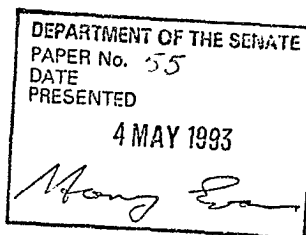


The Parliament of the Commonwealth of Australia



AUDIT COMMITTEES

AN ISSUES PAPER

JOINT STATUTORY COMMITTEE ON
CORPORATIONS AND SECURITIES

DECEMBER 1992

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JOINT STATUTORY COMMITTEE ON

CORPORATIONS AND SECURITIES

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The Senate
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CANBERRA ACT 2600

DUTIES OF THE COMMITTEE

Section 243 of the *Australian Securities Commission Act 1989* reads as follows:

The Parliamentary Committee's duties are:

- (a) to inquire into, and report to both Houses on:
 - (i) activities of the Commission or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or
 - (ii) the operation of any national scheme law, or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of a national scheme law;
- (b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and
- (c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

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INTRODUCTION

As part of its responsibility for monitoring the corporate law, the Committee announced in October 1992 its intention to conduct an inquiry into audit committees. Its original plan was to complete the inquiry by the end of the current session of Parliament. In the intervening period two developments have taken place which make it appropriate for the inquiry to be put back until March 1993.

The first of these is a survey of listed Australian companies being jointly undertaken by Arthur Andersen and the Australian Institute of Company Directors. The purpose of the survey is to establish practical insights into the operation of audit committees in leading Australian companies. The Committee welcomes this survey for the hard data it will generate and it considers that it is worth waiting until February 1993 for the results.

The other important development was the release by the Australian Stock Exchange(ASX) of an Exposure Draft on proposed Listing Rule amendments. The Exposure Draft seeks views about whether the ASX should "adopt a policy encouraging/requiring" the appointment of an audit committee and /or independent directors. It is not expected that the response to the Exposure Draft will be available before February 1993. The views of the ASX and companies listed on it are important and will provide a valuable context for the Committee's inquiries. The responses to the Exposure Draft will be especially valuable as a complement to the survey by Arthur Andersen and Australian Institute of Company Directors survey.

AUDIT COMMITTEES

1. The Committee seeks views and opinions on the range of topics set out below. It notes that there have been many reports which have recommended that audit committees be set up. The report of the Senate Standing Committee on Legal and Constitutional Affairs¹ on *Company Directors' Duties* in November 1989 recommended that:

- (i) the establishment of an audit committee be made a requirement for public listing of a company
- (ii) the chairperson and a majority, or all, of the members of the audit committee be non-executive directors;
- (iii) the audit committee be required to meet regularly and report to the board;
- (iv) the audit committee have direct access to the company's auditors (internal and external) and senior managers, and the ability to consult independent experts where necessary; and
- (v) as a high but lesser priority, similar requirements be introduced for larger non-listed companies.

2. The Government Response² to that report was that:

the establishment of the audit committees has the potential to enhance the quality of financial information about Australian companies and alleviates concern relating to the difficulty of maintaining a proper balance between the wishes of company management and the interests of shareholders and creditors; and

¹ The Cooney Committee

² Tabled in the Senate on 28th November, 1991

- . it proposes to monitor the development of audit committees before giving consideration to a legislative approach.
3. In June 1990 a working group³ chaired by Mr Henry Bosch issued a discussion paper which was released in 1991 in its final form as *Corporate Practices and Conduct*. The working group recommended that:

Each public company Board should appoint an Audit Committee with at least a majority of non-executive Directors. Membership of the Committee should be published in the annual report. The Board must clearly define in writing the terms of reference for the Audit Committee, and management, internal auditors and external auditors should have a clear understanding of that role. The Committee must have unrestricted access to the chief financial officer, the chief executive officer, the internal auditors and the external auditors. Similarly, the auditors must have access to the Committee. The Committee should also be able to consult independent experts as required.

4. The paper stated that the audit committee's primary functions should include reviewing:

- . Financial statements with both management and the external auditors prior to their approval by the Board;
- . Accounting policies adopted, or any changes made or contemplated;
- . Effectiveness of the annual audit, ensuring emphasis is placed on areas where the Committee, management or the auditors believe special attention is necessary;
- . Significant transactions which are not a normal part of the company's business;

³ Made up of representatives of the Australian Merchant Bankers association, the Australian Society of CPA's, the Australian Stock Exchange, the Business Council of Australia, the Law Council of Australia, the Australian Institute of Company Directors, the Institute of Chartered Accountants in Australia and the Securities Institute of Australia

- . Effectiveness of the internal audit function;
- . Co-ordination of audit approach between internal and external auditors;
- . Interim financial information; and
- . Effectiveness of management information and other systems of internal control.

5. In November 1991 the House of Representatives Standing Committee on Legal and Constitutional Affairs⁴ in its report, *Corporate Practices and the Rights of Shareholders*, recommended that the ASX Listing Rules be amended to require every listed company to:

- . establish an audit committee, with the chairman and a majority, or all, of the members of the audit committee being non-executive directors: where there are not sufficient non-executive directors on the board to comply with this, the function of the audit committee must be performed by the whole board;
- . require that the audit committee meet regularly and report to the Board;
- . require that the audit committee have direct access to the company's auditors (internal and external) and senior management and have the ability to consult independent experts whenever it concludes such to be necessary;
- . require that the audit committee review financial information to ensure its accuracy and timeliness and the inclusion of all appropriate disclosures;
- . ensure the existence and effective operation of accounting and financial controls oversee the audit of the company, including nominating the auditors, approving the scope of the audit and examining the results to provide a link between the auditors and the board; and

