Financial literacy of audit committee members

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.

MCCG Practice 8.5
Collectively, the Audit Committee should possess a wide range of necessary skills to discharge its duties. All members should be financially literate and are able to understand matters under the purview of the Audit Committee including the financial reporting process.

All members of the Audit Committee should undertake continuous professional development to keep themselves abreast of relevant developments in accounting and auditing standards, practices and rules.

(The application of this Practice in its entirety entails the possession of a wide range of necessary skills and financial literacy of all members of the audit committee as well as their undertaking of continuous professional development.)

The internalisation and application of the content “Why” and “How” should be read in tandem with the line of sight outlined by the Intended Outcome.

Why
The case for change

Financial literacy is a key cornerstone of a well-functioning audit committee. As a committee that is specialised and focused, the audit committee is relied upon by the board to, amongst others, provide advice in the areas of financial reporting, external audit, internal control environment and internal audit process, review of related party transactions as well as conflict of interest situations.

Point for reflection
As businesses become more complex, globalised, and increasingly face new risks, the breadth and complexity of the audit committee responsibilities similarly continue to increase. The need for audit committee members to possess sound financial understanding is now made more important than ever by the changes in business models and financial reporting requirements.

A recent KPMG Audit Committee Institute’s Global Pulse Survey in 2017 revealed that a lack of understanding of business drivers (e.g. changes in the industry) and poor oversight of the implementation of new accounting standards (e.g. revenue recognition and leasing) were amongst the main weak spots of audit committees.

What could go wrong:

- Financial statements do not serve as reliable sources of information.
- Transactions carried out are detrimental to the interests of the company.
The changing landscape of the financial reporting environment is exemplified by a review of the recent amendments to International Financial Reporting Standards (“IFRS”) which revealed that there were a total of 29 changes made between the years 2014 to 2016 (depicted in the chart below). The changes to IFRS, to a large extent, have resulted in more subjective judgments on accounting estimates and valuations. It is therefore now incumbent on the audit committee to be more informed and increasingly scrutinise the risk for management bias in the application of these judgments.

In order to ensure that the audit committee is well-equipped to carry out its mandate, regulators have emphasised the importance of having members with accounting or financial acumen.

Paragraph 15.09(1)(c) of Bursa Securities Listing Requirements

At least one member of the audit committee –

(i) must be a member of the Malaysian Institute of Accountants; or
(ii) if he is not a member of the Malaysian Institute of Accountants, he must have at least 3 years’ working experience and –
   (aa) he must have passed the examinations specified in Part I of the First Schedule of the Accountants Act 1967; or
   (bb) he must be a member of one of the associations of accountants specified in Part II of the First Schedule of the Accountants Act 1967; or
(iii) fulfils such other requirements as prescribed or approved by the Exchange.

It is important to note that financial literacy is a prerequisite for each member to deliver tangible value to the functions of the audit committee. Having only a single audit committee member with special knowledge or skills in accounting would place undue reliance on that one individual and render the deliberations of the audit committee ineffective. To this end, the audit committee as a whole should consist of financially literate members who would be able to challenge, encourage and support each other in a more meaningful manner.
The practice in substance

In considering the composition of the audit committee, the board should have regard to the range of skills, experience, knowledge and qualifications possessed by committee members. It is imperative for the audit committee to comprise members with a sound understanding of the language of accounting and finance in order to perform the duties that have been entrusted to it by the board.

Key considerations relating to the application of this Practice are discussed below.

What constitutes a financially literate audit committee member?

Financial literacy goes beyond basic familiarity with financial statements and would include the following:

Attributes of a financially literate audit committee member:

- ability to read and understand financial statements, including a company’s statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, cash flow statement, notes to the statements, cost accounting, budgets and management’s discussion and analysis (“MD&A”);
- ability to understand and assess the general application of accounting principles and apply a critical view on the underlying assumptions;
- ability to analyse financial statements and challenge management’s assertions on financials;
- awareness of, and familiarity with, new financial reporting standards and how they impact the company’s financial performance to enable the member to ask pertinent questions;
- ability to assess the effectiveness of the audit process and the company’s finance functions in generating reliable and timely financial information; and
- ability to ask probing questions about the company’s operations against internal controls and risk factors.

Adapted from the Guidebook for Audit Committees in Singapore (2014) issued by the Audit Committee Guidance Committee

Note: A sample questionnaire is provided in the Appendix IV of this Pull-Out in order to further understand and assess who may qualify as a financially literate member.

What are the potential indicators which may signal that a lack of financial literacy is impeding the effective functioning of the audit committee?

