

## **AUDITING PRACTICES BOARD**

### **POSITION PAPER ON THE ROLE AND RESPONSIBILITIES OF AUDIT COMMITTEES**

In 1991, the Auditing Practices Board's predecessor (also called the APB) was established to set auditing standards for the United Kingdom and the Republic of Ireland. In 2002 the APB was reconstituted as part of the Accountancy Foundation.

Both 'old' and 'new' APBs are unique in terms of world auditing standard setters because of the significant involvement of non-auditors representing the wider financial community. 'Lay' membership has allowed both APBs to view auditing from a broad perspective and, from the beginning, the Boards' work has been closely related to developments in corporate governance including the work of the Cadbury, Greenbury, Hampel and Turnbull Committees.

#### **Summary of views**

We are of the view that, to help ensure continuing confidence in our capital markets, listed and other public interest companies should be required to establish an audit committee that would:

- be responsible for independent oversight of the internal controls, financial policies and published financial information;
- be responsible, publicly, for recommending to shareholders the auditors to be appointed and agreeing the auditors' remuneration;
- add further independence into the relationship between the company and its auditors;
- review the quality of the audit process and key audit judgements; and
- report in writing to shareholders within the annual report and require the chairman of the audit committee to answer questions from shareholders at the Annual General Meeting.

In mandating the requirement for there to be an audit committee and in specifying the committee's responsibilities care should be taken not to weaken the concept of the unitary board or to absolve the whole board of directors from its financial responsibilities including the presentation of financial statements that present a true and fair view.

Great care also needs to be taken when formalising the remit of audit committees to ensure that individuals with the appropriate skills and experience continue to be motivated to stand for appointment as non-executive directors. There is a danger that unless non-executive directors are given adequate compensation and reasonable protection from the adverse consequences of possible litigation the job will be unattractive to those who are experienced in business and financially literate.

## **1. Defining the role of the audit committee**

The role of an audit committee is not defined by law or regulations although the Combined Code, which is appended to the Listing Rules, sets out principles of good governance and a code of best practice.

Little specificity is, however, provided by the Combined Code. Principle D.3 states that *'The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.'* To this end, the provisions of the Combined Code indicate that the board should establish an audit committee (D.3.1), and that *'The duties of the audit committee should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors.'* (D.3.2)

The Combined Code does not:

- give the audit committee a responsibility to consider the integrity of published financial information; or
- provide standards or guidance as to how the audit committee should keep under review the scope, results and cost effectiveness of the audit and the independence and objectivity of the auditors

The APB believes that different boards of directors interpret the scope of audit committee responsibilities in different ways. We believe that the most effective audit committees:

- reinforce management's commitment to the establishment and maintenance of a satisfactory control environment and a sound system of internal control;
- appraise and, where appropriate, challenge the actions and judgments of management as they relate to published financial information, including being satisfied that management's attitude to financial reporting has not been unduly influenced by commercial pressures; and
- consider the effectiveness of the audit and the independence and objectivity of the auditors.

This role is however demanding in terms of time and skills. The APB believes that action should be taken to define more precisely the role of an audit committee and thereby to increase the consistency in the way audit committees operate and, in so doing, increase their overall effectiveness.

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## **2. Ensuring that appropriate processes exist for the preparation of high quality published financial information and to considering the integrity of such information.**

In June 2001 the APB published a Consultation Paper entitled 'Aggressive earnings management'. The primary purpose of the paper was to alert executive directors, non-executive directors, auditors, regulators and users of financial statements to the potential threat that increasing commercial and economic pressures may result in the publication of misleading financial statements. At the time the paper was written there had been a number of

cases in the US where companies had adopted aggressive accounting practices including the selection of inappropriate accounting policies and/or stretching judgments as to what is acceptable when forming accounting estimates.

Commentators to the APB's consultation paper acknowledged the importance of the subject matter and emphasised that good corporate governance was essential if aggressive earnings management was to be countered.

Subsequent to APB's Consultation Paper further events, including those relating to Enron, WorldCom and Xerox, confirm the seriousness of the situation, at least in the United States. These events raise concerns about the actions of individual executive directors and also about the effectiveness of audit committees and the independence of non-executive directors. The APB believes that, to minimise the possibility of aggressive earnings management resulting in misleading financial statements, it is vital that audit committees should have an explicit responsibility not only to consider the processes that are in place regarding the preparation of the financial statements but also to consider the integrity of the published financial information itself.

In considering the integrity of published financial information audit committees will consider the appropriateness of

- significant accounting policies; and
- key judgements and assumptions

relevant to the annual financial statements, the preliminary release, interim reports and important regulatory returns. Establishing a requirement for audit committees to consider the company's financial processes should not imply a reduction in the responsibilities of the full board of directors.

The role of the audit committee to consider the integrity of published financial information will be assisted by auditing standards. Statement of Auditing Standards (SAS) 610 requires auditors to report to those charged with corporate governance the findings from their audit including unadjusted misstatements and their views on the qualitative aspects of the entities accounting practices and financial reporting. This information will provide a valuable insight into quality of the company's financial reporting including the threat of aggressive earnings management .

