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Keeping audit committees effective

By Eric Turner

For an organization's audit committee to operate effectively, it is increasingly important that it keep abreast of current best practices

In the past year, a series of highly publicized events in Canada and the United States has led to renewed interest in governance and the role that audit committees can play in strengthening oversight of financial reporting. A 1998 study by the Conference Board of Canada ("Success in the Boardroom! - 25 Years of Canadian Directorship Practices: 1973-1998") indicates that Canada's boards lead the world in corporate governance practices. However, as the report points out, "today's leader can become tomorrow's laggard unless change is embraced and innovation encouraged."

What is being recommended today as best practice for the structure and responsibilities of audit committees? First, you should ensure that your committee members are independent of management. As a representative of the shareholders, the audit committee must often question the judgment of management or take positions that may be contrary to those of management. Because of this, independence is essential for an audit committee if it is to function effectively. This has been recognized by a number of authorities: the Cadbury and Hampel committees in the United Kingdom, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in the United States, and the MacDonald commission and the TSE in Canada. All have endorsed the idea that audit committees include outside directors.

When the New York Stock Exchange and the National Association of Securities Dealers Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees issued its report last February, it took a strong stand on audit committee independence. There were two key recommendations. First, the Blue Ribbon Committee defined an independent committee member as one who has no relationship to the corporation that might interfere with the exercise of independence from management and the corporation. It also recommended that audit committees of large listed companies (market capitalization more than $200 million) be comprised solely of independent directors.

The next step in evaluating your audit committee is to look at the number of members, their financial literacy and the frequency of meeting. Arthur Levitt, chair of the US Securities and Exchange Commission (SEC), says that stories abound of audit committees whose members lack expertise in the basic principles of financial reporting as well as the mandate to ask probing questions. "In fact," he says, "I've heard of one audit committee that convenes only twice a year before the regular board meeting for 15 minutes."

In Canada, most audit committees required by statute must have at least three members. The Blue Ribbon Committee also recommended this minimum number in recognition that the size of the committee is a balancing act: it should be small enough to allow all members to participate actively, yet large enough to represent a balance of views.

The Blue Ribbon Committee went on to recommend that each member should be "financially literate" and at least one should have "accounting or related financial management expertise." The COSO report indicates that most audit committees of the companies in which fraud was found lacked members who were certified in accounting or who had work experience in key accounting or finance positions. A familiarity with financial matters should, therefore, be considered as a qualification when selecting audit committee members.

The timing and number of audit committee meetings should be appropriate to allow the committee to fulfil its responsibilities. For many committees, this means meeting quarterly to review interim financial statements. The 1998 "Report of the Committee on Corporate Disclosure, Responsible Corporate Disclosure - A Search for Balance" proposed creation of a legal liability regime that would apply to those associated with continuous disclosure violations. If these proposals are enacted, many boards might decide to expand the audit committee's responsibilities to include reviewing additional core documents, such as prospectuses and circulars, for which a due diligence standard must be met. This, in turn, might increase the need for more frequent audit committee meetings.

It is also important that the audit committee take responsibility for supporting the auditor's independence by setting - and enforcing - policies to ensure there is independence in fact as well as in appearance.

The auditor's independence is vital, both for providing an objective audit opinion and for reporting freely to audit committees. The US Independence Stand-ards Board's number one independence standard recognizes this by requiring the auditor to discuss with the audit committee, in writing, "all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may be reasonably thought to bear on independence." The auditor should confirm in the letter that the auditor is independent of the company, and should discuss his or her independence with the audit committee.

Consistent with this point of view, the Blue Ribbon Committee recommends that the audit committee be responsible for ensuring receipt of the "independence letter" and for actively engaging the auditor in a dialogue on independence. In addition, the committee recommends that the audit committee charter specify that the auditor is ultimately accountable to the board of directors and the audit committee, which, as representatives of the shareholders, have the ultimate authority and responsibility to select, evaluate and, as appropriate, replace the external auditor. Formalized processes such as these ensure that the audit committee and the auditor engage in a two-way discussion on auditor independence.

Another best practice recommended by the committee is to ensure that the audit committee has a clearly defined mandate. A written charter can provide a framework for an audit committee's structure and responsibilities that can be referred to by the board of directors, committee members, management, auditors and others. The Blue Ribbon Committee recommends that the written charter describe in detail the responsibilities and duties of the audit committee, and that it be reviewed and updated annually. Companies should report annually to shareholders whether or not the audit committee has met its responsibilities under the charter during the year.

