

## CHAPTER 10

### AUDIT COMMITTEE

*Listed companies should be required by law to establish an audit committee*

10.1 An amendment moved in the Senate during debate on the Company Law Review Bill 1997 concerned the requirement that listed companies must establish an audit committee.<sup>1</sup>

10.2 The amendment reads as follows:

#### **Audit committees**

- (1) The Directors of a listed company must establish and maintain an audit committee with functions that include:
  - (a) assisting the directors of the company to ensure that financial reports comply with the requirements of this Law; and
  - (b) assisting the directors of the company to ensure that the company at all times has a proper system of management and financial controls; and
  - (c) providing a forum for communication between the directors, the senior managers of the company and auditors of the company.
- (2) A majority of the members must be persons who are not executive officers of the company.
- (3) An audit committee must be established and maintained on such a basis that a meeting cannot be held unless there are at least 2 members who are not executive officers of the company.
- (4) The chair of an audit committee must be a member who is not the chair of the board of directors of the company.

10.3 Few submissions to the PJSC supported a requirement in the Corporations Law for listed companies to establish an audit committee.

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<sup>1</sup> Hansard, *Senate*, 24 June 1998, P3585.

## **Arguments in favour of a statutory requirement for listed companies to establish an audit committee**

### *The consequences of inadequate audit systems*

10.4 The PJSC was told that it was preferable for listed companies to determine their own arrangements regarding auditing. On balance, however, the deficiencies with auditing were such that a compulsory audit committee should be considered. Such a committee should consist of independent, non-executive directors with sole power to appoint the auditor and with sole responsibility for the auditor and audit:

On the other hand, with the failure of many public companies toward the end of the eighties and the beginning of the nineties, billions of dollars have been lost by investors and creditors. Many of these losses were caused to some degree by inadequate audit and judgments have been given. Many are alleged to have been caused by inadequate audit, and litigation is still continuing. The mistakes by auditors in court judgments, or Royal Commission Reports are egregious, and could not have happened except for overweening influence exercised on the auditor by management. That is, the auditor did what he was told, otherwise he would lose his appointment.<sup>2</sup>

### *Improving company efficiency*

10.5 The PJSC was told that the establishment of an audit committee comprising non-executive directors would increase public confidence in the company. It would ensure that the company was operating within the appropriate legal framework and that adequate controls were in place to prevent fraud, embezzlement and other criminal conduct. An audit committee would also give advice on improvements in company efficiency. While some costs would be incurred the benefits gained from an effective audit committee will exceed the costs.<sup>3</sup>

### *Composition of audit committees*

10.6 Arthur Anderson submitted that all listed companies should be required to establish an audit committee but its effectiveness depended on the presence of a significant number of independent, non-executive directors with relevant financial expertise. Arthur Anderson noted that the auditor should be able to

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2 Mr John Wilkin, Submission 21, p 8.

3 Mr Stan Rogers, Submission 8, pp 1-2.

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communicate with the main board irrespective of the presence of an audit committee.<sup>4</sup>

*No exceptions to requirement*

10.7 The Accounting Bodies submitted that the requirement should apply to all listed companies irrespective of the size of the company. Where it is impracticable for a company to establish an audit committee, the duties of an audit committee should be undertaken by the entire board:

In terms of audit committees, the accounting bodies support the concept that listed companies should be required to establish audit committees and that this should be best practice for other forms of disclosing entities. This would also bring Australia into line with the requirements in major overseas jurisdictions in capital markets where mandatory audit committees are a requirement. In situations for perhaps the smaller listed companies which may run the argument that it may be impractical or inappropriate to establish a separate audit committee, we believe that the board, as a whole, could really undertake the functions that an audit committee would ordinarily perform.<sup>5</sup>

**Arguments against a statutory requirement for listed companies to establish an audit committee**

*Requirement not appropriate given the diversity of companies*

10.8 The Australian Law Reform Commission (ALRC) noted that a statutory requirement for all listed companies to establish an audit committee would be costly and unnecessary for some companies. The appropriateness of an audit committee for a listed company depended on the company's size, structure, diversity and area of operation. For some companies, it would be redundant or of very limited value. The ALRC preferred the alternative of requiring listed companies which choose not to have an audit committee to report that fact and to describe the internal audit and accountability processes that render an audit committee unnecessary.<sup>6</sup>

10.9 The Australian Stock Exchange (ASX) opposed the requirement for an audit committee. Given the amendment provides for the appointment of at least two non-executive directors, the ASX advised that this would impose a

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4 Arthur Anderson, Submission 22, pp 1-2.

