13 March 2012

The Office of the Secretary,
Public Company Accounting Oversight Board,
1666 K Street, NW
Washington, DC, 20006-2803 USA

Email: comments@pcaobus.org

Sir / Madam,

PCAOB Rulemaking Docket Matter No. 030
PROPOSED AUDITING STANDARD RELATED TO COMMUNICATIONS WITH AUDIT COMMITTEES; RELATED AMENDMENTS TO PCAOB AUDITING STANDARDS AND TRANSITIONAL AMENDMENTS TO AU SEC. 380

The Institute of Chartered Accountants in Australia (Institute) is pleased to have the opportunity to respond to the above Rulemaking Docket.

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world.

Representing more than 70,000 professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession’s commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

Chartered Accountants hold diverse positions across the business community, as well as in professional services, government, not-for-profit, education and academia. The leadership and business acumen of members underpin the Institute’s deep knowledge base in a broad range of policy areas impacting the Australian economy and domestic and international capital markets.

The Institute of Chartered Accountants in Australia was established by Royal Charter in 1928 and today represents more than 58,000 members and around 12,500 talented graduates working and undertaking the Chartered Accountants Program.

The Institute is a founding member of the Global Accounting Alliance (GAA), an international coalition of accounting bodies and an 800,000-strong network of professionals and leaders worldwide.

As mentioned in previous submissions to the PCAOB we are of the view that, as a premier audit regulatory body, the PCAOB and its findings influence audit regulation globally and it is for this reason we offer our comments on this matter.

In summary we fully support efforts to improve communications between external auditors and audit committees. We consider an open and frank interchange to be a significant driver in enhancing audit quality and see the development of the proposed standard since the 2010 exposure draft to be positive.
The Institute continues to explore the role of audit committees and has recently completed a joint project with the United Kingdom’s Financial Reporting Council, as well as the Institute of Chartered Accountants of Scotland, obtaining insights from members of audit committees across multiple jurisdictions. The resulting joint publication is titled *Walk the line: Discussions with leading audit committee members* and was launched in February 2012. A copy is attached for your information.

The Foreword to this paper captures the importance of the audit committee in corporate governance and interaction with the external auditor:

‘The thoughts, insights and opinions presented in this paper certainly reiterate the pivotal role played by the audit committee in assisting the board of directors in enhancing the transparency and integrity of financial reporting. The paper highlights the importance of the committee having a clear remit and the right mix of skills and experience, and of the relationships it forges with management, the auditor and the rest of the board of directors to create a culture of open and frank discussion. It is this open debate and mature questioning that are fundamental to the effectiveness of the audit committee.’

Some participants even suggested that the audit committee was the single most significant board committee.

A matter which the PCAOB may wish to consider for the standard is for the inclusion of a requirement dealing with the following, which was included in the Australian equivalent of *ISA 260 Communication with Those Charged with Governance*:

*Aus 19.1 If the auditor is concerned that a written report intended for those charged with governance has not been, or may not be, distributed to all members of that group, the auditor shall endeavour to ensure all members are appropriately informed of the contents of the report.*

We would be happy to elaborate on the foregoing matters should you wish.

Yours sincerely

Yasser El-Ansary CA
General Manager - Leadership and Quality
Institute of Chartered Accountants in Australia
Walk the line:
Discussions and insights with leading audit committee members
The Institute of Chartered Accountants in Australia
We are the professional body for Chartered Accountants in Australia and members operating throughout the world. Members serve the public interest through their obligation to uphold high standards of service within many facets of the economy, in public practice and commerce, and sectors including government, not-for-profit and academia. The Institute has a pivotal role in promoting financial integrity in society. We do this through our leadership and our advocacy work on influencing policy and regulatory frameworks in Australia, and in relevant international settings. We represent up to 70,000 current and future business leaders, with more than 97,000 members, and around 13,000 talented graduates working and undertaking the Chartered Accountants Program. Through the Global Accounting Alliance, Institute members are also part of an 800,000-strong network of professionals and leaders worldwide. Established by Royal Charter in 1928, we have a long tradition of leading the Australian Chartered Accounting profession. You’re welcome to find out more about the work we do at charteredaccountants.com.au

Financial Reporting Council (UK)
The Financial Reporting Council (FRC) is the UK’s independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC promotes high standards of corporate governance through the UK Corporate Governance Code. It sets standards for corporate reporting and actuarial practice and monitors and enforces accounting and auditing standards. It also oversees the regulatory activities of the actuarial profession and the professional accountancy bodies and operates independent disciplinary arrangements for public interest cases involving accountants and actuaries.