Examples of indicators which may highlight a lack of financial literacy amongst audit committee members are as follows:

- inability of the audit committee to critically probe highly risky transactions as well as key accounting policies and judgments adopted by the company in its financial reporting;
- undue reliance by the audit committee on management, auditors and experts to ensure the reliability of the financial statements; and
- lack of strategic input from the audit committee to the board on the drivers of financial performance.
What are the other qualities that should be considered in selecting audit committee members?

An audit committee’s effectiveness is certainly enhanced by, and is often dependent upon the personal and professional attributes of individual members.

Personal and professional qualities that should be considered in selecting audit committee members:

- a strong understanding of the business and industry in which the company operates;
- ability to be proactive in advising the board of any concerns;
- ability to ask tough and incisive questions, evaluate the responses and continue to probe for information until completely satisfied with the feedback provided;
- ability to appreciate the company’s values and have the determination to uphold these values coupled with a thoughtful approach to the ethical issues that may be faced;
- a professional approach to duties, including an appropriate commitment of time and effort;
- courage to take and stand by tough decisions and high ethical standards; and
- ability to accept mistakes and not ascribe blame.

As such, in addition to financial literacy, it would be desirable for members to have experience that is relevant to the business and the industry the company operates in. For example, given the complex nature of the banking industry, it would be highly value-adding for audit committee members to have previous experience in that particular sector with a granular understanding of the pertinent nuances such as financial instruments and credit models.

What is the nature of continuous professional development programmes that should be undertaken by audit committee members?

Given the ever changing financial reporting and corporate landscape, it is essential for members of the audit committee to undertake continuous professional development to keep themselves abreast of relevant developments, as outlined in the areas on the following page.
How can the deliberations of the audit committee be enriched?

Effective audit committee deliberations necessitate members to get to the root of the issues that is impacting the company’s financial reporting process. This includes an assessment of relevant non-financial information such as business model and other operational aspects that can have a significant bearing on the company’s value creation process. Audit committee members are required to apply an inquiring mind and make informed inquiries. Whilst audit committee members are entitled to avail themselves to external advisors, they should take a diligent and an informed interest in the information that is presented to them.

Applying an inquiring mind and making informed inquiries are key aspects of effective audit committee oversight. One of the world’s distinguished investors, Warren Buffet is known for three key questions he developed for audit committees to consider, and he suggests the discussion of these matters be documented in the minutes of their meetings\(^1\).

---

A list of indicators that the audit committee should be aware of in relation to financial reporting and examples of questions to be posed to management on financial reporting are outlined in Appendix I of this Pull-out.

**Case study: Centro Properties Group (Australia)**

**Background:**
- Section 295A of the Companies Act 2001 in Australia obligates directors to ensure the integrity of financial statements while Section 180(1) and 344(1) of the Corporations Act 2001 enumerate provisions on statutory duty of care and diligence pertaining to directors.

**Facts:**
- The Australian Securities and Investment Commission (“ASIC”) brought proceedings against the directors of certain companies in the Centro Properties Group on grounds that the directors failed to take all reasonable steps to ensure compliance with the financial reporting obligations of the Corporations Act 2001, and breaches of their statutory duty of care and diligence.
- The allegations were related to the disclosures in the 2007 annual financial statements of companies within Centro Properties Group. Those financial statements wrongly classified liabilities of about AUD $ 2.1 billion as non-current liabilities instead of current liabilities and failed to disclose certain post balance date related party guarantees.
- The court held that notwithstanding the fact that neither Centro management nor the auditors had detected the error, the erroneous disclosure could have been identified by the directors if they had carried out a careful and diligent review of the financial statements.

**Lessons Drawn:**
- Scepticism: Directors must question the information provided to them. There is no defence for wilful blindness.
- Accounting knowledge: Directors are expected to have financial literacy and accounting knowledge.
- Accountability and control: It is up to directors to ensure that management has put in place systems, protocols and controls to ensure sound corporate governance.

---

**Question I**
If the auditor were solely responsible for the preparation of the company’s financial statements, would they have been prepared in any way different than the manner selected by management? The audit committee should inquire as to both material and non-material differences.

**Question II**
If the auditor were an investor, would he have received the information essential to a proper understanding of the company’s financial performance during the reporting period?

**Question III**
Is the company following the same internal audit procedure that would be followed if the auditor himself were the chief executive officer (“CEO”)? If not, what are the differences and why?
Regional/international perspectives

As in the case of Malaysia, selected jurisdictions including Canada have enumerated prescriptions for the audit committee as a whole to possess financial literacy in order to enhance the effectiveness of the committee.

<table>
<thead>
<tr>
<th>Country</th>
<th>Provision(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>Every audit committee member must be financially literate [Provision 3.1(4)].</td>
</tr>
</tbody>
</table>