

AuditQuality®

Evolution Impact of audit committees on auditing Background paper

General

The concept of the audit committee is now well established in many countries around the world. Over the last twenty years, the evolution of the audit committee has largely been driven by developments in the UK and the US. Although there are significant differences between the two countries in their regulatory and corporate governance frameworks, there are many similarities on matters related to the role of audit committees.

In a broader context, one area of current difference between the UK and the US is that shareholders in UK listed companies are able to play a more active role in corporate governance, primarily based on their entitlements in company law. UK audit committees are sub committees of boards and carry out a specialist function. In the US, they act more as a proxy for shareholders. As such, shareholders in UK listed companies have a much greater ability to influence and to hold boards to account and this can lead to different perceptions in the role of the audit committee.

In the European context, the audit committee concept has been accepted in many European Member States. Audit committees are widely recommended in the codes of corporate governance issued in various Member States. In addition, all Member States will during the course of the next year be implementing the requirements on audit committees contained in Article 41 of the Statutory Audit Directive. Many of the Directive's requirements are aligned with existing parts of the UK's framework for audit committees.

The UK

The concept of the audit committee has existed in the UK since the 19th century. Early audit committees performed functions that are now carried out by external auditors. As the accountancy profession grew, audit committees started to manage the relationship with the external auditors rather than undertaking an audit themselves.

The Code of Best Practice of the Cadbury Committee (1992) elevated the role and status of the audit committee. Soon thereafter almost all of the FTSE 350 and many others companies listed on the Primary Market of the London Stock Exchange had an audit committee.

In 2003, an updated Combined Code on Corporate Governance was produced. Section C.3 of the Code, entitled *Audit Committee and Auditors*, includes one main principle that companies apply and seven provisions with which they comply (or provide a suitable explanation as to why they have not complied with each provision). To assist companies in making suitable arrangements for their audit committees, guidance (often referred to as the Smith guidance) was produced in 2003 to supplement the revised Code's provisions on audit committees.

Main principle C.3 states that "the Board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors."

Code provision C.3.2 outlines the main role and responsibilities of the audit committee which should include, to:

- monitor the integrity of the financial statements of the company; reviewing significant financial reporting judgements contained therein;
- review the company's internal financial controls and, if so asked by the Board, to review the wider internal control and risk management systems;
- monitor and review the effectiveness of the company's internal audit function;

- make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process; and
- develop and implement policy on the engagement of the external auditor to supply non-audit services, and to report to the Board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

Code provision C.3.6 expands upon the appointment, re-appointment or removal of external auditors and states that "if the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position." Code provision C.3.7 states that the annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

The APB issued ISA (UK and Ireland) 260 Communication of Audit Matters with those charged with Governance. This builds on an earlier UK standard SAS 610, which established certain key requirements for auditors to communicate to audit committees, in addition to fulfilling their statutory audit requirement to prepare their audit report for shareholders.

The US

The concept of the audit committee in the US dates back to the late 1930s. Since the 1960s, when a recommendation was made that all publicly held companies should form an audit committee, there have been developments in each subsequent decade with pronouncements aimed at strengthening audit committees from the SEC, the NYSE, the Public Oversight Board and the AICPA.

Some federal legislation such as Federal Deposit Insurance Corporation Improvement Act (1991) also affected audit committees, as have pronouncements from various commissions or committees such as the Treadway Commission (1987) and the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee when, in 1999, it issued its *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*.

The Sarbanes-Oxley Act (2002) saw audit committees take more of a central role with Section 301 of the Act requiring the SEC to introduce rules governing the independence of audit committee members and the relationship between the external auditor and the audit committee.

The SEC subsequently issued a rule that contains requirements as follows:

- each US domestic registrant must have an audit committee;
- every audit committee member must be 'independent', with certain exemptions for foreign private issuers;
- the audit committee must be directly responsible for the appointment, compensation, oversight and retention of the external auditors;
- non-audit services provided by the external auditors must be pre-approved;
- the audit committee must receive reports on critical accounting policies and practices as well as alternative accounting treatments;
- the audit committee must have the authority and appropriate funding to engage outside advisors; and
- the audit committee must establish procedures for handling complaints from whistleblowers.

The topics of independence of audit committee members, funding to engage outside advisors and whistle blowing also feature in the UK's Combined Code and/or the Smith guidance.