The Institute of Chartered Accountants of Scotland
The Institute of Chartered Accountants of Scotland (ICAS) is a professional body for around 19,000 world-class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader. Almost two thirds of our working membership work in business, many leading some of the UK’s and the world’s great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country. We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in Europe and the UK, always acting in the public interest. ICAS is the first professional body for accountants and was created by Royal Charter in 1854. We are a member of The Global Accounting Alliance (GAA) – an alliance of the world’s leading professional accountancy bodies, which was formed in 2005. The GAA is intended to promote quality services, share information and collaborate on important international issues. It works with national regulators, governments and stakeholders, through member-body collaboration, articulation of consensus views, and working in collaboration, where possible with other international bodies, especially IFAC.

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Walk the line: Discussions and insights with leading audit committee members
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Foreword

In an increasingly interconnected world with internationalisation of the business environment and major markets, it is important to invest time in forging collaborations.

The Institute of Chartered Accountants in Australia, the Institute of Chartered Accountants of Scotland and the Financial Reporting Council in the United Kingdom have collaborated to present an international view on the role of audit committees in helping their boards discharge their financial and fiduciary responsibilities to shareholders.

Our joint project involved direct meetings and telephone interviews with chairmen of audit committees and boards in different jurisdictions around the world, but with a particular focus on companies based in Australia and the United Kingdom. We would like to take this opportunity to thank each of the participants, listed in Appendix 2, who so generously gave up their time to contribute to this paper. We would also like to acknowledge the assistance of the UK Audit Committee Institute for arranging and participating in many of the interviews.

The thoughts, insights and opinions presented in this paper certainly reiterate the pivotal role played by the audit committee in assisting the board of directors in enhancing the transparency and integrity of financial reporting. The paper highlights the importance of the committee having a clear remit and the right mix of skills and experience, and of the relationships it forges with management, the auditor and the rest of the board of directors to create a culture of open and frank discussion. It is this open debate and mature questioning that are fundamental to the effectiveness of the audit committee.

A strong sentiment prevails among audit committee chairmen we interviewed: their role and responsibilities are well understood and there is a clear understanding of the leadership, knowledge and accountability needed to provide for their committees to operate effectively. This suggests that a major overhaul of the remit and the composition of audit committees is probably not necessary. But challenges still remain, not least how to communicate meaningfully to shareholders what audit committees are doing to protect their interests.

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Walk the line: Discussions and insights with leading audit committee members

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Executive summary

Many of the prominent failures of corporate governance in the last couple of decades have involved breakdowns and deficiencies in communication, internal control processes and financial reporting. Unfair to some, the perception is that boards and audit committees failed to prevent these failures and the external auditor failed to discover them.

The upswing of government intervention and the general call from investors for transparency and corporate accountability demands a response from boards, management and auditors. Against this backdrop, the role and function of the audit committee has come under the spotlight.

To explore the workings of the audit committee further, the Institute of Chartered Accountants in Australia, the Financial Reporting Council (UK) and the Institute of Chartered Accountants of Scotland have interviewed audit committee chairmen and others involved in working with audit committees of top tier companies in major securities markets to learn how these committees work and the challenges they face.

Questions were designed to evoke discussions around how these leading practitioners ensure their committees are effective (these questions are summarised in Appendix 1). It is believed that these reflections will be of wider interest, particularly to other audit committee members, while recognising that there is no ‘one-size-fits-all’ best practice.

The interviews affirm that audit committees have grown to become one of the main pillars of the corporate governance system.

The existence of an independent audit committee is recognised internationally as an important feature of effective corporate governance. A clear sentiment resonates among audit committee chairmen interviewed: there is a robust acceptance of, and obligation to, conduct the job of providing assistance to the board to fulfil its oversight responsibilities.

The audit committee runs a balancing act: effectively dealing with its additional oversight functions while, at the same time, maintaining the collegiality and relationships that are expected of board directors.

To do this, the audit committee must give thought to the relationships it has with the board (in particular, the chairman of the company), management, other sub-committees and the internal and external auditors. The audit committee is in a key position to encourage open and frank communication.

The approach to the role of audit committee chairmen and some of the challenges facing audit committees today are discussed in this paper. Many of the regulations and governance structures imposed on audit committees across the different jurisdictions differ in the detail, and the exact remit of the committee also varies, but all share the common objective of ensuring effective, independent oversight of financial reporting.

Four clear messages were heard consistently:

> Audit committees owe their primary responsibility to the board and work best when they are an integrated part of the board process
> Open debate and mature questioning are fundamental to their effectiveness
> Audit committee members need sound commercial and financial knowledge but not necessarily deep accounting knowledge
> Audit committees need high quality and reliable information to fulfil their role and have an important responsibility in the selection of those responsible for delivering that information.