5 Mr Gerard Meade, Committee Hansard, 16 June 1999, p 27. See also Joint Submission by the Australian Society of CPA and the Institute of Chartered Accountants in Australia, Submission 73, p 4.

6 Australian Law Reform Commission, Submission 10, p 5. See also Preuss Feinauer and Associates, Submission 27, p 2.

substantial cost burden on the majority of small to medium sized listed companies.<sup>7</sup> The ASX argued that emphasis should be placed on greater disclosure rather than the prescription of specific governance structures, which took no account of the differing circumstances of listed companies.<sup>8</sup>

10.10 The Association of Mining and Exploration Companies Inc (AMEC) also opposed a statutory requirement on the grounds that it was contrary to the corporate law simplification process. Further, AMEC pointed out that in small companies audit matters are addressed by the board. On the other hand, many larger companies have voluntarily established audit committees.<sup>9</sup>

*Present arrangements are adequate*

10.11 The Accounting Association of Australia and New Zealand (AAANZ) did not support a requirement that listed companies establish an audit committee, preferring measures to ensure the independence of the auditor:

It is unclear, however, whether the requirement is necessary. The current Australian Stock Exchange disclosure requirements, which require reporting entities to disclose specific details concerning their audit committee, or disclose the reasons why an audit committee has not be formed, appears to work well in practice.<sup>10</sup>

10.12 The Australian Listed Companies Association Inc advised that PJSC that the top 200 companies already have an audit committee. Many of the other thousand or so other listed companies often have only 3 to 4 directors who act as the audit committee.<sup>11</sup> Similarly, the Group of 100 Inc did not believe there are compelling reasons to mandate existing arrangements without proper due process.<sup>12</sup>

10.13 The Law Society of Western Australia noted that the present arrangements are flexible and take account of the diversity of listed companies:

There is always a difficulty in trying to find a one-size-fits-all solution for companies that range from junior Western Australian

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7 Australian Stock Exchange, Submission 44, p 9. See also KPMG, Submission 71, pp 3-4.

8 Australian Stock Exchange, Submission 44, p 10.

9 Association of Mining and Exploration Companies, Submission 45, p 3.

10 Accounting Association of Australia and New Zealand, Submission 16, p 2. See also Australian Institute of Company Directors, Submission 47, p 5; Investment & Financial Services Association Ltd, Submission 34, pp 8-9; Mr Tim Hammon, Committee Hansard, 17 August 1999, pp 270-71 and Mr Ted Rofe, Committee Hansard, 18 August 1999, p 308.

11 Australian Listed Companies Association Inc, Submission 66, p 3. See also Mr Rick Crabb, Committee Hansard, 16 August 1999, p 180.

12 Group of 100 Inc, Submission 15, p 1. See also the Chartered Institute of Company Secretaries in Australia, Victoria Branch, Submission 24, p 3.

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explorers to the BHPs, Tesltras and so on. A general statement requiring fairness and equality of opportunity and then leaving the company to work out a system within that is probably the best solution, until it is proven that that does not work. One then needs to get more prescriptive.<sup>13</sup>

### *Diminution of board responsibilities*

10.14 The Law Society of Western Australia cautioned that the introduction of a statutory requirement for an audit committee would inevitably lead to the diminution of the main board's responsibilities in reviewing the effectiveness of internal controls. The audit committee functions would therefore need to be carefully defined:

**Mr Young**-I have come to the view that it is inevitable that the audit committee takes a wider role. I suppose it therefore follows that if the audit committee is mandated then, to a degree, the role is mandated and that could be a wider role than merely technical. You would have to be careful in deciding how wide that role is, otherwise I think you have some potential for taking from the board what is the board's responsibility generally within the myriad of control mechanisms that exist.

The audit committee is always a committee of the board. It only recommends to the board; it investigates on behalf of the board; it gets its hands dirty, if you like, for the board-so the board knows that somebody has done it. It is not in any way superior to the board; it is a creature of the board. The design criteria would have to be very carefully worked out.<sup>14</sup>

### *ASX Indicative List of Corporate Governance Matters*

10.15 As noted in Chapter 9 of this Report, the Appendix 4A of the ASX's Listing Rules provides an indicative list of corporate governance matters when companies prepare a statement for the purposes of Listing Rule 4.10.3. The seventh item on the ASX's *Indicative List of Corporate Governance Matters* requests disclosure of the main procedures that a company has in place for the nomination of external auditors and for reviewing the adequacy of existing external audit arrangements, with particular emphasis on the scope and quality of the audit.

