

The role and function of the Audit Committee

Paper prepared for the Audit Committee Chair Forum
by Dr Ruth Bender, Cranfield School of Management

Executive summary

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- There is no universal standard for the way in which audit committees work. Although broadly they covered the same activities, the number of formal meetings of companies reviewed ranged between 3 and 13 in the year. The time taken per meeting also differed considerably.
- Although all audit committee members must be independent non-executives, practice differs considerably as to whether the company chairman and/or the CEO regularly attend audit committee meetings.
- The documentation supporting audit committee work needs to be managed carefully to ensure that the committee members are well-informed, but are not so overloaded with information that key points are missed.
- Dealing with regulatory matters takes a great deal of audit committee time. It can be useful to schedule a ‘white space’ meeting to discuss broader risk issues.
- Having multiple directorships, and being able to compare practices in different companies, is an advantage to audit committee members both in evaluating the performance of their committees and in providing strategic advice.
- Audit committee evaluation takes place in a variety of formal and informal ways, including interviews and questionnaires, administered internally and by external professionals.
- It is very important to non-executives that they feel that they can trust the company’s executives. The corollary to this is that in situations where the executives are considered less trustworthy, governance might be difficult as well-qualified potential non-executives might be reluctant to join the board.
- There appears to be an expectations gap between how the audit committees see their regulatory role and how this is perceived by the media. For example, some parts of the media appear to see the audit committee role as the prevention and detection of fraud. This view sits uncomfortably with the views of audit committee members – in line with regulation – that theirs is an oversight function.
- Although audit committee practices differ widely, they appear to evolve to suit the companies’ and individuals’ particular contexts. Accordingly, legislation to standardise practice might not be useful, indeed, it may be counter productive. Given the potential changes to UK regulation that could arise from implementing the EU 8th Directive, it is important that this point be made explicitly to legislators.





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Introduction

This paper summarises the discussions of a meeting of the Audit Committee Chair Forum held on 15th December 2005 regarding the role and function of audit committees. Additionally, it draws upon interviews conducted with six audit committee chairmen who are members of the Audit Committee Chair Forum, and on a review of a sample of published audit committee reports¹.

Between the interviews and the meeting, the views of 11 audit committee chairmen, with a wide range of experience in different companies, were obtained. In addition, the meeting solicited the views of three audit partners and a company chairman.

The role of the audit committee

“[The purpose of the audit committee] is to help managers risk-manage the business, and within that process to apply the necessary standard of governance. It has to be relevant to the ongoing management of the business.”

The role of the audit committee is laid out in the Combined Code (2003) and expanded upon in the Smith Guidance (2003). A brief summary of these duties is set out at Appendix 1. All of the audit committees represented in this work carried out all of these functions, and often had further responsibilities, for example a review of the company’s CSR (corporate social responsibility) policies.

Although the basic role of the audit committee was the same for all companies, each committee conducted its business in very different ways. In some companies the whole of the risk assessment of the business was under the remit of the audit committee; others had separate committees dealing with, for example, health and safety, or risk. The structure of the board and its committees, and the remit of the audit committee, were specific to the context of the company.

It was agreed by all participants that the audit committee role is to oversee rather than to manage. Their role is twofold: supporting and advising management alongside acting as a governance body.

¹ The interviews were performed by Dr Ruth Bender, Dr Ashley Braganza and Dr Arnoud Franken of Cranfield School of Management. They were carried out between 23rd August and 24th November 2005. Interviews, conducted by two or all three of the interviewers, lasted between 50 and 100 minutes, and were taped and transcribed. The five published audit committee reports that were reviewed were selected at random from FTSE 100 companies. All of the quotations in this report come from audit committee chairmen, either at interview or at the Audit Committee Chair Forum meeting.



Audit committee meetings

Although the audit committees appeared to cover similar agendas, the level of engagement and the way in which the tasks were carried out differed considerably between companies.

