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The Parliament of the Commonwealth of Australia

**THE ROLE OF AUDIT COMMITTEES
IN CORPORATE GOVERNANCE
- A PROGRESS REPORT**



**PARLIAMENTARY JOINT COMMITTEE ON
CORPORATIONS AND SECURITIES**

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PARLIAMENTARY JOINT COMMITTEE ON

CORPORATIONS AND SECURITIES

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The Senate
Parliament House
CANBERRA ACT 2600**

DUTIES OF THE COMMITTEE

Section 243 of the Australian Securities 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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BACKGROUND

As part of its responsibility for monitoring the corporate law, the Committee announced in October 1992 its intention to conduct an inquiry into the role of audit committees. An issues paper prepared by the Committee was tabled in the Parliament and widely circulated in December 1992.

The Committee's original plan was to complete the inquiry by the end of the budget session of Parliament, 1992. In the period since the several developments took place which made it appropriate for the inquiry to be postponed.

The first of these was knowledge that a comprehensive survey of all listed Australian companies was being jointly undertaken by Arthur Andersen and the Australian Institute of Company Directors. The purpose of the survey was to establish practical insights into the operation of audit committees in leading Australian companies. The Committee welcomes this survey for the important data it has generated.

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 sought views about whether the ASX should 'adopt a policy encouraging/requiring' the appointment of an audit committee and /or independent directors. The views of the ASX and companies listed on it are important and have greatly assisted the Committee. The response to the Exposure Draft is valuable as a complement to the survey by Arthur Andersen and the Australian Institute of Company Directors survey.

In March, 1993, a general election was called which impeded the progress of work undertaken by the Committee. In the 37th Parliament, new members were appointed to the Committee and it was agreed to adopt the reference and proceed with the inquiry.

The Committee has now considered the findings of the Arthur Andersen/Institute of Company Directors survey, as well as advice from the ASX and other submission to the Committee.

THE ROLE OF AUDIT COMMITTEES IN CORPORATE GOVERNANCE

Audit Committees - the 1993 Position

- 1 In October 1992 the Committee decided to pursue an inquiry into the role of audit committees in corporate governance. In December 1992 the Committee published and circulated a discussion paper reviewing the current situation in Australia in relation to Audit Committees highlighting recent developments. The paper sought comments on a range of issues including:
 - . the value of audit committees;
 - . the membership and role of audit committees;
 - . whether they should be compulsory for some, or all, public companies; and
 - . the powers and legal status of audit committees.
- 2 The Committee received a small number of submissions, principally from the accounting profession, in response to the issues paper.
- 3 At the time of publication of the Committee's discussion paper, a detailed survey of all publicly listed companies in Australia (some 1200) had been jointly undertaken by Arthur Andersen and the Australian Institute of Company Directors.
- 4 The principal findings of the survey, published in early 1993, were as follows¹
 - . Despite the absence of regulatory requirements, 48 per cent of companies had established an Audit Committee;

¹ 'Audit Committees in the 1990's. Results of the 1992 Arthur Andersen survey of Audit Committees' (2 volumes), (Arthur Andersen and the Australian Institute of Company Directors), 1993.

- . Audit Committees were evenly distributed across industry groups, with the exception of the Natural Resources/Mining industry, where only a third of companies had an Audit Committee;
 - . 63 per cent of Audit Committees were located in companies that had annual turnover in excess of \$100 million;
 - . 87 per cent of Audit Committees had between three and five members. Highlighting the importance of addressing financial and related matters, 78 per cent of Audit Committees contained members with accounting qualifications. Other members were mainly from legal, management/administration, banking/investment, finance/economics or commerce backgrounds; and
 - . Most Audit Committees had a formal written charter outlining duties and responsibilities, and most met quarterly.
- 5 The executive summary of the Arthur Andersen survey is attached to the report as attachment A.
- 6 At the same time as this survey was conducted, the Australian Stock exchange issued for comment an exposure draft of a paper entitled *Proposed Listing Rule Amendments and Other Issues*. Included in the exposure draft was a section dealing with 'Independent Directors and Audit Committees'. The ASX wrote to the Committee in July 1993 advising the Committee of responses to the exposure draft, and the ASX's proposed approach to placing a requirement on public companies to appoint audit committees.
- 7 In its advice to the Committee, the ASX noted (in respect of its current listing rules) that