Who's saying what

Name	Date	Thrust of recommendations
Arthur Levitt, Chair, US Securities and Exchange Commission	September 1998	Made speech about "earnings management" issues. Recommendations included strengthening of the audit committee process.
Lynn Turner, Chief Accountant, US Securities and Exchange Commission	October 1998	Letter to AICPA outlining concerns with financial reporting. Recommendations included improving communications between management, external auditors and audit committees.
US Independence Standards Board	January 1999	Issued Standard No. 1 (ISB No. 1) setting out procedures for auditor to discuss auditor independence issues with audit committee.
Blue Ribbon Committee	February 1999	Issued a 10-point plan for improving the effectiveness of corporate audit committees.
Committee of Sponsoring Organizations	March 1999	Issued research report on fraudulent financial reporting from 1987 to1997. Study highlighted how companies involved with fraudulent financialreporting often had weak audit committees.
David Brown, Chair, Ontario Securities Commission	June 1999	Made speech about apparent erosion of confidence in audited financial statements. Referred to audit committee's vital role in ensuring that responsibility for full, true and plain disclosure is met.

The COSO report notes that an independent audit committee's effectiveness can be hindered by the quality and extent of information it receives. To monitor effectively, it says, the audit committee needs access to reliable financial and nonfinancial information, industry and other external benchmarking data, and other comparative information that is prepared on a consistent basis. "Boards and audit committees should work to obtain from senior management and other information providers relevant and reliable data to assist them in monitoring the financial reporting process," the report adds.

This recommendation was echoed by Lynn Turner, Chief Accountant of the SEC, in a 1998 letter to the director of Audit and Attest Standards of the American Institute of Certified Public Accountants (AICPA). Turner believes that a critical part of the auditing committee's oversight role consists of ongoing and timely communication with both the auditor and the chief financial officer so that the audit committee is sufficiently informed about significant internal control and financial reporting matters. Turner also stresses that the audit committee must be able and willing to ask the CFO and auditor the necessary tough questions about the selection and application of accounting principles and estimates.

There is increasing focus on audit committees enhancing their oversight of the financial reporting process. David Brown, chair of the Ontario Securities Commission, says Canadian audit committees should take responsibility for ensuring that accounting policies are consistent with "not only the letter of GAAP but also the spirit." Similarly, the Blue Ribbon Committee requires the external auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.

But how do the audit committee and the auditor do this? Lynn Turner's letter to the AICPA indicates that the auditor should ensure that the audit committee is informed about certain matters. (Similar guidance is also contained in the CICA Assurance Guideline, AuG-11, "Communications with Audit Committees".) These matters include: the initial selection of, and changes in, significant accounting policies and their application; the process used in formulating sensitive accounting estimates; adjustments proposed by the auditor but not recorded by the entity that could cause future financial statements to be misstated; disagreements with management and whether or not satisfactorily resolved; cases when management consulted with other accountants about auditing and accounting matters; difficulties encountered in performing the audit; and other information, such as Management's Discussion and Analysis.

By asking probing questions in these areas, an audit committee will be in a position to fulfil its oversight responsibility for the financial reporting process more effectively.

Another recommended best practice is to have your audit committee report to the shareholders. The Blue Ribbon Committee noted: "General disclosure about the audit committee's review of the entire audit process - from management's and the internal auditor's accounting practices to the outside auditor's audit of the company's financial statements - will highlight that the audit committee is in place to assure shareholders that procedures that promote accountability are integrated into the roles and practices of all the other relevant players."

The committee recommends that, in order to raise public awareness of the importance of the audit committee's role, audit committees include in the company's annual report to shareholders a letter disclosing whether or not a number of steps have been taken.

The letter should indicate that management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements. It should state whether or not the external auditors have discussed with the audit committee the external auditors' judgment of the quality of those principles and judgments. It should include a statement that the members of the audit committee have discussed among themselves - without management or the external auditors present - the information described above. Finally, it should state that the committee, relying on the review and discussions conducted with management and the external auditors, believes that the company's financial statements are fairly presented in conformity with generally accepted accounting principles in all material respects.

This last point is one of the more controversial recommendations of the Blue Ribbon Committee because of concerns about increased potential legal liability of audit committee members and because members are often unfamiliar with the intricacies of GAAP.

With reaffirmation of the importance of the effective audit committee to corporate governance in today's environment, audit committees should stay abreast of the recent flurry of pronouncements from regulators and others. Audit committees that are assessing their effectiveness should take account of recent pronouncements when considering questions such as those set out in this article, and will also find Assurance Guideline AuG-11, Communications with Audit Committees, a useful reference source.

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