CHAPTER 8

AUDIT COMMITTEES

8.1 One way in which a board of directors can better focus on particular issues is to set up committees of the board to examine them and report back. A committee charged with a specific responsibility can more efficiently deal with an issue than a meeting of the whole board. For example, the board of Mayne Nickless Limited has a superannuation committee, a remuneration committee and a committee responsible for donations, sponsorships and community activities.[1]

8.2 One major task suitable for committee work is the scrutiny of financial matters. Committees constituted for this role are commonly called audit committees.

8.3 Audit committees, like other committees of the board, allow directors to examine particular issues in greater detail than would be possible for the whole board. They are a way of bringing to the board's attention and, possibly, shareholders' attention, details of matters which should be considered by them.[2]

8.4 In 1979, Mr Spender QC wrote that audit committees were 'little heard of in Australia'.[3] The Committee is unable to judge the extent to which audit committees are used by corporate boards in Australia today, although it appears to be less than in the United States and Canada. Mayne Nickless told the Committee that

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1. *Evidence, p 442 (Mr Webber).*
2. *Evidence, pp 148-9 (Mr Harper).*
3. *Corporate Affairs Commission (NSW), Final Report into the Affairs of Gollin Holdings Ltd and Gollin Nominees Ltd, Parliamentary Papers (NSW) 1978-79, vol 2, p 1231 (Gollin Report) at p 1255.*

'many companies' now use audit committees.[4]

8.5 The Committee was told that the New York Stock Exchange (which 'essentially sets the rules for the United States listing of companies') requires companies it lists to have audit committees.[5] It was suggested this requirement was introduced to strengthen the role of auditors in a situation where, unlike Australia, companies report financial information pursuant to accepted standards rather than statutory requirements.[6] In Canada, public companies are required by statute to have audit committees.[7]

8.6 There are proposals in the United Kingdom (where, until recently, approximately only 36% of directors were non-executive directors) to require companies with a majority of executive directors to appoint audit committees with at least a majority of non-executive directors.[8]

8.7 An audit committee is normally a standing committee of the board. It usually consists of, or has a majority of, non-executive directors - that is, people not involved in the day-to-day management of the company - and in its deliberations meets with the company's auditors and financial managers. The basic responsibilities of an audit committee might include:

- reviewing financial information to ensure that it is accurate and timely and includes all appropriate disclosures;
- ensuring that effective accounting and financial controls exist and are operating effectively;

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4. *Supplementary submission from Mayne Nickless Ltd, p 3 (Evidence, p 411). Also see Evidence, pp 148 (Mr Harper), 440 (Mr Webber).*
5. *Evidence, p 12 (Mr Richardson); see also submission from Peat Marwick Hungerfords, p 3 (Evidence, p 5); Gollin Report, p 1256.*
6. *Evidence, p 12 (Mr Richardson).*
7. *Canada Business Corporations Act 1975, s 165.*
8. *Submission from the NCSC, p 4 (Evidence, p 563).*

- overseeing the audit of the company (both external and internal, if there is an internal audit programme), including nominating the auditors, approving the scope of the audit and examining the results;

- providing links between the auditors and the board; and

- helping to ensure that decisions are made at appropriate levels in the company.[9]

8.8 An example of an audit committee was provided by BHP:

> BHP's Audit Committee is constituted by 4 non-executive directors. The Committee meets as required, usually 6 times a year in advance of scheduled meetings of the Board. The Committee reviews in detail accounting and audit matters which are to go before the Board. It settles the form of a Directors' Questionnaire to Management which is issued each year to managers throughout the Company and it reviews the responses. The questionnaire is directed to facts and issues forming the basis of the annual accounts. The Committee reviews the annual accounts, it periodically reviews the work of the Internal Audit Group and it deals with questions relating to the external auditors. An important feature of the Committee's role is that it has direct access to senior financial executives, the internal auditor and the external auditors. The Executive General Manager Finance (an executive director) and the General Manager Accounting attend the Committee's meetings by invitation, as does the Internal Auditor when required, and other senior executives attend from time to time for items relevant to their responsibilities. The Committee is able to question relevant company executives in detail. The external auditors attend meetings when the annual accounts are being considered and when otherwise appropriate. The non-executive members are able to discuss issues with the auditors, both internal and external, in the absence of the

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9. *These points are drawn from the submission from Peat Marwick Hungerfords, p 3 (Evidence, p 5), and from the Gollin Report, p 1256.*

executive officers.[10]

8.9 It is important to remember that matters examined by an audit committee remain the responsibility of the whole board.[11] However, as BHP pointed out, an audit committee

> is able to provide the Board with greater assurance about the effectiveness and integrity of accounting systems and performance within the Company.[12]

8.10 Several advantages have been identified as flowing from the use of audit committees.[13]

- The quality of accounting and financial control clearly can be improved.
- The integrity and credibility of financial reports, and thus public confidence in the company, can be enhanced.
- Directors' awareness of their legal responsibilities is increased, and the committee can assist directors in meeting those responsibilities.
- The role of non-executive directors is strengthened by having access to information other than through auditors and financial managers. They no longer have to rely on senior management for this information.[14]
- The position of the auditors is strengthened because better