⁴ The Lavarch Committee

- . undertake such other functions as are allocated to it by the board provided that the extra functions do not compromise its ability to perform its primary function as listed above.
6. These recommendations largely repeated those of the Cooney Committee.
7. Audit committees were considered in the draft report⁵ of the *Committee on The Financial Aspects of Corporate Governance* (the Cadbury Committee, United Kingdom) in May 1992. The Committee recommended that:

- . all listed companies should have established effective audit committees within the next two years;
- . audit committees should be formally constituted to ensure that their relationship with the boards to whom they are answerable is clear; they should be given written terms of reference; and should meet at least three times a year;
- . membership should be confined to the non-executive directors of the company and the majority of audit committee members should be independent of the company;
- . the finance director, the external auditor and the head of internal audit should normally attend meetings of the committee but not as members of the committee;
- . the committee should have explicit authority to investigate matters within its terms of reference;
- . the audit committee's duties should normally include:-
 - making recommendations to the board on the appointment of the external auditor, the audit fee and any questions of resignation or dismissal;

⁵ The final report of the Cadbury Committee was released on 30 November 1992. At the time of writing, a copy of that report had not been received. The Committee understands that the recommendations in relation to audit committees are changed only to the extent that it will not be compulsory for the chairman of the audit committee to report to the annual general meeting.

- review of the half-year and annual financial statements before submission to the board;
- discussion with the external auditor about the nature and scope of the audit, co-ordination where more than one audit firm is involved, any problems or reservations arising from the audit, and any matters which the external auditor wishes to discuss, without executive members present;
- review of the internal audit programme and any significant findings of internal investigations;
- review of the external auditor's management letter, and of the company's statement on internal control systems prior to endorsement by the board; and

The chairman of the audit committee should be responsible for answering questions about its work at the Annual General Meeting.

8. In 1987 in the United States the *National Commission on Fraudulent Reporting*⁶ recommended that:

- The board of directors of all public companies should be required by SEC rule to establish audit committees composed solely of independent directors;
- Audit committees should be informed, vigilant and effective overseers of the financial reporting process and the company's internal controls;
- All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it periodically, and modify it as necessary;
- Audit committees should have adequate resources and authority to discharge their responsibilities;

⁶ The Treadway Commission.

- . The audit committee should review management's evaluation of factors related to the independence of the company's external auditor. Both the audit committee and management should assist the auditor in preserving his independence;
 - . Before the beginning of each year, the audit committee should review management's plans for engaging the company's external auditor to perform management advisory services during the coming year, considering both the types of services that may be rendered and the projected fees; and
 - . All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.
9. The Committee has identified the following range of issues as relevant to its inquiry into audit committees.
10. Value of audit committees
- . What particular contribution does an audit committee make to corporate governance?
 - . What is the evidence that they are effective?
 - . If they are effective, in what way are they effective?
 - . Are there examples of companies with audit committees which have collapsed or suffered a scandal? Has the role of the audit committee in such cases been analysed?
 - . Do audit committees contribute any more to corporate governance than a warm inner glow?
 - . What is the cost-benefit outcome to the company or its shareholders?
 - . Does the experience in overseas jurisdictions where audit committees are mandatory provide any lessons for Australia?
 - . What has been the experience of companies with audit committees?
 - . Is management made more responsive to the Board's requirements and values?
 - . Are shareholders any better off as a result of audit committees?
 - . Are there other ways of giving shareholders better access

to the auditor?

11. Directors and the Audit Committee

- . Is the establishment of an audit committee an abdication by the Board of its responsibility?
- . Does the creation of an audit committee amount to a vote of no confidence in the directors?
- . Does the existence of a committee transfer liability from the Board to the committee members?
- . Would an audit committee be a vehicle for empowering non-executive directors? Do they need to be empowered?
- . If there was an audit committee what effect would that have on the duties of the Board?
- . Is there a risk that through the audit committee the directors will drift too far into the operational management of the company?
- . Does the existence of an audit committee improve the standard of material flowing to the Board?

12. The nature of an audit committee

12.1 Membership -

- . Who should be on the committee?
- . Is there any justification for including executive directors, particularly Chief Executive Officers, as members?
- . Should the audit committee only be a committee of the Board? Should shareholders have the right to appoint a member or members or, to be members themselves?
- . How can the independence of the committee be assured? Should directors who are in a professional relationship with the company, for example as bankers, lawyers or consultants, be permitted to serve on the committee?
- . Should directors who are executive directors on other Boards be members of the committee?
- . Is it appropriate to have retired executives of the company as members of the committee?
- . Should experts who are non-Board members be on the committee?
- . Should audit committee members be a cross-section of the Board or should they have specific skills or experience e.g.

in accounting?

- What is the appropriate relationship between the committee and the internal and external auditors?

12.2 Size -

- What is the appropriate number of members?
- If executive directors are to be appointed what should be the proportion of executive to non-executive directors?
- How would the situation be dealt with where all of the directors are executive directors or the Board is so small in numbers as to make it impracticable to establish an audit committee?

12.3 Accountability -

To whom should the audit committee report:

- To the Board?
- To members?
- To the annual general meeting?

12.4 Areas of responsibility -

- Should the committee be concerned only about financial matters?
- Should it report on compliance issues generally?
- Should it report about matters such as the environment, affirmative action, occupational health standards, achievement of the corporate code of ethics?

12.5 Functions of the Committee -

Are there any functions that should be added to or deleted from the following list?

- selection of the external auditor;
- liaison with the external auditor;
- monitoring of the external auditor's independence;
- providing an independent, authoritative venue for whistle blowers;
- review of the external audit;