Number and duration of meetings

The Smith Guidance suggests that the number of audit committee meetings in a year should be no fewer than three. Of the companies reviewed in this research, the minimum number of meetings was three, and the maximum number of meetings found during the research was the 13 reported by BP plc². The number of meetings will in part be a function of unusual circumstances during the year (eg. initial application of Sarbanes-Oxley or international financial reporting standards); however discussion showed that different companies do have a different number of ‘standard’ meetings scheduled for the year.

Meetings generally last between 2 and 3 hours, although one audit committee chairman reported knowing of a company where the audit committee meetings regularly lasted between 4 and 6 hours.

In reading the published reports of audit committees and their terms of reference it is difficult to see why some committees can conduct their formal business in about 8-10 hours per year, and others take 30-40 hours. As an example, the published reports of Cadbury Schweppes plc (4 meetings per year) and BP plc (13 meetings) have been compared in Appendix 2. It will be seen that both companies covered the same agenda, although obviously the style and detail must differ. These differences will be driven to some extent by the companies’ context and industry, and partly by the personalities and preferences of those concerned, particularly the audit committee chairmen.

Attendance of executives at audit committee meetings

“The risk of the [company] chairman attending is that he exerts the influence even though he’s not a member: if he’s not in the room, then it’s easy.”

The Combined Code states that the audit committee members should comprise independent non-executives, and not include the company chairman. However, audit committee meetings were attended by many parties other than the actual members: external and internal auditors, and the chairman and members of the executive being the main such attendees.

Finance directors (FD) generally attended the meetings; practice as to attendance of other executives differed considerably. From our interviews and discussions

² The research did not include a systematic review of the published audit committee reports of all listed companies, and so no conclusion can be drawn that 13 is the highest number of audit committee meetings in a year.

we found that in some companies it was common practice for both a company's chairman and its CEO to attend all or the majority of audit committee meetings (albeit that they, and the FD, would leave for part of the meeting so that the non-executives could discuss matters privately with the auditors). However, the attendance of the chairman and/or CEO at audit committee meetings was by no means universal. In some companies, either or both of them attended often, but by invitation only. In other companies the CEO and company chairman did not attend the audit committee meeting, which was seen as having mainly a non-executive governance function.

On the other hand, in one company the whole board – executive and non-executive – attended the audit committee meetings, which were seen as an integral part of the risk management function of the company. All corporate governance matters were dealt with at these meetings.

A stated advantage of having the key executives attend the audit committee meetings is that they have a great deal to contribute, and they get to see what issues are concerning the non-executives (“reading the body language” at the meeting). A stated disadvantage is that a powerful chairman or CEO may hijack the meeting to his or her own agenda, or may dominate the discussion.

Supporting papers

“It’s the dilemma of the American 20-F. It’s comprehensive rather than comprehensible.”

The audit committee chairman has detailed input into the preparation of papers for the meetings.

It was generally agreed that papers that are too detailed are “comprehensive rather than comprehensible”, and that by “hiding behind transparency” management can actually overload the non-executive directors (NEDs) with detail and thus – deliberately or otherwise – obscure important matters. One committee chairman commented that as the volume of documentation had grown with new regulation, his job, and the job of the finance team, in preparing it had increased considerably.

From our interviews and discussions it emerged that one of the important roles of the audit committee chairman is to ensure that management summarises the papers adequately for the committee members. However, the general view of best practice was that the audit committee chairman should ensure that all committee members do get all of the relevant papers and not just summaries thereof. (This view was not necessarily universal. In at least one committee only a summary was distributed for some papers.)

Although proper discussion can only take place if committee members have read all of the relevant papers in advance of the meeting, it was agreed that not all papers distributed for an audit committee meeting needed to be read in detail. For example, some committee members might only read summaries of detailed statutory filings. However, it was agreed that the audit committee chairman should read all of the material.



Creating space to think

“How do you make sure... that you’re not missing the potentially big risks?”

“...there is the danger that some boards will be so mesmerised by the process of regulation that they’re not thinking creatively and positively; that must be a danger.”