"... Since January 1992, ASX has included in the preamble to its Appendices 3 & 4, the Half Yearly Report and the Preliminary Final Statement, the following line:

"The company^{} has/does not have a formally constituted Audit Committee of the Board of Directors".*

^{} Delete as required*

In order to achieve consistency between companies that same line will now be included in the preamble to the new Appendix 8 and the Quarterly Statement of Consolidated Cash Flows which will have to be prepared by mining exploration companies from 1 July 1993. In addition, in order to ensure that the information is communicated directly to shareholders, there has been an amendment to Listing Rule 3C which deals with information to be included in the annual report. This involved adding a new part to Listing Rule 3C(C) as follows:

(i) A statement whether or not, as at the date of the directors' report, the company has an audit committee of the Board of Directors.

Following a recent meeting with the Commonwealth Attorney-General the Exchange has undertaken to examine further whether it should also be a requirement of the Listing Rules that a listed company should state, if it does not have an audit committee, why not"

- 8 The full ASX letter to the Committee is attached as attachment B.
- 9 In October 1993, the Institute of Chartered Accountants of Australia (ICAA) wrote to the Committee regarding its current attitude to Audit Committees. The Institute advised the Committee

"the most common argument forwarded by those opposed to making audit committees compulsory - as evidenced by the response to the ASX's Exposure Draft on proposed Listing Rule amendments - is that it is inappropriate for all companies to have an audit committee, particularly those with a small Board and/or those without any non-executive directors. In such cases, the Institute suggests that the Board form itself into an audit committee at least once a year. Although such a system is not as desirable as one in which independent directors comprise the majority of the committee, it is still deemed preferable to not having any audit committee at all".

- 10 The ICAA paper 'ICAA Position Statement on Audit Committees' is attached as attachment C.

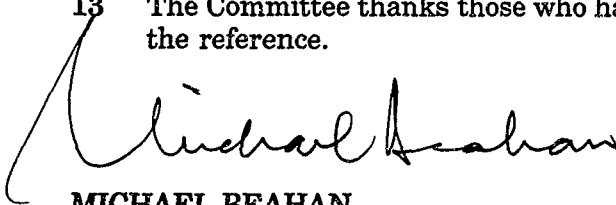
The Future of the Committee's Inquiry into Audit Committees

- 11 The results of the Arthur Andersen/Australian Institute of Company Directors survey indicate a number of positive benefits of a publicly listed company having an Audit Committee, namely.

- . companies with Audit Committees took a more active role in assessing the risk of fraudulent or otherwise misleading financial reporting;
- . companies with Audit Committees were more active in raising accounting and regulatory issues with both Management and External Auditors; and
- . companies with Audit Committees used the Committee to focus on regulatory requirements and internal controls.

- 12 The Committee has noted the advice from the ASX on progress made towards introduction of some requirement for a listed company to notify its approach to Audit Committees. In the list of the advice received by the Committee, the Committee will in 1994 review developments in the implementation of Audit Committees in Australian public companies and decide whether to make further inquiries into the matter of Audit Committees at that time.

- 13 The Committee thanks those who have made submissions to it on the reference.



MICHAEL BEAHAN
CHAIRMAN

November, 1993

ATTACHMENT A

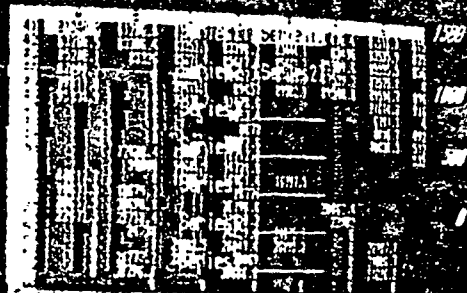


Arthur Andersen Audit Committees in the 1990's

Results of
the 1992
Arthur Andersen
Survey of
Audit
Committees

Executive
Summary

1990's



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EXECUTIVE SUMMARY

AUDIT COMMITTEES: A WORLDWIDE TREND

An Audit Committee is a sub-committee of a company's Board of Directors. The prime role of an Audit Committee is to act as an independent overseer of a company's financial reporting functions. Typically this involves assessing the corporate control environment and overseeing both financial reporting to shareholders and others, and a company's business ethics.