Interviewees said that the long-term effectiveness of the audit committee will in part depend on its ability to renew itself. Infusing fresh talent with new ideas will offer different perspectives. Diverse backgrounds and varied experience enhance the efficacy of committees, especially when advising newly-listed companies.

Diversity of skills and experience among committee members is seen as an essential characteristic of an effective audit committee. Financial expertise and literacy are important for most interviewees, but so is the ability of audit committee members to understand a company’s business and risk profile.

While regulation is clearly relevant to the effectiveness of audit committees, it is not considered the determining factor. Rather, the key to a truly effective audit committee is the behaviour and culture emanating from the board throughout the organisation’s management, committees and assurance activities. This is something that cannot be regulated for.

The volatility of capital markets combined with the thirst for transparency and investor information is increasing at a steady rate. The audit committee can play a key role in meeting these demands. At the same time, a number of interviewees warned of the danger of unrealistic expectations around what committees can achieve.

This warning was also directed to companies and, looking forward, there needs to be caution as to how far the role of the audit committee extends. In handing new responsibilities to the audit committee, there is a risk of it becoming so burdened that it is unable to carry out its core functions effectively.
The functions of the audit committee

Effective audit committees foster high quality financial reporting and good corporate governance. This emerged as a common observation from all interviewees with some even suggesting that the audit committee was the single most significant board committee.

Interviewees said their core role as audit committee chairmen was to provide oversight of the preparation of the financial statements and to examine the related internal controls. In some countries, audit committees typically also have responsibility for broader aspects of internal control.

There was an acknowledgement that nurturing and building good relationships with internal stakeholders, including the board, management and internal auditors was a key ingredient to well-functioning committees. Interviewees also highlighted the crucial oversight role committees play in managing good relationships with external auditors.

When asked about whom they believed they were responsible to, most interviewees responded that their primary responsibility was to the board as a delegate of the board. The board in turn was responsible for looking after the interests of shareholders.

It has been delegated to a committee that I chair to ensure that particular aspects of governance are well and truly looked after on behalf of the shareholders... Knowing that you are really doing it on behalf of the broader board.

In markets where companies had concentrated ownership, there was a clear recognition of a potential conflict of interest when a director held his or her position as the ‘representative’ of a major investor. In other markets where ownership is more dispersed, such as the UK, this did not emerge as an issue. But all interviewees firmly recognised their legal responsibility to all shareholders as discharged through the board.

All interviewees recognised the crucial role played by the audit committee chairman. The chairman is the voice of the committee at board meetings. They are also responsible for ensuring open discussion in committee meetings, allowing all viewpoints to be heard and considered, and for managing the committee’s relationship with the board, management and the external and internal auditor.

You need a strong chairman of the audit committee. That chairman should make sure that the audit committee functions correctly. He or she should be responsible back to the board to say what they did... They should be smart enough, as most of them are, to present the problems, and summarise them for the board.

The oversight function of the audit committee

The core functions for all audit committees are oversight of the integrity of the financial reporting process and reporting to the board. As part of this role, the committee receives and considers the external audit plan, the financial statements and the external auditor’s long form report to those charged with governance. The audit committee engages in a process of enquiry and discussion with both management and the external auditor, and highlights significant areas of judgement.

A general consensus among interviewees across jurisdictions was that the audit committee should carry the principal responsibility for advising the board on the selection, appointment and rotation of external auditors and, if appropriate, recommend an extension in an audit partner’s rotation period.

Also sitting at the heart of the audit committee function is the oversight of the internal audit plan: reviewing and challenging management remediation plans, particularly the timing, and identifying areas of significant risk. Many of the audit committees covered by the interviews, particularly in the banking sector, also had responsibility for the selection of internal auditors.

In addition, interviewees acknowledged that audit committees have a responsibility for the overall financial governance of a company. This includes responsibility for ensuring that there is sound oversight of the processes used to maintain effective internal control over financial recording.

Fundamental to the work of an audit committee is its capacity to engage in a timely fashion in the activities that it has to monitor. The protocols to achieve this are varied but include timely engagement with auditors so that key areas of judgement can be given full consideration. In some cases this also includes protocols for the audit committee to consider the accounting consequences of major transactions while they are in progress.

Internal control and risk management

While all interviewees agree that overall responsibility for risk rests with the board, there are differences in the way in which oversight responsibilities are delegated at board committee level.

In some cases the audit committee is combined with a risk committee; in other cases the audit committee is combined with a finance committee. Many interviewees, particularly in Australia, preferred the separation of the audit committee from either the risk or the finance function but this preference was not universal. Some interviewees in the United States of America and the UK expressed little enthusiasm for separate risk committees.
If there is an evil of having two separate committees versus a single committee, I think it is the lesser of two evils. The risk of missing something or not connecting the financial implications on risk is a lesser evil than not giving it the oversight it warrants just because time runs out.

