, we found that most reports included a largely generic description in this regard. In light of the revised standards[4] on auditor reporting which require a more robust auditors' report detailing key audit matters, we expect to see a corresponding increase in the commentary included in the audit committee report. In August 2015, the first of these "long-form" auditors' reports were released in South Africa. One such report was in respect of Imperial Holdings Limited, which was included in our sample of selected audit committees. We noted that the audit committee report robustly commented on the significant areas of judgement in the financial statements, some of which were discussed as part of the key audit matters detailed in the auditor's report.

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.

Does the audit committee report in the AFS include commentary on financial statements, accounting practices and internal financial control?

[4] The International Auditing and Assurance Standards Board (IAASB)'s amended standards are effective for years ending on or after 15 December 2016.

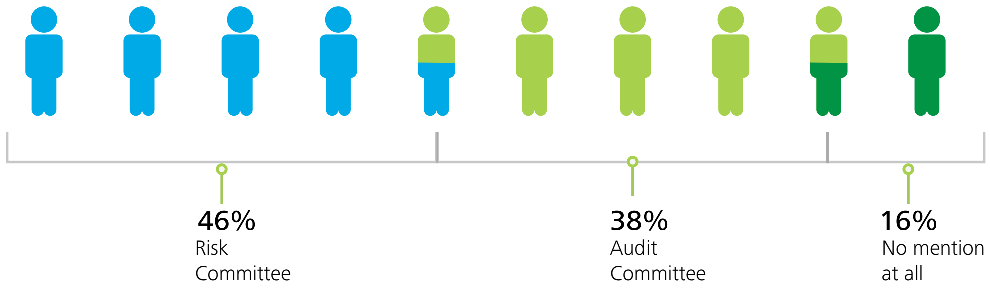
Other disclosures in terms of the JSE Listings Requirements and King III

The JSE Listings Requirements require a statement in the integrated report on whether the audit committee or a separate risk committee has monitored compliance with the risk management policy and whether the entity has complied with the policy during the year.

Risk Management

In 16% of the reports, no mention of this statement was made at all. We found that 38% of the reports noted the audit committee was responsible for monitoring the company's compliance with its risk management policy. In 46% of the reports, this responsibility was assigned to the risk committee. In many of these reports however, we found that the statement was not made with sufficient clarity as it was often not clearly discernible whether the company had in fact complied in all material respects with the company's risk management policy.

Does the integrated report state whether the audit committee or separate risk committee has monitored compliance with the risk management policy?

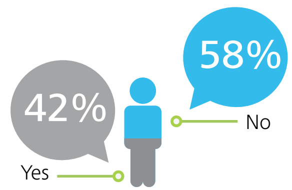


King III recommends that a statement be included in the integrated report regarding whether the audit committee considered and recommended the internal audit charter for approval by the board.

Internal Audit

We found that only 42% of the reports included the statement on internal audit as recommended by King III. Many of the reports stated that the audit committee reviewed the internal audit charter, but was silent on whether the committee had recommended the charter to the board for approval. Furthermore, we found that only 54% of the reports included a description of the working relationship with the Chief Audit Executive/Head of Internal Audit and the audit committee.

Does the audit committee report include a statement on whether or not the audit committee considered and recommended the internal audit charter for approval by the board?

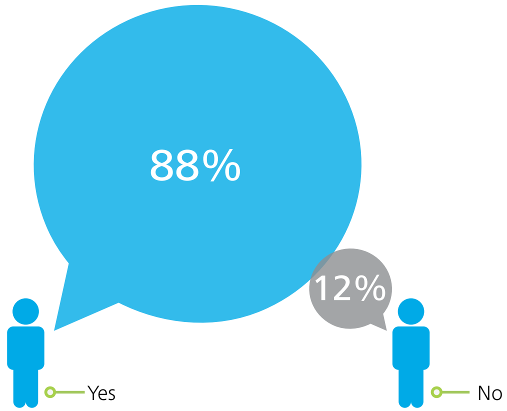


Terms of Reference

King III recommends that formal terms of reference are established and approved for each committee of the board. It specifies that the terms of reference of the audit committee should be approved by the board. 78% of the reports included a clear statement that the audit committee adopted formal terms of reference or a charter that was approved by the board. Of these reports, 92% clearly stated that the committee had satisfied its responsibilities for the year in compliance with its terms of reference or charter.

Finance function, financial director and recommendation of the integrated report

Does the integrated report include a reference to the assessment of the appropriateness of the expertise and adequacy of the resources of the finance function by the audit committee?



King III recommends that the finance function is reviewed annually by the audit committee and the results of this review are disclosed in the integrated report. Our analysis revealed that 88% of the reports included such disclosure. Furthermore, in terms of the JSE Listings 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.

King III proposes that the audit committee should recommend the integrated report for approval by the board. 66% of the reports included a clear statement in this regard.

100% of integrated reports disclose whether the audit committee is satisfied with the expertise and experience of the financial director.

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 heighten market place confidence.

It is clear from the survey results that the audit committees of the top 50 JSE listed companies 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 evaluate 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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