Corporate governance, and the roles and responsibilities of Audit Committees in particular, are widely debated issues. A major question facing Australian business and regulatory communities is this:

Should publicly listed companies be compelled to establish Audit Committees, as is the case in, for example, Canada? If so, should this requirement be statutory or self-regulatory?

The Australian accounting profession and other business groups are strongly in favour of such committees.

The Joint Parliamentary Committee established to monitor the operation of the Corporations Law is to conduct an enquiry into Audit Committees in 1993 and the Australian Stock Exchange in a recent exposure draft has also sought views on whether publicly listed companies should be required to establish Audit Committees. The results of this survey will be available to the Joint Parliamentary Committee and Australian Stock Exchange to assist them in their enquires.

COMPANIES IN QUESTION

In November 1992 Arthur Andersen surveyed all publicly listed companies (approximately 1,200) in Australia.

The survey achieved a high response rate of 19%. The resultant sample covered a range of company sizes and included all industry groups. Accordingly, the results of the study can be accepted as a good indicator of the views and practices of the broader, publicly listed company population.

THE AUDIT COMMITTEE PROFILE

Despite the absence of regulatory requirements, 48% of companies had established an Audit Committee.

Audit Committees were evenly distributed across industry groups, with the exception of the Natural Resources/Mining industry, where only a third of companies had an Audit Committee.

63% of Audit Committees were located in companies that had annual turnover in excess of \$100 million.

87% of Audit Committees had between three and five members. Highlighting the importance of addressing financial and related matters, 78% of Audit Committees contained members with accounting qualifications. Other members were mainly from legal, management/administration, banking/investment, finance/economics or commerce backgrounds.

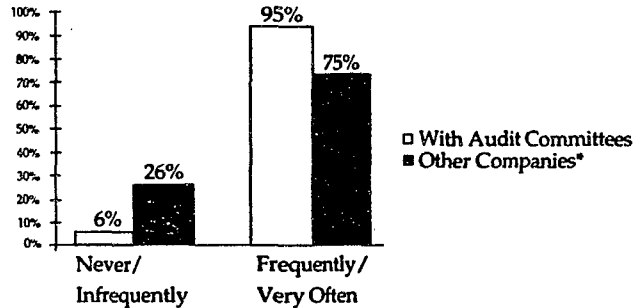
Most Audit Committees had a formal written charter outlining duties and responsibilities, and most met quarterly.

ADDING UP THE BENEFITS

The survey results provide considerable evidence that those companies with Audit Committees took a more active role in corporate governance.

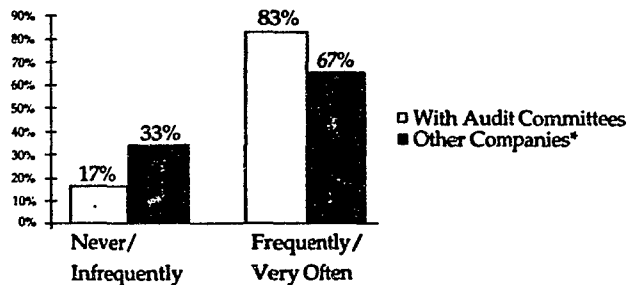
Overall, companies with Audit Committees were more frequently involved in assessing the potential risk of fraudulent or otherwise misleading financial reporting. In particular, they more frequently reviewed important financial statement judgements, accounting principles and accounting reporting practices.

Frequency of Reviewing Important Judgements Relating to Financial Statements



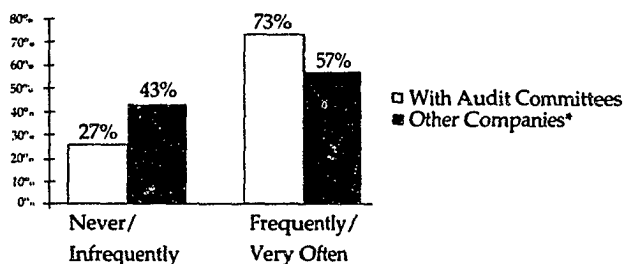
Financial and business control issues, and regulatory requirement issues were more frequently addressed with management in companies with an Audit Committee. Audit Committees clearly considered these to be important roles to undertake. These issues received less frequent attention where there was no Audit Committee.

