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Corporate Governance Practices with regard to Audit Committees

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Abstract

Audit Committees play a very pivotal role in corporate governance practices all around the world. Firms rely on audit committees to supervise their financial reporting and to maintain its integrity. This paper focuses on the issues and status of the audit committees in the United States, the United Kingdom, Australia and New Zealand. It also brings forth various comparisons of the corporate governance practices with regard to audit committees after the regulations have been imposed in these countries. It is difficult to get a direct comparison between these countries due to their different cultural and business backgrounds, but this study will give a closer look at the issues and help in the comparative study to the best possible extent.
Keywords: Audit committees; corporate governance practices

Introduction

Due to the accounting scandals, there has been a lot more appreciation for the audit committees these days. Regulators, market participants and the public now understand how audit committees have a vital role in the smooth functioning of financial markets. After the series of major accounting scandals and the demise of Arthur Anderson, corporate governance has become the central point of major reform efforts anticipated at enhancing the quality of financial reporting and audit processes. Therefore, audit committees have a crucial role to perform, as the capital markets have a lot of expectations from the audit committees.

This paper discusses the corporate governance practices of audit committees in US, UK, Australia and New Zealand. The structure of this paper begins with definitions of corporate governance followed by the background of corporate governance and audit committees. Thereafter, it highlights the guidelines pertinent to audit committees in each of these countries. A general comparison is made concerning the issues and changes with regard to audit committees and corporate governance practices.

What is corporate governance?

"Corporate governance is about promoting corporate fairness, transparency and accountability" (Mathiesen, 2006).

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board,

managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance" (Mathiesen, 2006).

Audit committees play a key role to ensure that financial reporting is of high quality with proper transparency of the financial information. The natural tension between the board's dual function as an advisor to management and a fiduciary to shareholders is increased with audit committees often at the center of the tension. Audit committees also possess the responsibility for oversight of the company's risk management program related to fraud, taxes and information security.

Background

A fundamental component for corporate success is good corporate governance which tells us how companies are directed and controlled. Audit committees are in-charge of looking over the entity's financial reporting process and ensuring a quality audit. The most important aspect of the audit process is the communication between the auditor and the audit committee (Securities Commission New Zealand, 2004). The audit committee plays a significant role in getting the confidence of the investors by verifying accurate and reliable financial information about the companies. It makes sure that the procedures are in place to assess the firm's practices and internal controls.

Audit Committees in the United States

According to NYSE Sections 303A(6) and 303A(7), each NYSE listed company needs to have a minimum of three-person audit committee comprising entirely of directors that meet the independence standards of both NYSE Section 303A(2) and Rule 10A-3. Also, the interpretation to NYSE Section 303A(7)(a) desires that each member of the audit committee to have finance knowledge or the member must become financially literate within a reasonable period after he or she is appointed to the audit committee. In addition, at least one member of the audit committee must be proficient in accounting or related financial management, as the company's board requires such qualification for business judgments.

NYSE Section 303A(7)(c) requires each company's audit committee to provide a written audit committee charter which points out the committee's role, an annual performance evaluation of the audit committee and the duties and responsibilities of the audit committee. This means that the audit committee is required to obtain the financial reports from the independent auditor, discuss the company's audited financial statements with the board, internal auditors and the independent auditor. They must also discuss the company's earnings press releases, different policies regarding risk assessment and risk management. Audit committees need to bring it to the attention of the independent auditor if there are any audit problems and report everything regularly to the board (Securities and Exchange Commission, 2003).

Audit Committees in the United Kingdom

The Revised Code in the UK contains principles on how the board should establish an appropriate relationship with the company's auditors. The board should form an audit committee of at least three members for large firms and at least two members in case

of smaller companies. All the members must be independent non-executive directors. The board must make sure that at least one member of the committee has considerable knowledge of finance.

The main responsibilities of the audit committee should be to check the reliability of the financial statements of the company, to keep a check on any formal announcements relating to the company's financial performance, to watch and evaluate how effective the company's internal audit function is, to help with the appointment of the external auditor, to review the external auditor's objective and effectiveness of the audit process. It is the responsibility of the audit committee to appoint, reappoint and remove any external auditors. If for any reason, the board does not agree with the audit committee's recommendation, then it should be explained in the annual report. The annual report should explain to the shareholders in detail if any auditor has performed non-audit services.