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10. *Submission, para 27 (Evidence, pp 610-11).*
11. *See, eg, Evidence, p 149 (Mr Harper).*
12. *Submission, para 28 (Evidence, p 611).*
13. *These points are drawn mainly from submissions by Peat Marwick Hungerfords, p 3 (Evidence, p 5) and Australian Shareholders' Association Ltd, p 4; the Gollin Report, p 1256; and Priddice, JA and Seaman, RF, Corporate Audit Comittees: A Guide for Directors, CCH Australia Ltd, Sydney, 1981, p 2.*
14. *See, eg, Evidence, p 440 (Mr Webber).*

communication between the auditors and the directors is facilitated. (It was suggested to the Committee that auditors' independence is in many cases 'a myth',[15] as the auditors will often belong to a firm which relies on the company for work. If the auditors are able to bring matters which worry them to the attention of the board through an audit committee comprised of non-executive directors, a measure of independence may be restored.)

- The accountability of executives to boards is strengthened.

8.11 Audit committees are not necessarily a panacea for all problems relating to financial scrutiny. An audit committee does not relieve directors of the responsibility of satisfying themselves that the company's accounts are in order. Its effectiveness may be limited by practical factors. The functions an audit committee can perform will depend on the skills of its members and the amount of time they are able to devote to it. In a large corporation with a complex financial structure, thorough scrutiny of the accounts can become an onerous task for a group of non-executive directors whose commitment to the company is a part-time one. Directors will often lack the skills of auditors. They may not be able to ask the appropriate questions in many instances. The audit committee must therefore rely on the company's internal and external auditors to bring problems to its attention.[16]

8.12 An audit committee might even cause problems. Where its functions are ill-defined, it can encroach on areas which are the proper province of management. This may impair efficiency. If the purposes of the audit committee are not properly explained, managers may gain the impression that its existence is a reflection on their competence or integrity.[17]

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15. *Evidence, pp 360-61 (Professor Baxt).*
16. *Evidence, p 149-50 (Mr Head, Mr Harper).*
17. *Gollin Report, p 1257.*

8.13 The NCSC said the need for audit committees in Australia is 'less compelling' than elsewhere, 'as over 70% of Australian directors are non-executive directors'.[18]

8.14 The Committee considers that the potential drawbacks of audit committees are outweighed by their advantages. Most members of the Committee also see some advantages in legislatively prescribed standards for the establishment and operation of audit committees. Some writers have argued that an audit committee's field of inquiry should be limited to that determined by the board, and that its establishment should be encouraged rather than enforced.[19] The Committee considers that the community will benefit most where corporate audit committees are required to be established by listed companies and if their operations are reasonably uniform.

8.15 The Committee therefore recommends that:

(i) **the establishment of an audit committee be made a requirement for public listing of a company;**

(ii) **the chairperson and a majority, or all, of the members of the audit committee be non-executive directors;**

(iii) **the audit committee be required to meet regularly and report to the board;**

(iv) **the audit committee have direct access to the company's auditors (internal and external) and senior managers, and the ability to consult independent experts where**

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18. *Submission, p 4 (Evidence, p 563).*
19. *Priddice, JA and Seaman, RF, Corporate Audit Committees: A Guide for Directors, CCH Australia Ltd, Sydney, 1981, p 6; Gollin Report, p 1257 (although Mr Spender did suggest that audit committees should be required by legislation if companies had not adopted them of their own accord within a reasonable time).*

necessary; and

(v) as a high but lesser priority, similar requirements be introduced for larger non-listed companies.

8.16 The Committee recommends that **audit committees have the following functions:**

(i) reviewing financial information to ensure its accuracy and timeliness and the inclusion of all appropriate disclosures;

(ii) ensuring the existence and effective operation of accounting and financial controls;

(iii) overseeing the audit of the company, including nominating the auditors, approving the scope of the audit and examining the results;

(iv) providing a link between the auditors and the board; and

(v) any other functions allocated to it by the company, provided that the extra functions do not compromise its ability to perform the tasks set out in paragraphs (i)-(iv) above.

8.17 Smaller unlisted companies will in many cases have too few directors for an audit committee to be feasible, or will have accounts which are too simple for one to be necessary. The Committee recommends that **smaller unlisted companies be encouraged to set up audit committees, or, in the absence of an audit committee, have auditors present at board meetings which approve financial statements prior to their distribution to shareholders.**

8.18 In the Committee's view, this encouragement should be part of the education of company directors. Education should cover the role of audit committees and their advantages, and also the possible disadvantages to which directors must be alert.

8.19 The establishment of audit committees may well encourage the development of a code of ethics for directors. Audit committees are formed by the directors and it is the directors who must see to the proper running of the company. This requires that they take a conscious and active role in the company's affairs. Audit committees will provide one means of playing this role.