Frequency of Reviewing/Discussing with Management Financial & Business Controls



* Where the company did not have an Audit Committee, the results shown relate to the frequency of review by the Board of Directors.

Frequency of Reviewing/Discussing with Management Regulatory Requirements



* Where the company did not have an Audit Committee, the results shown relate to the frequency of review by the Board of Directors.

Companies with Audit Committees were more likely to have raised a range of specific financial reporting matters with management. In the past year these included asset valuations, related party dealings, reporting requirements (eg. the Corporations Law and AASB 1024: Consolidated Accounts), internal controls and accounting policies and procedures.

Many companies with Audit Committees predicted that in the coming year, significant attention will be given to the valuation of non-current assets. Reviews of internal procedures and reporting practices will also feature on their agendas.

ROLES AND RESPONSIBILITIES

The most important roles and responsibilities of Audit Committees were considered to be:

- Overseeing financial reporting to shareholders and others
- Assessing and monitoring the corporate environment
- Understanding the organisation's practices for managing and monitoring regulatory compliance

- Reviewing income and other taxation matters, including understanding significant judgemental items
- Understanding the changing regulatory environment
- Reviewing the organisation's ethical behaviour
- Reviewing the implementation status of critical information systems

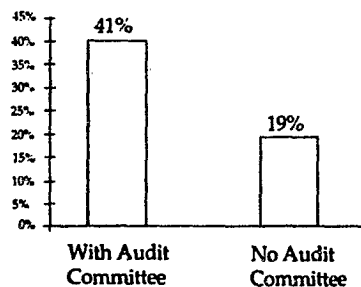
Typical agenda items dealt with by Audit Committees included the following:

- Internal and external audit issues (audit reports, review of the scope of audits, internal procedures and controls, the cost of external audit)
- Reporting on company accounts
- Compliance and Accounting Standards issues
- Management response issues
- Public disclosures
- Asset valuations.

Although Audit Committees were reported to have satisfactory relationships with Internal Auditors, their relationships with Management and External Auditors, respectively, were comparatively closer and more satisfactory.

Only a third of companies had a written Code of Conduct. As the graph below shows, companies that had an Audit Committee were also significantly more likely to have such a Code.

Companies with A Code of Conduct



INTERNAL AUDIT

A third of the surveyed companies had an internal audit function.

The majority of internal audit functions operated in the larger company domain.

Most companies that had an internal audit function also had an Audit Committee.

Of those without an internal audit function, only 2% planned to establish such a function in the next year.

Companies with Audit Committees & Internal Audit Functions

		Has Audit C'ee		Totals
		Yes	No	
Has Internal Audit Function	Yes	25%	5%	30% (n = 66)
	No	23%	47%	70% (n = 154)
Totals		48% (n* = 106)	52% (n* = 114)	

* n = number of respondents

The profile of the typical internal audit function was as follows:

- was an in-house function
- had between one and five members
- had a formal charter which was reviewed by the Audit Committee
- had its annual work plan reviewed and approved by the Audit Committee.

As expected, the majority of internal audit functions tested routine accounting procedures and transactions, reviewed and tested internal control and EDP systems, worked in operational areas such as the assessment of performance measures and reviewed accounting policies.

Of note was the finding that less than half the internal audit functions were reported to be involved in treasury operations (including foreign exchange) and in income and other taxation areas.

While companies with internal audit functions rated the effectiveness of internal audit very positively, few employed objective performance measures to assess internal audit.

EXTERNAL AUDIT

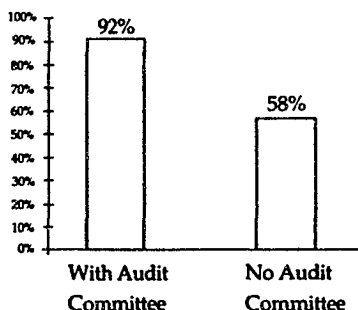
Companies with Audit Committees reportedly had effective and productive relationships with External Auditors. Among companies without Audit Committees, relationships with External Auditors were somewhat less extensive, although still considered satisfactory.

Involvement by Audit Committees or Boards of companies without Audit Committees in the external audit planning process was generally productive, in that changes to the audit scope at times resulted.