I don’t think there’s a one-size-fits-all solution. If you are talking financial services companies or resources companies, I would absolutely separate them. If you are talking about a manufacturer there might be an argument for combining them, because of the nature of the risks.

When the audit committee is separated from other committees with responsibilities for risk, the need for linkages between them is critical. Indeed there were concerns that without close cooperation between those committees, information could fall between the committees and not be properly addressed.

This dilemma was often dealt with by ensuring cross-membership between the different committees. Interestingly, some audit committees also had shared membership with the remuneration committee to make sure that there was consistency between them.

As chairman of the board, I have given the audit committee chairman the role of also chairing other sub-committees of the board. I feel that we need a link between these sub-committees as a way of managing risk overall. And every time we speak to corporate governance people or anybody else we sell it as a positive.
Building on relationships

There is strong consensus among interviewees about the role of the audit committee, which is seen as a vital institution in assisting the board of directors in enhancing the transparency and integrity of financial reporting. Audit committee chairmen recognise and embrace the role and function they hold within this environment.

The audit committee and the board

Across all jurisdictions, the interviewees are very strongly of the view that, as a committee of the board, the audit committee should work within the collective and collegiate responsibility of the board.

Recent regulatory litigation in Australia, the Centro case, has highlighted that financial governance and financial reporting are the responsibility of the full board and cannot be abrogated or passed to other parties, whether audit committees or the auditors. This is consistent with interviewees’ experience in other countries.

The board can’t walk away from any responsibility it has in relation to financial statements. Of all the things that the board does, the thing that’s most visible out there is the financial statements.

Interviewees consider that the audit committee works more effectively when all board members have a clear understanding of this devolved responsibility and how to work with it. Interviewees noted that there is greater understanding of the importance of collective responsibility in today’s boardrooms. Whereas in the past boards often devolved substantially all of the responsibility for the financial information in the annual report and its preparation to the audit committee, interviewees reported that the full board is now more appropriately engaged in such matters.

So what are the keys to the effective working relationship between the audit committee and the board? While each will need to determine their own ways of working together, and processes and protocols will need to be tailored to the individual company, this paper has attempted to distil some fundamentals from the experiences of the interviewees. Interviewees said that the board needs:

> A clear understanding of its responsibility to appoint an audit committee with an effective balance of skills
> A process of contact and communication, generally through the company chairman, that fosters effective collective understanding of, and engagement in, the work of the audit committee
> To assess individual audit committee members not just as directors, but in relation to their suitability for their specific devolved role
> To ensure that the audit committee is fully informed of all transactions that might affect its work.

Likewise, the audit committee needs to understand its responsibility to:

> Act diligently
> Report fulsomely to the board
> Ensure all of the significant risks and value judgements that it may have to consider in its processes are brought to the attention of the board.

Of paramount importance is the fluent conversation between board members, audit committee members and those reporting to them such as auditors and corporate executives. Trust, properly earned and carefully maintained, is a fundamental attribute.

The board needs to be in a position, and individual directors need to be in a position, to feel as though there has been fulsome reporting back from the committee to the board. Board members must feel that they have had the opportunity to either ask questions or raise issues and participate in debate. And in that regard, I think the flow of information is important.

Interviewees gave many different examples of how to ensure this flow of information took place. It is partly a function of board size. In some companies with smaller boards, all non-executive directors are members of the audit committee or are invited to attend some or all of its meetings. In other companies where this was not the practice, greater emphasis is placed on the committee chairman reporting to the full board. In Continental Europe, in particular, there was a tendency for the committee chairman to provide formal written reports to the board.

The relationship between the audit committee and company chairman is key. In practice they will usually determine the size and composition of the audit committee, factors that are vital to its effectiveness. Thereafter a strong relationship remains critical, not only for the purposes of communication but also so that the committee chairman is assured of the broad support of the board when it is necessary for them to challenge management. For this reason, many interviewees felt that the company chairman should attend committee meetings.
The audit committee and management

All interviewees expressed an adamant view that a good but independent working relationship with management is essential to effective oversight.

The audit committee and management have the same objective of ensuring robust financial reporting. Seeing the relationship as adversarial is the wrong approach. There is a virtuous circle where strong relationships enable strong oversight. Weak relationships make robust oversight very difficult if not impossible.

Many interviewees warned about the risk of audit committees abrogating management’s role. Audit committees seeking to understand their company risks and processes can become so engaged that they inadvertently assume management roles. Complex businesses are particularly vulnerable to this as their audit committees seek to understand and advise on management’s processes.

