Independence of the audit committee

MCCG Intended Outcome 8.0

There is an effective and independent Audit Committee.

The board is able to objectively review the Audit Committee’s findings and recommendations. The company’s financial statement is a reliable source of information.

Step Up 8.4

The Audit Committee should comprise solely of Independent Directors.

Why

The case for change

Independence is the cornerstone of a well-functioning audit committee. The ability of its members to exercise their judgment in an informed and impartial manner is important to the fulfilment of the audit committee’s mandate, especially in overseeing the areas of financial reporting, related party transactions and conflicts of interest, internal control environment, internal audit and external audit processes.

It should be noted that the core functions of audit committees set out in many, if not all, global authoritative governance documents, are expressed in terms of “evaluation”, “assessment” or “review” of the aforementioned areas. The undertaking of such responsibilities would naturally necessitate audit committee members to critically and objectively apply a probing view on pertinent matters, particularly in areas which involve a high degree of judgment. In many instances, audit committee members are expected to take tough, constructive or even unpopular stances, all of which call for independence in “thought and action”.

As a former Senator of the United States, Howard Metzenbaum puts it, “audit committees that lack independence frequently have a fealty to the management that an audit committee shouldn’t have”¹. To coin it differently, audit committees should not be having a "debt" to the management which is then "repaid" when a tough issue (e.g. financial reporting issue) arises.

Recognising that objectivity is essential to the proper functioning of the audit committee, regulators have outlined provisions on the composition of the audit committee with due regard to the element of independence.

What could go wrong:

- External and internal auditors are unable to perform their functions in an independent manner due to a lack of support from the audit committee.
- Failure of audit committee members to get to the root of pertinent issues that impact the company.

¹ Bostelman, JT et.al 2010, Public Company Deskbook: Sarbanes-Oxley and Federal Governance Requirements, Practising Law Institute
Paragraph 15.09(1)(a) and (b) of Bursa Securities Listing Requirements

A listed issuer must appoint an audit committee from amongst its directors which fulfils the following requirements:

(a) the audit committee must be composed of not fewer than 3 members; and

(b) all the audit committee members must be non-executive directors, with a majority of them being independent directors.

Note: Only requirements pertaining to the composition of the audit committee are extracted from the said paragraph. Similar provisions are also applicable for financial institutions under Standard 12.3 of Bank Negara Malaysia’s Policy Document on Corporate Governance. The requirements in relation to the composition of audit committees for financial institutions are the same as that of other board committees.

Whilst it is not a recommendation prior to the issuance of MCCG, many companies are already having wholly independent audit committees, premised on the proposition that such a committee would be better positioned to perform the functions entrusted to it. A review of annual reports across the top 100 listed issuers (by market capitalisation) in Malaysia as at 31 December 2016 revealed that 54% of them have audit committees which are composed exclusively of independent directors.

Companies with wholly independent audit committees in the top 100 listed issuers (by market capitalisation) as at 31 December 2016.

Point for reflection

Several research studies have shown that the value of having an audit committee comprising solely of independent directors can be particularly evident when a company is undergoing financial distress.

For example, a prominent research performed by Bronson et.al highlighted that wholly independent audit committees are more likely to protect external auditors’ independence during a dispute with management of a financially distressed company. The research highlighted that given the negative consequences associated with a going concern report (an opinion by the auditors that the company may not be viable in the foreseeable future), management may try to pressure the external auditor into not issuing the said report when one is warranted. In such a scenario, having a fully independent audit committee would more likely lead to objective support for the external auditor and mitigate pressure from management relating to the going concern reporting decision. Conversely, audit committees with members who are affiliated with management were found to be more likely in replacing the external auditor in such a circumstance.

In the course of establishing a fully independent audit committee, boards are not expected to compromise on the skill sets and make unwieldy changes to the composition of the audit committee. In order to create a conducive environment for insightful deliberations of the audit committee, boards should ensure that the enlisted independent audit committee members are financially

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2 Referring to audit committees comprising wholly of independent directors
3 Review undertaken by KPMG Management & Risk Consulting Sdn Bhd in 2017
4 Bronson, SN et al. 2009, “Are fully independent audit committee really necessary?”, Elsevier
literate and have a sufficient understanding of the company’s business (as highlighted in Guidance to Practice 8.5 of MCCG).