In the majority of companies with Audit Committees, the Audit Committee met with the External Auditors to discuss the findings of the audit prior to the Board of Directors signing the annual accounts. In companies without Audit Committees, the Board met with the External Auditors less frequently.

Audit Committees were reported to take a major role in the management letter process. Companies with Audit Committees were more likely to have a program to ensure a meaningful response by management to the External Auditors' management letter.

A Meaningful Response to the External Auditors Management Letter



IMPLICATIONS

The findings of the survey provide continued evidence of the benefits of a publicly listed company having an Audit Committee.

The most important evidence supporting the value of Audit Committees were:

- Companies with Audit Committees took a more active role in assessing the risk of fraudulent or otherwise misleading financial reporting
- Companies with Audit Committees were more active in raising accounting and regulatory issues with both Management and External Auditors
- Companies with Audit Committees used the Committee to focus on regulatory requirements and internal controls.

The three points mentioned above have obvious implications for Boards of Directors. Clearly Boards of Directors operate under a wide charter, and thus have limited time in which to focus on financial and reporting control issues. The specialist role of the Audit Committee provides Boards with that safeguard in an efficient manner.

A further consideration for Management is that companies with an internal audit function rated the effectiveness of internal audit positively. Comment was made that the value of internal audit depends to some extent on the "respect" shown by Management towards the function and on the need for internal audit "to sell" the benefits of the audit to the functions being audited. The introduction of objective performance measures with which to evaluate the effectiveness of internal audit functions is an area for future improvement.

The area of non-current asset valuation was flagged as a highly important and ongoing issue in the coming year. The widespread attention to this issue reflects current economic and regulatory environments.

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ATTACHMENT B



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Our Ref: 92C/0151

5 July 1993

Mr Frank Nugent
Acting Secretary
Joint Statutory Committee on Corporations
and Securities
Parliament House
CANBERRA ACT 2600



Dear Mr Nugent

AUDIT COMMITTEES

In October 1992 the Australian Stock Exchange issued an Exposure Draft on *Proposed Listing Rule Amendments and Other Issues* inviting public comment by 15 January 1993. The Joint Committee on Corporations and Securities asked to be informed of the nature of the responses received on that part of the Exposure Draft dealing with "Independent Directors and Audit Committees" and on the course of action adopted by ASX on this matter.

The Exposure Draft introduced the topic in the following way:

"The House of Representatives Standing Committee on Legal and Constitutional Affairs in its report entitled *Corporate Practices and the Rights of Shareholders* (the Lavarch Committee) recommended that the Listing Rules require audit committees for listed companies. The proposal is examined below. It is stressed that the Exchange has no firm view on whether it should require audit committees for listed companies".

Paragraph 9.98 on page 60 of the Exposure Draft reads as follows:

"Issues for consideration include whether the Exchange should:-

1. Adopt a policy of encouraging/requiring the appointment of independent directors, but not of audit committees.
2. Adopt a policy of encouraging/requiring the appointment of audit committees but not of independent directors.
3. Adopt a policy of encouraging/requiring the appointment of both independent directors and audit committees".

The responses tended to deal with the question of audit committees and ignore that relating to independent directors, although where the latter question was addressed the majority of respondents was opposed to ASX's interfering directly in the composition of the board of directors of a listed company.

Forty responses to the Exposure Draft addressed the question of audit committees. Although their classification was at times a little difficult, our analysis of these responses is as follows:

a)	support ASX requiring audit committees	13
b)	oppose ASX requiring/encouraging audit committees	9
c)	support ASX encouraging (but not requiring) audit committees	18

Category (a) included 7 large listed companies (all of which already had audit committees), one well known law firm, one professional group and 2 financial journalists. Some of the responses were qualified, for example, by limiting the requirement to the larger companies only.

Category (b) included 2 large mining companies, one well known law firm, one large stock broking firm, one professional group and one financial journalist.

Category (c) included 4 large companies, 6 professional groups and one financial journalist. The classification within this group was the most difficult and it is possible that one or two could have been viewed as supporting stronger action.