That said, there are differing views about where the line between the role of management and that of the audit committee should be drawn. Interviewees sitting on American company boards, for example, seemed to take a more ‘hands on’ approach to the detailed aspects of financial reporting than was typical in other countries. A number of interviewees on UK boards commented on the benefits of the committee getting involved at an early stage so that they understand issues as they are developing rather than being presented with a fait accompli. This argues for regular meetings with management and the internal and external auditors.

You’ve got to be careful that you don’t take on the role of manager, but you need to be alert. I mean you can’t just accept or wait to receive papers and reports. You need to be proactive. If things come to your attention, you need to raise them with management and ask them have they thought of it, have they addressed it, why is this not an issue?

There are differing views about the extent to which management should be invited to attend audit committee meetings. In practice, attendance by the chief executive officer is varied. The chief financial officer is a more regular attendee. Some Australian interviewees expressed the view that audit committee meetings were more effective when the chief executive officer was not present (at least not for the whole meeting).

All interviewees recognised that, with the possible exception of attendance by the board chairman, it was the prerogative of the audit committee to determine who should and should not attend. And all interviewees recognised the importance of ‘committee only’ time (a part of which would include in-camera discussions with internal and external auditors).

The audit committee and the auditor

One of the audit committee’s key responsibilities is the oversight of the external auditor.

In the USA, the Sarbanes-Oxley Act says that the external auditor works for and is accountable to the audit committee and the board of directors as the representatives of the shareholders.

In Australia and the UK, the committee’s role in overseeing the external auditor is not bound by legislation, but is considered best practice. It is recognised as important that audit committees and external auditors work together effectively to strengthen the corporate reporting and governance process.

In practice, a three-way relationship exists between the committee, management and the external auditor. The respective roles of the committee and management vary between companies but there is a view, at least among some UK interviewees, that the auditor should formally report to both.

The audit committee needs information from the auditor at critical points such as in the planning phase of the audit, during the early warning discussion on initial findings (including materiality or any other important factors), and at the close of the audit.

Interviewees felt that the role of the audit committee in providing a conduit for the external auditor to communicate freely and openly is crucial to improving audit quality overall.

Twice a year, I meet with all the auditors, sometimes just one-on-one unless any other audit committee member wants to come along, outside of the formal in-camera session, just to talk to them about what they’re seeing. In that sort of environment they’re much freer in the way they talk.

The appointment of the external auditor is widely seen as the responsibility of the audit committee on behalf of the board, although executive input remains important. In practice it is not felt desirable to appoint an external auditor without the agreement of management as this might make it difficult to establish an effective relationship. In at least one case, the audit committee had taken over responsibility for negotiating the audit fee from management. Directors were concerned by suggestions that regulators might play a role in deciding which auditors were appointed and/or how frequently they were rotated.
Internal audit

Interviewees reported different views of the role of internal audit. In some cases internal audit is viewed as an arm of management with primary reporting responsibility to the chief executive officer. In those cases the internal audit function was perceived as a means by which executive management could achieve important insights into the functioning of the control processes for which they were responsible.

In other cases there is far more emphasis on internal audit as a function independent of management with primary responsibility to the board or the audit committee.

However, all interviewees considered that internal auditors and the audit committee chairman should have a direct or dotted-line reporting relationship as, irrespective of the primary reporting obligation, internal audit is an important source of advice and assurance for the audit committee.

The audit committee and shareholders

There are two main channels of communication between the audit committee and the shareholders: the written report which forms part of the published financial statements, and the annual general meeting, at which the audit committee chairman is available to answer questions.

The majority of audit committee chairmen interviewed do not believe that, as a sub-committee of the board, it is necessary or appropriate for them to have face-to-face contact with investors. This is felt to be the responsibility of the board chairman on governance matters and management on issues relating to the performance of the company. Rather, the sentiment is that the committee chairman should be willing to meet with investors if requested to do so.

Interviewees consider that any meeting with the audit committee chairman and investors should generally be limited to questions about governance and the manner in which the financial statements are put together, rather than financial commercial questions which are better left to the chief financial officer.

I don’t think it’s necessary... There is quite extensive dialogue, as you can imagine, between chairmen and major institutional shareholders at the moment. I don’t think there’s a need for the audit committee representative to get into that space.

The experience at annual general meetings is that while the board chairman may pass questions to the chief financial officer or chief executive officer or, in the case of remuneration, to the chairman of the remuneration committee, there are almost no instances when questions are passed to the audit committee chairman.
Building an effective audit committee

Once the role of the audit committee and its key relations has been established, there is still the task of establishing and ensuring an effective committee. This involves getting the membership right, managing the meeting agenda and creating the right environment for debate and challenge.