If any of these procedures involves an audit committee, a summary of the committee's main responsibilities and rights, and the names of

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13 Mr Grahame Young, Committee Hansard, 16 August 1999, p 166.

14 Mr Grahame Young, Committee Hansard, 16 August 1999, p 172.

committee members. If one or more members are not directors of the company, their positions in the company.

10.16 The accompanying ASX Guidance Note further provides that:

It is considered best practice for a company with an audit committee to state its policy regarding the committee's composition. Furthermore, there is considerable support in guides to best practice for the proposition that audit committees should be comprised of a majority of non-executive directors (preferably independent directors), including an independent chair (who is preferably not chairman of the board). Where executives participate in audit committee discussions, it is normally considered appropriate that, at a minimum, non-executive directors on the committee should have an opportunity to discuss matters with the auditors in the absence of members of management.<sup>15</sup>

10.17 ASX Listing Rule 4.10.2 requires companies without audit committees to disclose the reasons for not having such a committee. According to the ASX, a common explanation by smaller companies is that a separate audit committee cannot be justified on the basis of a cost-benefit analysis. In some cases smaller companies have advised the ASX that certain practices are considered inappropriate for that company.<sup>16</sup> This conclusion was supported by a survey of large, medium and small West Australian listed companies undertaken in 1995 which was presented to the PJSC for its consideration.<sup>17</sup> Of the 16 companies surveyed, 10 were small companies with a market capitalisation of less than \$250 million and a workforce of less than 1,000.<sup>18</sup>

10.18 The survey found that the size of each company's board had considerable influence on the composition of the audit committees and consequently the number of directors available for selection. For the large companies there was awareness of a need to only use non-executive directors on the audit committee. A typical audit committee comprised 4 non-executive directors (2 with an accounting background) and by invitation, the external auditor, company secretary, chief accountant and executive finance director or managing director.<sup>19</sup> On the other hand, for the small listed companies all audit committees were either made up of either solely non-executive directors or the

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15 ASX Guidance Note: Disclosure of corporate governance practices: listing rule 4.10, para 30.

16 ASX Guidance Note: Disclosure of corporate governance practices: listing rule 4.10, para 31.

17 See Mr Laurie Factor, Committee Hansard, 16 August 1999, p 129.

18 Mr Laurie Factor, "Corporate Governance Practices of Listed Companies in WA", *Australian Journal of Corporate Law*, Vol 6 No 3, October 1996, pp 380-409.

19 Mr Laurie Factor, "Corporate Governance Practices of Listed Companies in WA", *Australian Journal of Corporate Law*, Vol 6 No 3, October 1996, pp 391.

board as a whole fulfilled this role. The committee memberships were as follows (E = executive director; N = non-executive director):<sup>20</sup>

Board 1E/2N - Audit Committee 2N  
 Board 1E/3N - Audit Committee 2N  
 Board 1E/3N - Audit Committee 2N  
 Board 1E/3N - Audit Committee 3N  
 Board 1E/3N - Audit Committee All directors  
 Board 2E/2N - Audit Committee 2N  
 Board 2E/2N - Audit Committee All directors  
 Board 2E/3N - Audit Committee 2N  
 Board 2E/3N - Audit Committee All directors  
 Board 1E/6N - Audit Committee 2N

10.19 The problem for small companies was the size of their boards which did not consist of enough non-executive directors with an adequate experience range to properly staff an audit committee. Small companies considered their best interests lay in appointing directors from their field of business, not in satisfying a regulatory perception. The survey concluded that:

It was a strongly held view by small companies that this committee was not appropriate for their size of company. The only function of their audit committees was to act as a reviewer of financial statements. There was no capacity to properly assess the scope or quality of the audit. There was great reliance upon the auditor for complete advice in this field.<sup>21</sup>

#### *Low levels of disclosure*

10.20 An article authored by Ms Tracie Arkley-Smith, a Lecturer at the School of Accounting, Charles Sturt University, was also submitted for the PJSC's consideration.<sup>22</sup> The article reported a study by the same author of audit committee disclosures in the annual reports of 310 listed companies for the 1996 financial year.