In addition to the necessary ‘process’ matters for committee consideration, in one of the committees there was a specific time set aside as “white space” – free time to think broadly about company risks. The reason for making this time was a belief that audit committees, especially those which have to comply with Sarbanes-Oxley, are becoming too process-driven. Given this, it is important not to lose sight of the big issues. One of the Audit Committee Chair Forum participants ensured that his committee always had “white space” time. Others at the meeting thought that this could be a useful event, although no others specifically followed it. In one company such issues were taken up at board away-days, and in one other they were discussed twice a year at a private dinner of the non-executives, held under the chairmanship of the SID (senior independent director).

One audit committee chairman noted that there was no time in his company for such “white space” meetings, as most of the year had been taken up with Sarbanes-Oxley compliance! This comment does reflect the time management problems faced by NEDs as their regulatory workload becomes more demanding.

Effectiveness of the audit committee

“...the danger of over-regulation is that it becomes a box-ticking exercise, rather than giving thought to the bigger picture and understanding the business better and the people better. Regulation is no substitute for that, and sometimes you can spend too much time going through the checklist and not enough time using your judgement.”

As stated earlier, the work of the audit committee is twofold, and involves both ensuring ‘Conformance’ to governance regulation and encouraging ‘Performance’ by advising management. This is a broad remit, often with little tangible output. Accordingly, it can be difficult to assess how effective the committee is.

Evaluation of the audit committee

The Combined Code states that there should be an annual evaluation of the performance of the board and its committees. In the companies reviewed, this was done in a variety of ways, both formally and informally, using questionnaires and interviews, and using internal and external assessors. However, the participants agreed that it can be difficult to establish clearly whether an audit committee is doing a good job.

One part of the evaluation process is to take the views of the external auditors, who are considered to be experts, as they have the chance to observe many such committees in action. However, it was noted that at times an auditor may not be totally frank with a poorly-performing audit committee chairman, given the commercial relationship that exists. Accordingly, it might be appropriate for the audit committee evaluation to be conducted by the company chairman rather than the chairman of the audit committee.

Evidence discussed by the interviewees to support their judgement on the effectiveness of the committee and their trust in the executives included: the conduct of committee and board meetings; no one person dominating meetings; the ability to receive papers that were complete and on time; the ability to bring matters to board or committee meetings and to have free discussion; etc. Broadly this can be summarised by one interviewee's comments that he was satisfied because "there are no impediments to me doing my job".

Role of the audit committee chairman

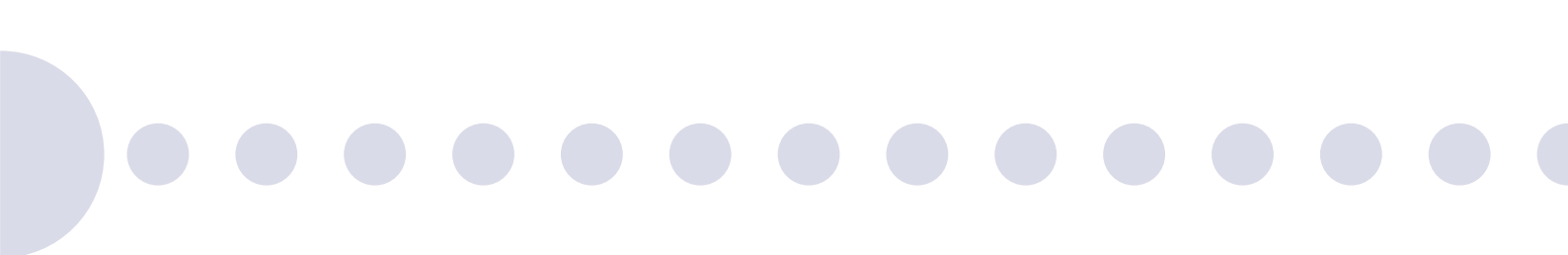
In committees of any sort, the role played by the chairman is critical in setting the tone and structure of the work. It has been seen that the conduct of audit committees can differ considerably, and one reason for this will be the personal style of the audit committee chairman. Indeed, a couple of our interviewees who sit on several committees commented that those committees do operate in different ways.