The composition of the audit committee
All interviewees agree that audit committee members need to bring more than just narrow financial and auditing knowledge to the table. These skill sets need to be matched with strategic thinking and sound business knowledge. In the words of one interviewee:

I work on the basis that every member of the audit committee is capable of reading financial statements but I don’t expect them all to understand and be able to repeat all of the accounting standards back.

This means that companies need to look beyond financial and auditing professionals to get the mix of skills and experience needed for the audit committee to operate effectively.

The expertise of a former auditor can be very narrow. So often they understand the accounting standards, they’ll ensure that the accounts are true and fair or reasonable. But sometimes they don’t bring a full understanding of the broader-based commercial issues associated with being a company director.

The optimum mix will depend on the needs of the company and the nature of its business. But interviewees on UK, European and American boards generally said that the ideal audit committee included at least one ‘financial expert’ and in some cases two, if one is the chairman. In Australia, interviewees put more weight on financial literacy rather than financial expertise and on the ability of audit committee members (and other board members) to understand the company’s business and risk profile.

Interviewees said relevant business experience was particularly highly valued. Other attributes sought, depending on the size and type of company, included international experience, experience of the type of risks the company faced (not necessarily from the same sector – for example, one interviewee sat on the board of a company with a lot of long-term contracts, so they had selected someone with project management experience), and ‘soft skills’.

One of the main benefits of having a more diverse committee is that it brings more perspectives to the questioning of management and external auditors. The willingness and confidence to ask questions is seen as perhaps the most important attribute for audit committee members. As one Scottish interviewee phrased it, every audit committee needs someone prepared to ask the ‘daft laddie’ question and every chairman needed to create the environment that enabled them to do so.

I will appoint one person because he just comes from a different space intellectually. I’ll appoint another because they understand the industry; and another because they understand the broader economics. And then there is the fourth member, the one who doesn’t fit any of those moulds. Why do we put him there? For a range of reasons: one because he is left field, and so he asks something different.

Another important consideration is the size of the committee: too small and you risk not having the range of perspectives that are needed, too large and it becomes unwieldy. The audit committee chairman should work with the board chairman to ensure the size of the committee enables it to be effective.

A number of interviewees felt that it was important that the audit committee, and possibly the board more generally, receive the benefit of ‘new blood’. This is to ensure the continuous and important injection of new ideas and new thinking into the board and audit committee process.

With its brief to cover all aspects of a company’s business and the way in which these flow through to the financial statements, membership of the audit committee is also seen as an important way for new board members to learn and expand their understanding of the business.

Some Australian interviewees suggested that the audit committee may benefit from the inclusion of non-board members in some circumstances. These non-board members would act as ‘experts’ bringing new perspectives to the board.

There were three arguments which underpinned this suggestion:

> Non-board members would allow the audit committee to draw from a larger pool of industry or accounting expertise
> It may give the audit committee greater independence
> It can provide potential future board members with experience and allow the board to assess their suitability for full board membership.

I do believe from time to time your obligations as a board member and the views you might form as an audit committee member might not always be consistent. The way it’s crafted today the audit committee is a subcommittee of the board – and I don’t think that should change – but the question is: could somebody, an independent person, that’s not a board member add to the debate?
However, the vast majority of those interviewed in the UK did not support this proposal. There are concerns that there might be a temptation for audit committees to abrogate responsibility for important complex decisions to the ‘experts’ on the audit committee. And there are fears these independent ‘advisers’ could quickly transform into shadow-directors.

There were also questions around the form of legal liability these new positions would attract, as the board itself remained legally responsible for the matters addressed by the committee, and the information made available to ‘co-opted’ members, who may not be privy to the same information as full board members.

Finally, it was felt that, at least for larger companies, a need to bring in external committee members indicated that the board itself did not have the mix of skills and experience that it needed, in which case the problem should be addressed at board level, not committee level. However it was recognised that it could be helpful for audit committees to bring in experts to advise the committee on specific issues.

**Managing the audit committee meeting**

The breadth of responsibilities of an audit committee means the number and length of audit committee meetings has increased. To ensure efficient prioritisation of tasks, committee chairmen are developing innovative ways of managing the meetings and workload.

One interviewee said he would hold ‘pre-meetings’ over the phone with committee members to work through the routine matters which can drain time from face-to-face meetings when more critical issues should be discussed.

Similarly, another interviewee said he would hold early meetings with the external auditor so that he had a clear idea of the key issues well before the scheduled meeting. Effective financial reporting requires understanding on all sides, and as one interviewee said of his audit committee:

> Before we [the committee] finally get to our central two-day meeting, we’ve met four times, maybe only for an hour or two, on key issues. And by the time management comes to the committee it has a clear understanding of what the committee’s hot points are.