It is ASX policy to issue discussion papers and exposure drafts for public comment before deciding changes of policy or the Listing Rules. Following consideration of public comment on the Exposure Draft (and on an earlier discussion paper on *The Role of the Australian Stock Exchange and its Listing Rules* where ASX decided that its *primary role in respect of its protection of the interest of the public is to endeavour to maintain a fully informed market*), ASX decided to adopt a policy of extending its encouragement to establish audit committees and to ensure that their existence or otherwise is reported to shareholders. Since January 1992, ASX has included in the preamble to its Appendices 3 & 4, the Half Yearly Report and the Preliminary Final Statement, the following line:

"The company* has/does not have a formally constituted Audit Committee of the Board of Directors".

* Delete as required

In order to achieve consistency between companies that same line will now be included in the preamble to the new Appendix 8 and the Quarterly Statement of Consolidated Cash Flows which will have to be prepared by mining exploration companies from 1 July 1993. In addition, in order to ensure that the information is communicated directly to shareholders there has been an amendment to Listing Rule 3C which deals with information to be included in the annual report. This involves adding a new part to Listing Rule 3C(3) as follows:

- "(i) A statement whether or not, as at the date of the directors' report, the company has an audit committee of the Board of Directors."

Following a recent meeting with the Commonwealth Attorney-General the Exchange has undertaken to examine further whether it should also be a requirement of the Listing Rules that a listed company should state, if it does not have an audit committee, why not.

If you wish me to elaborate on any matter please let me know.

Yours sincerely



R J Schoer
Director, Operations

ATTACHMENT C

ICAA Position Statement on Audit Committees

The Institute of Chartered Accountants in Australia (ICAA) strongly recommends the establishment of audit committees for all listed companies. In conjunction with other private sector organisations, the Institute put forward its proposal in the report *Corporate Practices and Conduct* issued in 1991. This paper concluded that audit committees were deemed necessary to facilitate improved financial reporting and assist in effective management and accountability.

The findings in the AWA case reinforce the important role audit committees can play in corporate governance and in assisting both auditors and directors in maintaining open communications regarding substantive issues. In particular, audit committees provide directors — especially non-executive directors — with a valuable opportunity to keep abreast of important issues and concerns held by auditors.

There are numerous benefits afforded by appropriately constituted audit committees. They improve the quality, objectivity and credibility of financial reporting; maintain the real and perceived independence of external auditors; assist directors to fulfil their legal responsibilities; strengthen the role of non-executive directors; give directors the opportunity to consider issues in a wider time frame; enhance communication between the Board and internal and external auditors; improve the effectiveness of internal and external audit; and improve the quality of accounting systems and internal controls.

The accountancy bodies in Australia (the ICAA and the ASCPA) have reinforced their strong support for audit committees by approving issue by the Auditing Standards Board in May 1991 of Statement of Auditing Practice AUP 31 "Communication with an Audit Committee".

Overseas experience suggests that audit committees have been recognised as offering significant benefits to directors, auditors, management and shareholders alike. In North America, companies listed on the New York Stock Exchange and those subject to the Canada Business Corporation Act are required to establish and maintain audit committees. Legislation in Singapore also mandates the establishment of audit committees. In the UK, whilst not compulsory, audit committees have been persistently advocated by several committees and legislators.

Institute policy is that the establishment of audit committees should be made mandatory through Stock Exchange Listing Requirements for all publicly listed companies.

The ICAA's position has also been supported by two parliamentary committees in recent years. The Cooney Committee (1989) and the Lavarch Committee (1991) both recommended that listed companies be required to establish audit committees.

The Institute believes that the recent decision by the Australian Stock Exchange to require companies to disclose whether they have an audit committee is a step in the right direction but it does not go far enough.

There remains the possibility that the Commonwealth Government may move to legislate to make audit committees mandatory under the Corporations Law in light of the ASX's reluctance to make them compulsory as part of its Listing Requirements. The Institute

favours the requirement to have audit committees to be implemented through the ASX Listing Requirements rather than via the Corporations Law, because it is felt that a statutory regime would not be as flexible and adaptable as a self-regulatory system.

The Institute believes that the case for mandating all listed companies to establish and maintain appropriate audit committees is conclusive. Whilst not a panacea for all of a company's financial difficulties, the presence of an effective audit committee can nonetheless ensure that good corporate governance is maintained and that potential accounting, finance or audit-related problems are identified and attended to at an early stage.