One obvious role for the audit committee chairman is to determine what gets discussed, how and in what depth. All of the audit committee chairman participating in this research were involved in determining the agendas for the audit committee meetings generally in conjunction with the FD, sometimes with the external auditor. Some had a policy of always meeting with the external auditor before a committee meeting but this was not universal practice.

Relationships

"If I didn't trust the company directors I would not be an audit committee chairman – I think you're on a loser in every way you can think of. I'd only join a company where I felt that they had integrity – which is absolutely the answer you don't want. If you are a government you actually want people like me; you actually want us on [boards] in places where we can do the most good."

In assessing the effectiveness of an audit committee, many of the respondents discussed the nature of the relationships between members of the committee, and between committee members and the executives. It was generally agreed that trust between executives and NEDs is essential, and that governance cannot operate properly if that trust breaks down. Indeed, this level of trust (or, as one participant stated, "trust with verification") is an important criterion mentioned in evaluating the performance of the committee and the board.



Given that (anecdotally) there are fewer qualified individuals prepared to join the boards of companies as NEDs, due both to the increased time commitment and the increased threat of litigation, it seems likely from the above that these individuals will concentrate their talents in the good companies. However, it is the not-so-good companies who really need their governance abilities – and who are likely to have to settle for NEDs with lesser abilities.

In all of the committees referred to, the chairmen stated that they had good relationships with the external auditors, as well as with people inside the company such as the FD and the internal auditor³.

NEDs with multiple directorships

“There’s no doubt that if you’ve picked a problem up and dealt with it in one company and it comes up in another company, you’re better informed. And one of the things I’ve found, going to multiple boards, is that ...whatever’s on one company agenda tends to be on the next company agenda.”

Regarding board and committee evaluation, many of the interviewees and contributors commented on the advantage to a NED of sitting on more than one board.

Although in the past concerns have been raised regarding the time that can be spent by individuals with multiple directorships, and the narrow demographic of having the same people as non-executives in many companies, it does produce some benefits. By participating in more than one board, NEDs can contrast the processes and outcomes in different companies, and discuss ‘best practice’ with their peers, who have experience in further companies.

NEDs with multiple directorships also bring additional experience to their committees. An example noted at the Audit Committee Chair Forum was the ability to discuss disaster recovery processes in the context of what other companies did.

Some interviewees have commented that the increased regulatory burden may mean that individuals hold fewer non-executive directorships, which could have a negative impact on their overall effectiveness.

³ Given the voluntary nature of participation in both the interviews and the Forum meeting, this is not surprising. It is unlikely that individuals who were experiencing problems in this area would make themselves available for interview.

Expectations gap

“I think you’re there to minimise the chances of [fraud], reduce the chances of it. I don’t think you’re there to stop it. It’s not possible... My guess is that there are two communities. There are the informed and the uninformed. And the informed probably realise that it’s not possible to stop fraud. But I think the average person in the street probably will assume that it is.”

“...with the scandals in America, there’s a risk that people see the audit committee as the ultimate auditor. ...The risk is that they’re seen as the people who overall could control what the company puts in the public domain, and the way in which the company’s financial systems are run. And I don’t see that to be the case. You are talking about ...four or five people who spend say twenty days a year on the company’s business; three half-days of which are in audit committee. And they don’t have the knowledge of the audit firm which is in there for millions of pounds worth of fees, or the CFO and his team who are there on a day-to-day basis.”

