

# Corporate & Commercial ALERT

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INCORPORATING  
KIETI LAW LLP, KENYA

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### The benefits and pitfalls of constituting a voluntary audit committee

When it comes to audit committees, a private company is not required to appoint an audit committee unless it is required to do so by its memorandum of incorporation (MOI). Nevertheless, a private company that is not legally required to appoint an audit committee may still voluntarily constitute one. Deciding whether to voluntarily appoint an audit committee requires careful consideration of a number of factors, the most important being the particular business, structure and needs of the company or company group in question. Additionally, weighing up the pros and cons may provide important insights into whether or not voluntarily appointing an audit committee is advantageous to a business.



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## The benefits and pitfalls of constituting a voluntary audit committee

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Deciding whether to voluntarily appoint an audit committee requires careful consideration of a number of factors, the most important being the particular business, structure and needs of the company or company group in question. Additionally, weighing up the pros and cons may provide important insights into whether or not voluntarily appointing an audit committee is advantageous to a business.

There are a number of benefits to having an audit committee. Firstly, from a corporate governance standpoint, there is a clear advantage in having an audit committee for facilitating good governance in a company, given that the main role of an audit committee is to oversee the company's financial reporting and auditing processes, its system of internal controls and its compliance with laws and regulations.

### Board support

A further advantage is that an audit committee can provide support to the board, as the board may delegate additional duties or responsibilities to an audit committee, such as the approval of the annual financial statements, although the board ultimately remains accountable for such delegated responsibilities. Moreover, the functions of risk governance can be combined with the functions of the audit committee instead of having a separate committee responsible for risk management.

An audit committee can also enhance the integrity of a company's financial functions through reporting on matters such as:

- its views on the quality of the external audit in relation to external quality indicators such as those indicated in the inspection reports issued by external audit regulators;

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# The benefits and pitfalls of constituting a voluntary audit committee

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- its views on the effectiveness of the chief audit executive and arrangements for the internal audit;
- its views on the design and implementation of internal financial controls and any significant weaknesses in them that resulted in material financial loss, fraud, corruption or error;
- its views on the efficacy of the CFO and the finance function; and
- meeting annually with the company's internal and external auditors without management being present, in order to discuss matters that may not be appropriate for discussion in an open forum.

In the context of a group of companies, one may also consider appointing a single audit committee in respect of a holding company to exercise oversight over its

subsidiaries. This is permitted under the Act, provided that the audit committee of the holding company will perform the functions required under section 94(2)(a) and (b) of the Act on behalf of such subsidiary company(ies). In addition to the potential to save costs and simplify the administration around appointing an audit committee, having a single audit committee across a group of companies may also allow for firmer control over a group's financial function.

## Ensuring the committee's independence

When constituting a voluntary audit committee in terms of the Act, it should be borne in mind that the audit committee must comply with the requirements of section 94(4) of the Act, including that each member of a company's audit committee must be a director of the company and must satisfy any minimum requirements

prescribed by the Minister of Trade and Industry (as defined in the Act), and that members of an audit committee may not be:

- involved in the company's day-to-day management of its business or have been so involved at any time during the previous financial year;
- a prescribed officer or full-time employee of the company or another related or inter-related company or have occupied any such position at any time during the previous three financial years;
- a material supplier or customer of the company, such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship; and
- related to any person who falls within any of the criteria set out above.



## The benefits and pitfalls of constituting a voluntary audit committee

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### Potential disadvantages

One of the disadvantages to having audit committees is that independent directors may be hard to find, especially for companies whose boards comprise of a small number of directors or directors who are closely involved in the day-to-day management of the company. While a company could still appoint an ordinary committee of the board in terms of section 72 of the Act, whose functions are similar to an audit committee's functions but whose composition is determined by the board, this may detract from the benefits of having an independent committee and such a committee would in any event not be permitted to hold itself out as an audit committee as this would create a false impression of independence to stakeholders.

A further potential disadvantage to having an audit committee is the increased costs to the company that may accompany appointing such a committee, as members of an audit committee are board members who are likely to be highly paid employees. Furthermore, audit committee members are also likely to be highly skilled or qualified professionals, as the King IV Report recommends that members of an audit committee should, collectively, have the necessary financial literacy, skills and experience to execute their duties effectively, and consequently it is likely that such members would receive remuneration for their service on an audit committee. Accordingly, a cost-benefit analysis will be required to determine whether the increased costs of constituting an audit committee may nevertheless be worthwhile, given the additional oversight controls put in place over the company's finances.

Ultimately, the roles, functions and purpose envisaged for an audit committee should be considered to determine how a company might benefit from voluntarily appointing an audit committee, and these considerations should be weighed up together with the business' structure, needs and available resources to determine whether appointing an audit committee would result in a nett positive outcome for the company.

**Carmin Jansen van Vuuren and  
Andrew Giliam**



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#### **BBBEE STATUS: LEVEL ONE CONTRIBUTOR**

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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