10.21 The functions of an audit committee most frequently disclosed in the annual reports were an overview of the financial reporting process (38%), monitoring the activities of the external auditor (32%) and reviewing the effectiveness of the control environment (24%). The two functions, which were least frequently disclosed, were the frequency of meetings with the external auditor (1%) and recommendations on appointment and remuneration of the

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20 Mr Laurie Factor, "Corporate Governance Practices of Listed Companies in WA", *Australian Journal of Corporate Law*, Vol 6 No 3, October 1996, pp 392.

21 Mr Laurie Factor, "Corporate Governance Practices of Listed Companies in WA", *Australian Journal of Corporate Law*, Vol 6 No 3, October 1996, p 406.

22 Ms Tracie Arkley-Smith, "Audit committee disclosure: time to regulate?", *Australian CPA*, August 1999, pp 36-39.

external auditor (1%). The study found that larger listed companies disclosed more information than smaller companies.<sup>23</sup> The conclusion reached in the article was that the low level of disclosure of information on audit committees might lead to a loss of confidence in audit committees as a monitoring mechanism. The study did not recommend a statutory requirement for audit committees but the legal enforcement of disclosure of information on audit committees for large companies.

10.22 The results of the study are shown below:<sup>24</sup>

### **Audit Committee disclosures**

| Disclosure   | per cent of companies disclosing |
|--|----------------------------------|
| Number of non-executive directors  | 54.35                            |
| Terms of reference of committee  | 42.26                            |
| Duties include overview of financial report process                          | 38.06                            |
| Duties include monitoring the external auditor                               | 31.61                            |
| Duties included reviewing the effectiveness of control                       |                                  |
| Environment  | 23.87                            |
| Duties include monitoring the internal auditor                               | 16.77                            |
| Frequency of meeting with external auditor                                   | 00.84                            |
| Duties include recommending appointment and remuneration of external auditor | 00.68                            |

### **Conclusions**

10.23 The PJSC was told that the size and complexity of the listed company should determine whether a separately constituted audit committee was required. A large number of listed companies at present have an audit committee that has been delegated authority to review the audit process, both internal and external. The terms of reference for the audit committee encompass the review of half yearly and annual financial statements, the scope

23 Ms Tracie Arkley-Smith, "Audit committee disclosure: time to regulate?", *Australian CPA*, August 1999, p 38.

24 Ms Tracie Arkley-Smith, "Audit committee disclosure: time to regulate?", *Australian CPA*, August 1999, p 38.



of the internal and external audit, setting of audit fees, and review of directors' questionnaires to management. However, as witnesses told the PJSC, for most small to medium sized companies the requirement would be costly, impracticable and redundant. With only three or four directors acting as the board smaller listed companies would not be able to meet the requirement for an audit committee to have at least two non-executive directors and an independent chair. In the view of the PJSC the imposition of a mandatory audit committee for all listed companies is not justified.

10.24 The PJSC believes that it is essential that an audit plan is adequate to the company's circumstances and that the independence of the auditor should be encouraged. Communication between the auditor, the non-executive directors and the main board is also important. In the absence of an audit committee, a board would need to have other mechanisms in place to reassure shareholders and potential investors of the quality of the audit and the adequacy of the company's financial statements. The purpose of disclosing information on audit committees, or where the board as a whole undertakes this role, is to ensure that audit committees are, and are seen to be, operating independently and effectively.

10.25 The requirement for listed companies to establish an audit committee is addressed in the ASX Listing Rules. In the view of the PJSC, ASX Listing Rules 4.10.2 and 4.10.3 and the Guidance Note deal more than adequately with the functions and composition of an audit committee and, in terms of best practice, provide the same level of monitoring and accountability as sought under the proposed amendments. In fact the ASX Guidance Note goes much further. It requests companies to state their policy regarding the composition of the audit committee. However, the PJSC was not persuaded that the Law should regulate the disclosure of information on audit committees in annual reports. The diversity, size and circumstances of listed companies makes this proposal impracticable. Any low level of disclosure in annual reports is a matter that should be addressed in the first instance by the ASX and its contracting parties.

### **Recommendation**

10.26 The PJSC recommends that the Corporations Law should not require listed companies to establish an audit committee.