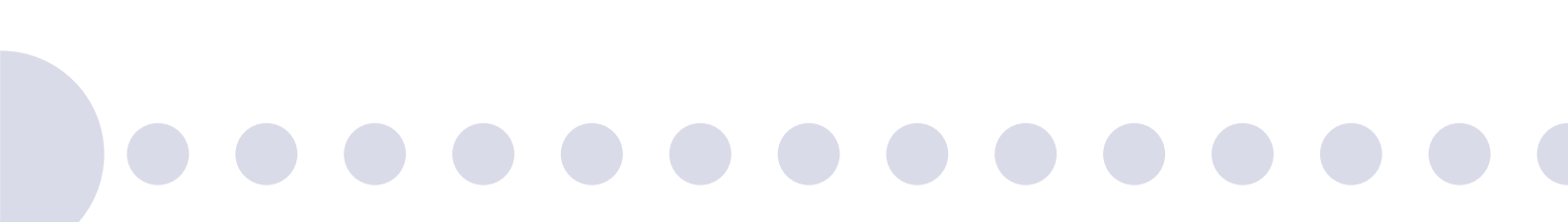
The term ‘expectations gap’ refers to instances where the legal responsibilities of a board or committee are at odds with the public expectations of those bodies. For example, a common view in the media, and of some smaller shareholders, appears to be that the audit committee is there to prevent fraud.

The general view of those interviewed was that in practice the audit committee is unlikely to be able to prevent and detect fraud, and that this has not changed with recent regulation. By its very nature, the committee is at a distance from the operations of the business.

Thus there is a gap between what the committee members believe they can achieve, and what part of the outside world sees as their role. This is not an expectations gap with the majority owners of the company, the institutional shareholders, but with the some of the opinion-formers. As such, the gap needs to be defined (as between the media, shareholders, regulators, etc.) and then addressed. In defining the gap it is important to understand that it may refer not just to the audit committee but to the organisation more broadly: the outside world may not differentiate between management, the board and the audit committee.

Potential changes to regulation

The Audit Committee Chair Forum considered the potential implications of changes to UK legislation or regulations following the implementation of the EU 8th Directive on statutory audit. There is the potential for any country to opt out of the Directive’s statutory requirement for an audit committee: the government’s solution in the Company Law Reform Bill is that the FSA be responsible for audit committees and corporate governance. The CBI position is that this should be an FRC responsibility following their present ownership of corporate governance under the combined code.



The meeting felt that this would be an unsatisfactory outcome. Given the wide variations in audit committee practice that have been noted in this research, and the desire for audit committees to serve a useful function in the context of their individual company circumstances, standardisation of practice was not considered to be useful.

A further regulatory issue discussed at the meeting was the move by some institutional shareholders and their representatives to have closer involvement with audit committees than they do now. Currently, the Combined Code states that audit committee chairmen should be available at companies' AGMs to answer shareholder questions, but gives investors no direct access other than that. The view of the participants at the meeting was that no benefit would be gained by allowing increased access. The issue is: does the audit committee exist for the benefit of the board, or for the benefit of the shareholders? Generally, the view was that it was the former: the audit committee is a sub-committee of the board to which certain responsibilities are delegated, and its role is to report to that board.

Conclusion

“How much of the time of the audit committee is directed towards non-productive work designed to protect you if you get sued?”

“Is it the job of the directors to ensure that the company doesn't do anything it shouldn't do, or is it the job of the directors to ensure that the company does everything that it could?”

The audit committee is a sub-committee of the board, with its remit normally including monitoring the integrity of the company's internal control systems and its published financial information. As well as undertaking its activities in accordance with governance regulation, audit committee chairs stated a desire that the committee should add value to the company.

The growing volume of governance regulation, and the related increased legal obligations of the non-executives, can lead to too much focus on process, or “box-ticking”, and too little time spent on value-adding activities, including thinking creatively about risk management. One way to avoid this narrow focus is to schedule time over the year for “white space” thinking.

A perceived strength of the system is the fact that non-executives sit on the boards and committees of more than one company. This enables them to contrast processes between companies, evaluate performance, and contribute to strategic discussion by bringing in experience from other contexts.

All of the companies reviewed in this research were compliant with regulation. However, the audit committees were run in very different ways, which the participants believed reflected the differing circumstances of companies as well as the preferences of the individuals. This was seen as a strength of the system – if a committee is to add value to the organisation, flexibility is needed in its approach. Any further legislation or regulation in the UK or Europe needs to take this into account. One size does not fit all.