The onus lies with the audit committee chairman to encourage open and frank discussion at the board level. There needs to be fair challenging of the material being reported to the committee, and it is equally important to have balance. The responsibility lies with the audit committee to ensure that the external auditor is heard as an independent source of information.
Challenges facing the audit committee

Across jurisdictions, a few common challenges were identified by the audit committee chairmen interviewed for this paper.

Unrealistic expectations
The thirst for transparency and investor information is increasing at a steady rate. The audit committee can play a key role in meeting these demands. At the same time, a number of interviewees warned of the danger of unrealistic expectations about what committees can achieve.

This warning was also directed to companies and, looking forward, interviewees felt there needs to be caution as to how far the role of the audit committee extends. In handing new responsibilities to the audit committee, there is a risk of it becoming so burdened that it is unable to carry out its core functions effectively.

Communications to bridge the expectation gap
There is recognition of a need to bridge what is referred to as the ‘expectation gap’ between investors’ understanding of what financial statements and reports convey and the underlying reality of the processes used to compile them. And very clearly there is the view that companies should be prepared to give investors what they need to understand the business within the limits bounded by commercial discretion.

Initiatives being put in place by the Financial Reporting Council (UK) are intended to provide greater transparency around the subjective judgements and risk assessments in financial reports and provide a vehicle for more communication between audit committees and investors.

However, these ideas are being viewed with caution by Australian committee chairmen. There were concerns that further reporting might increase the ‘clutter’ in the financial statements and result in an unhappy mixture of boilerplate statements and heavily cautious wording to avoid any potential risk or liability. There were also concerns about releasing information that was commercially sensitive.

It is also felt that reporting requirements should not give the impression that the audit committee is anything other than part of the board collectively.

Legal responsibilities and liabilities
Interviewees felt that there was little need for further rules which define the membership of audit committees, the frequency of their meetings or the scope of their work and responsibilities. The current framework is basically sound, and the onus should be on fostering and promoting good practice. Indeed, it is felt that imposing detailed rules defining the operation of the audit committee risked being counterproductive.

At the same time, from all of the interviewees, there is no sense that there is need for a material change in legislation or regulation to give audit committee members more protection from litigation liability. However, in the event that audit committees or their chairmen were given additional legal responsibilities, thought would need to be given to how to:

> Avoid creating board division through the allocation to the audit committee of matters formerly part of the whole board’s collective responsibility

> Provide the audit committee, and in particular its chairman, with sufficient discrete defences to allow them to undertake their more extended responsibilities.

Keeping the flow with new members
To the question, ‘is there a sufficient supply of skills for audit committee roles in your jurisdiction?’, the response, in relation to larger corporations, was that notwithstanding all the apparent risks that a board director might face there were significant numbers of people with a variety of operational and professional skills prepared to seek board roles.

In the UK there was a perception that it was becoming more difficult to recruit currently-serving chief financial officers to sit on audit committees because of the time commitment needed, but otherwise recruitment of suitable board members who could serve on the audit committee was not seen as a problem.

There is a clear recognition among interviewees in Australia that smaller companies may face difficulties in recruiting the right quality of audit committee member. Potential candidates were not always attracted to the boards of such companies, with the result that there was a potential or an actual shortage, both in terms of technical and professional skills useful to those boards and, more importantly, breadth of board experience. It was considered unlikely that regulation could provide any effective way of compensating for this skills gap.

As already noted, a key challenge facing all companies is how to introduce new blood and deliver a next generation of board members and audit committee members with the skills and experience to run those roles effectively. This is an area for further experimentation and consideration.
Quality of information

A principal challenge facing audit committees is the quality of the information they receive. Views were mixed on whether the information currently provided was fit for purpose. For example, most UK interviewees were satisfied on this score, but all interviewees agreed that an audit committee is only as good as the information at its disposal.

There is an imperative that audit committees undertake all reasonable steps to ensure they have access to the ‘right’ information, in an appropriate form and on a timely basis. This encompasses formal reports and presentations, but also informal discussions with management and professional development activities for audit committee members.

The ways in which interviewees deal with this challenge include:
> Effective involvement in the selection of key reports, from external and internal audit and the chief financial officer in particular
> Effective questioning of reports and information both during and outside of audit committee meetings
> Free and open discussion in meetings
> The use of pre-meetings to identify issues for discussion and sometimes to deal with routine matters
> Effective communication with auditors and executives, including access to management below the senior executive team
> Developing committee members’ understanding of the business, for example through site visits.