### **3. The appointment of auditors and agreeing the auditors' remuneration**

The shareholders of a company are formally responsible for appointing the auditors and agreeing their remuneration. In practice, however, the decision to appoint/re-appoint the auditors and how much they should be paid is taken by the board and it is not easy for shareholders to influence this process. The way in which auditors are appointed and remunerated therefore gives rise to concerns that they are not sufficiently independent from management. In particular there is a suspicion that, through minimising audit fees, the scope of the audit will be limited to management's advantage and shareholders' disadvantage.

In recent months this aspect of auditor independence has been debated and suggestions as to how it might be resolved have included the mandatory rotation of auditors and auditor appointment by an independent body. The APB has reservations regarding both proposals but, as an alternative, believes that audit committees of listed companies and other public interest

entities should take responsibility for appointing the auditors and agreeing their remuneration.

The APB believes that audit committees should discuss the audit appointment each year and decide whether to reappoint the existing auditor or to seek a replacement. In making this decision the audit committee should:

- consider the quality of the audit provided by the existing auditors and their relationship with management;
- recognise the importance of cumulative audit knowledge (auditors need to understand a company's business and risks and follow up from year to year the veracity of representations given to them );
- take account of the length of time the engagement partner has served; and
- have regard to changes in senior management in the company (a change of auditors can be dangerous where there is a rapid turnover in senior management positions).

The audit committee should agree an audit fee that is reasonable for a high quality audit. The audit should be cost effective and the audit committee should be concerned if the audit fees appear to be either unrealistically low or excessive having regard to the nature and extent of the risks facing the company, its scale and complexity, and the scope of work required to carry out an effective and efficient audit of the company's financial statements.

#### **4. Increasing the independence of the relationship between the company and its auditors**

There has also been much discussion in recent months on the issue of auditor independence in particular in relation to external auditors providing non-audit services to management and directors. This is a complex issue as some non-audit services are closely linked to the audit (for example providing assurance on matters of corporate governance, due diligence reports and reports of prospective financial information used to raise capital) and do not usually create a significant threat to auditor objectivity. Other services (for example undertaking valuations that are to be embodied in the financial statements, providing internal audit services and designing and implementing computer systems) may threaten auditor objectivity in some circumstances.

It is difficult to generalise as to which services do, and which do not, threaten auditor independence. Rather than there being some blanket prohibition in respect of non-audit services the APB believes that the audit committee should establish criteria for management as to which non-audit services the company may purchase from the audit firm. The audit committee may wish to be assured, for example, that:

- the services will not result in the auditors having to audit judgments made by their firm or place reliance on systems or controls that have been designed or recommended by their firm;
- the audit firm will not perform a management role or make management decisions for the company; and
- the total fees paid by the company to the audit firm will not be unduly significant in relation to the total revenues of the audit firm.

The audit committee should also:

- ensure it has received the auditors' confirmation of independence (required by auditing standards), understands the implications of any disclosed relationships and is satisfied with the related safeguards; and
- monitor the quality and nature of relationships between the auditors and management and, where possible, assist with the resolution of disagreements.

The audit committee should describe the criteria they have established in the company's annual report and, if not separately required by legislation, set out the fees paid to the auditor for non-audit services, analysed by type of service.

### **5. Reviewing the quality of the audit process and key audit judgements**

In order to decide whether to reappoint the existing auditor or to seek a replacement the audit committee should form a view on the effectiveness of the existing auditors' work. This task will be assisted by SAS 610 which requires auditors to report to those charged with corporate governance:

- the nature and scope of the work they propose to undertake;
- the findings from their audit including unadjusted misstatements, material weaknesses in internal control and their views on the qualitative aspects of the entity's accounting practices and financial reporting.

Further guidance may however be needed to assist audit committees review audit effectiveness.

### **6. Reporting to shareholders**

The APB believes that audit committees would become more accountable if there was greater transparency of their processes and decisions, if they issue a report on their activities in the annual report and require the chairman of the audit committee to respond to questions at the Annual General Meeting.

The report from the audit committee in the annual report might usefully include:

- membership details including skills and experience;
- their processes especially in relation to identifying and reacting to risk including the risk of fraud;
- their approach to reviewing the quality of external and internal audit;
- their recommendation regarding the appointment of the auditor with supporting rationale;
- consideration of auditor independence, including the criteria they have established for the provision of non-audit services provided by the auditor; and
- if not separately required by legislation, the fees paid to the auditor for non-audit services, analysed by type of service.

### **7. Actions to implement the extended remit of audit committees**

At the same time as formalising the remit of audit committees the APB believes that great care needs to be taken to ensure that individuals with the appropriate skills and experience continue to be motivated to stand for appointment as non-executive directors. There is a

danger that unless non-executive directors are given adequate compensation and some protection from possible litigation that the job will be unattractive to those who are experienced in business and financially literate. Actions that may need to be considered include:

- increasing remuneration;
- providing some protection from the adverse consequences of possible litigation. A possible approach to this difficult issue might be for the company to pay premiums for professional indemnity insurance cover; and
- issuing guidance and providing training to assist audit committees to undertake their role effectively.

August 2002.