Audit Committees in Australia

The board should form an audit committee as it is an important feature of corporate governance. In larger companies, it makes more sense to form an audit committee instead of the full board focusing on the company's financial reporting. If the company decides to go without an audit committee, then it should disclose the reasons for the same. It must assure the integrity of the financial statements and the independence of the external auditor. The audit committee should consist of only non-executive directors, most independent directors, an independent chairperson, who is not chairperson of the board and at least three members. (ASX Corporate Governance Council, 2003). The audit committee should consist of members who have considerable knowledge of finance, at least one member if not all and some should have an expertise in the industry in which the entity functions.

The charter should clearly state the responsibilities of the audit committee. The audit committee should monitor the integrity of the company's financial reporting. It should have regular meetings to discuss issues and perform its role effectively and its minutes should be included in the papers for the next board meeting. The audit committee should report to the board.

The report should contain everything related to the committee's role and responsibilities which includes assessment of whether external reporting is consistent and satisfactory, procedures for the appointment and removal of an external auditor, and whether the external auditor has maintained independence regarding non-audit services. The committee is also required to evaluate the performance and objectivity of the internal audit function and discuss the results of its review of risk management and internal compliance and control systems.

Audit Committees in New Zealand

The audit committee must have at least three directors and it should consist of only non-executive directors, most independent directors, at least one director who is a chartered accountant or has a considerable knowledge in finance and a chairperson who is independent and not the chairperson of the board.

The audit committee should have a written charter and their responsibilities should be clearly mentioned. The Board should assess the performance of the audit committee

on a regular basis. The directors and employees who are not the members of the audit committee should not attend the meetings until or unless invited by the audit committee. Another responsibility of the audit committee is to address the independence of auditors. (Business NZ, 2003).

According to the rules, majority of the committee must have independent directors and at least one member should have considerable knowledge about finance or accounting. Audit Committee has various responsibilities which include procedures on informing and updating the board regularly on financial matters, responsibility to appoint and remove an external or independent auditor, keeping a close watch on audit practices, procedures to maintain integrity of financial statements and finally communicating directly with independent and internal auditors with unrestricted access.

Changes and Issues with regard to audit committees in the United States after the Sarbanes-Oxley Act 2002

There has been a far-reaching change post the Sarbanes-Oxley Act. With the financial statements now representing a reliable picture, the audit committees have become more focused with their tasks and are allocating a significant amount of time on the management of risk and vital issues of financial aspects (KPMG International, 2006).

Post the Sarbanes-Oxley Act, the approach of the audit committees towards their work has added dimensions of taking new responsibilities, their meeting durations have extended, and the functions of the internal auditors have taken a better direction. It is also evident that after the advent of the Sarbanes-Oxley Act, the charters and the functioning of the audit committees have improved.

Audit committees are meeting for an extended duration with twice the level of time allotted for these meetings. Organisations that did not function with an audit committee have established one now. However, no addition has taken place in the number of financial experts or self-governing members on the audit committee. Probably, efforts are being made to hire superior people who can fulfill the role of a financial expert. The impact of Sarbanes-Oxley Act has led to the committees becoming more diligent and accountable, their plan of actions involves standard flow of information, and most importantly, the amount charged by outside auditors for both audit and non-audit services is being verified. The interactions between the audit committee and the internal auditor have also improved, as the internal auditor has been providing support to the audit committee. This is mainly on compliance issues, management of documentations, assistance to execute the plan of actions, involvement with whistle blowing processes etc.

It has been found that at times, the association between the audit committee and the outside auditor translates into constructive tension because of the stress associated to the compliance with the Sarbanes- Oxley Act. Also, the issues of complicated standards of accounting and the role of the committee to supervise the outside auditor’s role have been instrumental in hampering the relations between them. One of the challenges experienced by the audit committee was to keep the shareholders and regulators satisfied by reducing the flaws and complexities of accounting. The growing intolerance for accounting errors and earnings management has put a

premium on the quality and rigor of the audit committee's oversight process. (KPMG International, 2006).

Audit committees have undeniably become more efficient after the Sarbanes-Oxley Act. However, there are some issues faced by audit committees in areas of accounting judgments and risk management. Following the Sarbanes-Oxley Act, audit committee members have a propensity to believe that their legal duties and financial exposures are bigger than those of other board members.