In some cases, where a board had grown accustomed to delegating almost all the responsibility for financial reporting matters, audit committees faced the challenge of increasing board engagement and board understanding of major financial reporting issues.

Knowledge of accounting standards

While there is much discussion within investment and financial circles about the complexity of international accounting standards, these complexities are seen as part of life by the interviewees. There was a broad consensus that all board members should have an understanding, not in detail but in principle, of the interaction between those standards and the transactions that their companies were undertaking. Each company appeared to have developed different processes to achieve that level of board awareness.

However, there was at least one dissenting voice who considered that the fact that most current non-executive directors were of a generation who were not brought up with International Financial Reporting Standards created difficulties, as it made them too reliant on management and the external auditor.
Reflections and questions

What is clear from all interviewees is that the audit committee chairman’s role is critical to the effective workings of an audit committee. Each audit committee will function differently depending on the company’s business, the composition of the board and the committee, the quality of management and internal processes. This series of interviews did, however, identify some universal questions to be answered by audit committee chairmen:

> How do you keep the board fully informed?
> What sorts of reports should be given to the board before they are asked to approve financial statements?
> Should those reports come from the audit committee chairman or management?
> How do you ensure the audit committee and the board are up to speed with the changing regulatory framework?
> How do you ensure you get the best out of the external auditor?
> How often should the audit committee meet with the external auditor?
> How do you best deal with commentary from the external auditor that may be critical of management?
> How do you ensure you get the best from the internal auditor?
> How do you ensure you get the best out of the audit committee members?
> How do you ensure diversity of membership across the audit committee?
> How do you ensure frank and open discussions in audit committee meetings?

Resources
frc.org.uk
icas.org.uk
kpmg.co.uk/aci
charteredaccountants.com.au
companydirectors.com.au
asic.gov.au
Appendices

Appendix 1

Questions used as basis of meetings and telephone interviews:

> How would you define your role?
> How should your role discharge its obligations to the board (however they are defined)?
> In whose interests is the audit committee acting?
> What is the proper relationship between the audit committee and the rest of the board?
> What are the skill requirements of an audit committee?
> How should audit committees identify risk? For example, what regular reports should be available to audit committees (external and internal auditors, compliance reports and reports from chief financial officer/chief executive officer)?
> To what extent should the audit committee have responsibility for reviewing all material activities and transactions and management’s assessment of the financial risks in those transactions – and reporting thereon to the board?
> What part should audit committees play in the appointment of the chief financial officer, internal auditors, and external auditors?
> Should audit committee chairmen have a governance responsibility to meet with investors?
> Should the audit committee be limited to consideration of financial reporting matters or should it also consider other audit/financially related risks?
> What are the main challenges facing audit committees?
Appendix 2

All discussions in interviews and meetings were held under a modified version of the Chatham House Rule, whereby views expressed during private discussions are not attributed to individuals or their organisations.

Participants included:

Geoff Brayshaw  
Fortescue Metals Group

Jann Brown  
Cairn Energy, Hansen Transmissions International

Angus Cockburn  
Aggreko, Howden Joinery Group

David Crawford  
BHP Billiton, Lend Lease

Andrew Dougal  
Carillion, Premier Farnell, Creston

Paulett Eberhart  
CDI Corporation, Anadarko Petroleum Corporation, Advanced Micro Devices, Inc

Alan Ferguson  
Johnson Matthey, Croda International, Weir Group

David Gonski  
ASX Group, Coca-Cola Amatil, Singapore Airlines

Djunaedi Hadisumarto  
National Development Planning Agency (Bappenas)

Philip Hodkinson  
BT Group, Resolution, Travelex Holdings

Mark Johnson  
PwC

Brian Long  
Commonwealth Bank of Australia

Iain Mackay  
HSBC

Lindsay Maxsted  
BHP Billiton, Westpac Bank, Transurban

Anne McDonald  
GPT Group, Spark Infrastructure Group, Specialty Fashion Group

Iain McLaren  
Cairn Energy, Baillie Gifford Shin Nippon

Dave Merritt  
Charter Communications Inc, Calpine Corporation, Outdoor Channel Holdings Inc, Buffets Restaurants Holdings Inc

Brendan Nelson  
BP, RBS

John Ormerod  
ITV, Misys, Computacenter, Gemalto NV, Tribal Group

Kieran Poynter  
International Consolidated Airlines SA, Nomura, British American Tobacco, F&C Asset Management

Mark Rolfe  
Sage Group, Barratt Developments, Hornby, Debenhams

Nick Rose  
BAE Systems

Fergus Ryan  
Commonwealth Bank of Australia, Australian Foundation Investment Company

Brian Schwartz  
Brambles, Westfield Holdings, Football Federation Australia

Lim Swee Guan  
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