Corporate senates

8.20 The question of corporate senates was raised with the Committee by Mr Shann Turnbull.[20] Mr Turnbull said that a corporate senate was 'simply' a committee of company shareholders elected on the basis of one vote per shareholder, rather than one vote per share.[21] Its function would be to resolve all issues where there was a conflict of interest between the directors and the shareholders. The example that Mr Turnbull gave related to takeovers. He said:

> The principle of one vote per constituent is a fundamental requirement of political democracies and co-operative enterprises.[22]

8.21 Mr Turnbull suggested the corporate senate as an alternative to an audit committee. He suggested that a corporate senate was preferable because

> [a] fundamental flaw in the U.S. concept of an Audit committee is that it is a sub-committee of the Board appointed by the Board of

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20. *Paper entitled 'Self-regulation for Privatised Structures', delivered to a Company Directors' Association of Australia seminar on privatisation, 22 September 1987 (attached to submission from Mr Turnbull).*
21. *Attachment to submission, p 6.*
22. *Attachment to submission, p 6.*

> Directors. It is not appointed by the shareholders. U.S. Audit Committees thus do not have an independent bargaining position to control directors who are determined to 'cook the books' or just present financial reports in a way which makes themselves or their deals look better. The Directors are thus both 'players' and controllers of the 'score board'.[23]

8.22 According to Mr Turnbull, audit committees in Australian corporations are even worse off, because Australian directors are not subject to class actions.[24]

8.23 Mr Turnbull suggested that the 'fundamental flaw' he described (see paragraph 8.21) was overcome either by electing the audit committee or by having a corporate senate.[25]

8.24 Mr Turnbull suggested that many of the conflicts of interest between directors were

> created by the power, prestige and financial rewards available to directors which they seek to increase or just maintain, at the expense of shareholders.[26]

8.25 This conflict was most evident in takeover situations, which Mr Turnbull suggested should be resolved by a corporate senate. He also nominated levels of directors' fees, appointment of auditors, determination of accounting policies and appointment of financial advisers as matters appropriately dealt with by a corporate senate.[27] He suggested that a general requirement to consult the senate should apply to 'any proposals in which the directors have a beneficial interest or which would entrench their position as a director or officer'.[28]

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23. *Attachment to submission, p 6.*
24. *Attachment to submission, p 6.*
25. *Attachment to submission, p 6.*
26. *Attachment to submission, p 7.*
27. *Attachment to submission, p 6.*
28. *Attachment to submission, p 6.*

8.26 Mr Turnbull suggested that the corporate senate would have no management powers and it would not be able to initiate action, except to report to shareholders.[29] He said that the increase in employee participation, through owning shares, was a further reason for such a body, to encourage participation in the company.[30]

8.27 Mr Turnbull saw it as an important factor in the deregulation and privatisation debates. He suggested that the establishment of a self regulatory procedure such as a corporate senate should be a condition precedent to deregulation.[31]

8.28 Mr Turnbull also suggested that by requiring the establishment of a corporate senate as a pre-condition to privatisation

> governments could provide leadership to the private sector on initiatives for encouraging greater employee participation and corporate self-regulation.[32]

8.29 Mr Turnbull's criticisms of audit committees, as being merely sub-sets of the people they seek to scrutinise, is understood, but evidence before the Committee shows that audit committees work effectively, both here and overseas. The concept of a corporate senate does not readily fit with the existing law regulating companies, and much more analysis of the proposal would be needed before any final conclusion is reached.

Stakeholder councils

8.30 Mr Turnbull also raised the issue of stakeholder councils. He suggested that a stakeholder council would be

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29. *Attachment to submission, p 7.*
30. *Attachment to submission, p 1.*
31. *Attachment to submission, p 1.*
32. *Attachment to submission, p 8.*

elected by 'suppliers, customers, users, employees and the host community'.[33] It would have the power to nominate individuals for election to the board, but the shareholders would retain the right to appoint or not.[34]

8.31 Mr Turnbull said:

> An important consequence of introducing Stakeholder Councils would be in protecting the environment. This would arise from the stakeholders being those people who would be most adversely affected by any environmental degradation created by the company or its products. Indeed, stakeholders could be defined to be anybody on which the enterprise made an impact.[35]

Mr Turnbull suggested that the concept of a stakeholder council, if universally adopted,

> would provide the means for de-regulation of government involvement in consumer, creditor, employee and environmental protection.[36]

8.32 In a letter to the Australian Financial Review, Mr Turnbull suggested that the concept of stakeholder councils was developing overseas

> with corporations who seek to integrate their operations with their customers to improve their products and after-sales service.[37]

8.33 Mr Turnbull suggested that stakeholder councils were a means of providing expert advice to directors, independent of management.[38]

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33. *Attachment to submission, p 8.*
34. *Attachment to submission, p 8.*
35. *Attachment to submission, p 9.*
36. *Attachment to submission, p 8.*
37. *Australian Financial Review, 17 April 1989, p 15.*
38. *Ibid.*

8.34 The Committee expresses no view on this suggestion, noting that there is nothing that would prevent a corporation from adopting such a scheme if it were considered worthwhile. The Committee has not taken the matter further because it does not directly deal with directors' duties.