Independent audit committee members who possess the aforementioned attributes are able to exercise intelligent reviews of the processes, transactions and information on matters under its purview as well as continuously apply a critical view on the assertions made by management.

**HOW**

**The practice in substance**

It is therefore incumbent on the board to assess the independence of its audit committee and consider establishing a wholly independent audit committee with a view of going a step further in strengthening the company’s corporate governance practices and processes. Every member’s appointment is an occasion for careful deliberation and the board should have a strong understanding of how imperative is independence to the effective functioning of the audit committee.

Key considerations relating to the application of this Step Up are discussed below:

**How should the independence of the audit committee members be assessed?**

As with other independent directors, independent audit committee members should display a strong element of objectivity, both in appearance (“perceived independence”) as well as of mind (“independence in thought and action”).

In assessing “independence in thought and action”, the nominating committee or the board should, amongst others, evaluate if the audit committee members demonstrate vigilance, scepticism and more importantly, have the courage to stand up for an objective point of view.

Characteristics (non-exhaustive) that are commonly exhibited by audit committee members which demonstrate vigilance, scepticism and courage:

- clarifies objectives of the topics for deliberation to understand the issues and set expectations for possible solutions;
- drives for complete and accurate financial and non-financial information disclosures that reflect substance over form which can be issued on a timely basis;
- actively engages internal and external auditors and fosters candid two-way relationship;
- suspends prevailing assumptions and continues to ask questions until satisfactory responses are obtained;
- changes the angle of debate to probe for further information;
- raises any issues or “red flags” promptly with the audit committee chair; and
- leverages on internal and external audit findings to review the way management manages business risks as well as how the risks are managed to enhance shareholder value.

**Dos**

- Putting in place mechanisms for independent directors to disclose changes in relationships or circumstances that may impact their independence.
- Ensuring all questions and remarks (including dissenting comments made by audit committee members) are minuted.
- Developing channels for audit committee members to enlist the services of third party experts, if needed.

**Don’ts**

- Conceding that the element of financial literacy overrides the aspect of independence.
- Maintaining that adherence to the audit committee’s independence requirements set out in paragraph 15.09(1)(b) of Bursa Securities Listing Requirements is the be-all and end-all.
The consideration of independence is often a matter of substance rather than mere compliance with specific rules. The board should also be cognisant and mindful of situations in which the regulatory definition of independence is met, yet impairment of objectivity or perceived conflicts of interest may still arise.

**How should audit committee members deal with conflict of interest situations?**

Audit committee members should declare any matter in which they have an interest. Normally, the process for recording declarations of conflicts of interest in the audit committee should mirror that used by the board. Each member of the committee should undertake to declare proactively, at the outset of each meeting, any potential conflict of interest relating to the affairs of the committee or from changes in the member’s personal circumstances.

Depending on the nature, extent and potential duration of the conflict of interest situation, the chairman of the audit committee should then determine an appropriate course of action with the said member. For example, the member might be asked to abstain from deliberation and decision-making, or in more extreme cases, the member could be asked to step down from the committee.

If it is the chairman of the audit committee that has a conflict of interest, the board should ask another member of the committee to lead in determining the appropriate course of action.

**Regional/international perspectives**

Alongside Malaysia, jurisdictions such as South Africa and Canada have incorporated enumerations for public listed companies to establish audit committees which comprise solely of independent directors.

<table>
<thead>
<tr>
<th>Country</th>
<th>Provision(s)</th>
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<tbody>
<tr>
<td>South Africa</td>
<td>All members of the audit committee should be independent, non-executive members of the governing body <em>(Recommended Practice 56).</em></td>
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<tr>
<td>Canada</td>
<td>Every audit committee member must be independent <em>(Provision 3.1(3)].</em></td>
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*Regional/international perspectives diagram*