Questions to ask yourself

- What could your audit committee achieve if it had one extra meeting each year?
- Would your audit committee benefit from “white space”, a separate meeting to consider risks to the company? Do time constraints make this feasible?
- What does your audit committee do that you think is unnecessary, or could better be done in another part of the company or board?
- If you sit on more than one audit committee, what differences are there in the way that they operate? Could the practices of one usefully be adopted by another?
- Who attends your audit committee meetings and what influence, positive or negative, do they have on the decisions that are made and the risks that are considered?
- Are preparatory papers for your audit committee comprehensive rather than comprehensible? If so, what needs to happen to make them more useful?
- Our results suggest that a high degree of trust between NEDs and executives is essential for governance mechanisms to work properly. Do you agree? Do you have such a relationship on the boards on which you sit? If not, what needs to be done to improve the situation?
- How do you evaluate the effectiveness of your audit committee? Whose role should it be to undertake that evaluation?
- How do you manage the expectations gap between what the committee members believe they can achieve, and what the outside world sees as their role?



Appendix 1

The role of the audit committee

Summary of audit committee role from the Combined Code

- To monitor integrity of the financial statements.
- To review the company's internal financial controls (and its risk management systems unless monitored elsewhere).
- To monitor and review the effectiveness of internal audit.
- To recommend (to the board) appointment of the external auditor, and approve their remuneration and terms of engagement.
- To review and monitor the external auditor's independence, objectivity and the effectiveness of the audit process.
- To develop and implement policy on using the external auditor to supply non-audit services.
- To review whistle-blowing arrangements for staff.

Appendix 2

Activities undertaken by audit committees

The following table contrasts (in summary form) the published audit committee reports of Cadbury Schweppes plc and BP plc. It shows that similar activities appear to be undertaken by each company, but that these are conducted over four meetings in Cadbury Schweppes, and over 13 meetings in BP.

Cadbury Schweppes	BP
Number of audit committee meetings in 2004	
Four meetings	13 meetings (increased from nine in 2003)
Work done on published financial statements	
<ul style="list-style-type: none"> ● 2003 full year result announcement, annual review, summary financial statement, report and accounts, 20-F, report from the external auditor. ● 2004 interim report. ● Dealing with IFRS and other accounting issues. 	<ul style="list-style-type: none"> ● Reviewed all annual and quarterly financial reports, in particular looking at significant accounting policies, estimates and judgements.
Work done on internal audit, internal control, risk assessment	
<ul style="list-style-type: none"> ● 2003 full year report on internal audit and effectiveness of internal control. ● Reviewing internal audit processes and the audit plan for 2005. ● Monitoring the group's risk management and business ethics processes. ● Annual report of group legal matters. ● Security arrangements for IT. ● Preparation for Sarbanes-Oxley. ● Group's response to corporate governance developments in the UK and US. 	<ul style="list-style-type: none"> ● Specific reports on risk management and internal control were considered. ● Considers the internal auditors' programme and its effectiveness twice a year. ● Received separate reports regarding the group's environmental and decommissioning provisions, tax exposures, pension assumptions and the status of current litigation. ● Response to Sarbanes-Oxley.
External auditor	
<ul style="list-style-type: none"> ● Provision and scope of audit and non-audit work by external auditor. ● External audit fees for 2003 and 2004. 	<ul style="list-style-type: none"> ● Reviews independence, objectivity and viability of the auditors, and pre-approves any non-audit services provided by the auditors. ● Reviewed audit fees. (This is stated in the Report and Accounts, not the audit committee report.)
Whistle-blowing	
<ul style="list-style-type: none"> ● Introduction of group whistle-blowing policy. 	<ul style="list-style-type: none"> ● Received regular reports raised through the whistle blowing programme.
Audit committee review	
<ul style="list-style-type: none"> ● Annual review of the effectiveness of the audit committee. 	<ul style="list-style-type: none"> ● Critically reviews its own performance.