Changes and Issues regarding audit committees in the United Kingdom after the Revised Combined Code in July 2003

The Revised Combined Code (the Code) was published by the Financial Reporting Council in July 2003 and became effective for listed companies with reporting years beginning on or after 1 November 2003. The 2005 reporting season was therefore the first year in which all listed companies reported under the Code (PWC, 2010).

With the impediments of the corporate governance scandal, audit committees are placed in the central pivotal position to confront new challenges following the Revised Combined Code and the passage of the Sarbanes-Oxley Act.

Audit Committees are complying with the membership requirement, i.e. minimum three members. In fact, most of the companies are having four members, but as for the independence criteria (i.e. members to be independent non-executive directors), there are some issues, i.e. the board chairman who is not considered to be independent serves on many companies as one of the independent directors. The issue of having one member of the audit committee with financial experience remains. In many firms, this gap is filled by the chairman.

There has been heavy work load on the audit committee after the Combined Code. Following the Revised Combined Code, there have been changes in the functioning of reporting to the audit committee. However, in many small firms, communication and reporting problems on key risk areas have been observed. Overall, in large companies, there has been a major improvement towards compliance with the Combined Code. There is still an ongoing need for training.

Changes and Issues regarding audit committees in Australia after the principles issued by the Australian Stock Exchange (ASX)

Australian Corporate Governance guiding principles have a flexible approach based on the situations and conditions of each company. Any company not adopting any guiding principle must inform the shareholders as to which principle has not been adopted and the reasons for the same. Ernst & Young (2003) conducted a survey on banking and capital market firms and found that audit committees in Australia undertake 40% of the dealings in risks. The firms are also complying with the membership requirement; in fact, most of the companies have four members. Most of the companies comprise of two or more financial experts, which is a positive approach towards compliance with the new reforms.

Australian Stock Exchange (2006) conducted a survey that included an analysis of the corporate governance disclosures and the results showed the adoption reporting level of 82% for entities establishing an audit committee for listed trusts and 75% for listed companies. For most of the listed trusts, it portrayed a high level of adoption reporting

level for entities where the audit committee had only non-executive directors with most independent directors, a chairperson who is not the chairperson of the board, and at least three members. For listed companies, the adoption reporting level was average for some entities.

Many large companies in Australia comply with the principles of good corporate governance, but still there are many firms that are not complying comprehensively. The issue of all non-executive directors with most of them being independent is not observed in many companies. On the other hand, there have been improvements in the risk management reviews by the audit committees.

Changes and Issues regarding audit committees in New Zealand after the principles issued by the Securities Commission

In New Zealand, in the public sector, the audit committees are trying to position themselves in place with the international standards. Many audit committees have been set up due to the increase in their roles and responsibilities. KPMG (2004) conducted a survey for ministries and government departments and it was found that only a few audit committees involved most independent directors, and most of them had only one independent director. Many companies have an audit committee size of six to eight members which is different from the requirement of three to four members. Audit committees are performing their duties well through proper execution and analysis. The survey facts showed that the audit committee's composition has been extended.

Some issues were also found as there was minimal involvement with risk management. Overseeing the operation of the entity and strategic planning displayed a low percentage involvement of the committees. There are some positive aspects as the committees are being involved closely with the internal auditors, external auditors and the management. Most of the audit committees have at least one external member, but a small percentage of them had a majority drawn from outside the organisation. The audit committees range between six to eight members which is complying beyond the requirements of the regulations. Most of the firms are chaired by the chief executive instead of an independent external member, which again leads to non-compliance by most companies.

Discussion

With different regulations and diverse business backgrounds in each of these countries, a direct comparison is difficult. The passage of the Sarbanes-Oxley Act of 2002 changed the corporate governance scenario in all these four countries, as all of them have established audit committees. The obligations of a financial expert differ in these countries. Following the guidelines, the audit committees in all these countries have redefined their charters, they are taking responsibilities and have become more effective. However, there are some issues in the risk management areas. With so many reforms and regulations on corporate governance, it would be interesting to understand how the financial experts perform their duties in listed firms. Further research could be undertaken on the requirements for audit committees in private firms.

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