A bigger job for the boardroom vigilantes

The accounting profession has generally seen the role of audit committees as being limited to overseeing financial information and audit. In this article, ***Linda English*** *argues for a wider role in view of the accountability standards now expected of directors. The recognition at common law that directors have a duty to monitor rather than to manage, combined with changes to statutory provisions of the Corporations Law, implies that directors must monitor the systems providing them with information in order to be assured that they are fulfilling their duties adequately. Instructing a committee of the board to monitor the corporation's information systems is a sensible response. It seems logical to include this wider monitoring function among audit committee responsibilities.*

Dubious business practices are typically accompanied by the failure of accountability mechanisms. Public scrutiny of lax practices has produced a record littered with evidence of the breakdown of ethical standards and lapses in the monitoring or other supervision of senior management by non-executive directors (see, for example, Green 1992).

Boards must accept that community expectations of directors and their supervisory function are becoming more stringent. Disenchantment with corporate practices in the 1980s is reflected in the number of reports into various aspects of corporate governance[1] and in recent reforms to the Corporations Law[2]. Further, a spate of recent judgments indicate that the judiciary is also becoming harder on cases involving directors' duties, and less receptive to defences that in the past have shielded directors from liability (Warren 1992, Harding 1992).

In some quarters audit committees have been put forward as a possible solution to the failure of the supervisory function of boards (see McKenna in *New Accountant*, 1990). Because the functions and attributes of audit committees appear to be widely accepted (see the appendix of AUP 31 *Communication With an Audit Committee*, 1991), debate focuses on whether they should be made compulsory, which appears likely[3].

Current practice

The accounting profession defines an audit committee as "a committee comprising a majority of independent/non-executive members of the governing body of an entity to which has been assigned, amongst other functions, the oversight of the financial reporting and auditing process" (AUP 31, para. 6).

A survey of the accounting literature by Simnett *et al* (1993) concluded that audit committees had three major beneficial effects:

- to improve or maintain the quality of the financial reporting process;
- to aid the actual and perceived independence of the internal and external auditor; and
- to improve the confidence of the financial statement user in the quality of financial reports.

Simnett *et al* (1993) examined the annual reports of publicly listed companies over three years for information about audit committees. The sample consisted of 279 companies in 1988, 299 in 1989 and 249 in 1990. Where the existence of an audit committee

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was disclosed, the proportion of non-executive to executive directors on the committee was recorded.

The authors found that the percentage of large organisations disclosing the existence of audit committees increased across the three years, but was still low. The increase was from an identified disclosure rate of 9.3 per cent in 1988 to 13.3 per cent in 1990. Decisions to form and disclose audit committees appeared to be in response to user demands, pressure from business and professional groups, management incentives and political or regulatory pressure.

The accounting firm Arthur Andersen in November 1992 surveyed all of the approximately 1,200 publicly listed corporations in Australia. The response rate was 19 per cent, and the resulting sample covered a range of company sizes and included all industry groups. Forty-eight percent of respondents[4], which were evenly distributed across industry groups with the exception of the natural resources/mining industry, had established audit committees. Sixty-three per cent of audit committees were in companies with annual turnovers of more than $100 million. Apparently highlighting the importance of addressing financial and related matters, 78 per cent of audit committees contained members with accounting qualifications. According to Arthur Andersen, the results indicated that management believed the presence of audit committees was linked with enhanced corporate governance.

There is widespread belief that audit committees play an important role in the financial reporting process, including ensuring that effective accounting and financial controls exist and are operating effectively; overseeing the (internal and external) audit of the company; providing links between auditors and the board; and helping to ensure that decisions are made at appropriate levels in the company (Senate Standing Committee on Legal and Constitutional Affairs 1989). However, despite the agreed benefits of audit committees, it appears that less than half of Australia's public companies currently have audit committees, and only 20 per cent of those disclose their existence (Simnett *et al* 1993).

The Arthur Andersen survey provides evidence that managements of corporations with audit committees see a wider role for audit committees than does the accounting profession, which focuses on the financial reporting and audit functions (AUP 31 1991). Respondents indicated that the most important roles and responsibilities of audit committees include assessing and monitoring the corporate environment, understanding the organisation's practices for managing and monitoring regulatory compliance, and reviewing the implementation status of critical information systems.

What is expected of directors?

Whatever the fate of corporate law reforms currently proposed[5], including Attorney-General Lavarch's plan to simplify the Corporations Law, interest in law reform, the shift in the attitude of judges and greater community demands for corporate accountability mean that the spotlight will remain on directors.

How are directors to react? They can no longer assume that what was regarded in the past as acceptable practice will continue to be tolerated. Directors must learn to consider what a "reasonable person" would be likely to do in given circumstances. The reformulation of directors' statutory duty of care and diligence in s232(4) of the Corporations Law codifies the reasonable-person test. In practical terms, this is likely to translate into being able to show that they recognised the relevant issues, took the necessary steps to brief themselves on those issues, and made careful and honest decisions in the light of the available information.

The duty to monitor rather than to manage

One crucial factor for directors is the recognition that today boards are monitors rather than managers. Rogers J in *AWA Ltd v Daniels* [(1992) 10 ACLA 933] observed that the board of a large public corporation "cannot manage the corporation's day to day business. That function must by business necessity be left to the corporation's executives," and, elsewhere, "more recent wisdom has suggested that it is of the essence of the responsibilities of directors that they take reasonable steps to place themselves in a position to guide and monitor the management of a company".

There seems to be some uncertainty about what the duty to monitor entails. Harding states that it is necessary for board members "to keep abreast of the information that flows to the board as a result of monitoring procedures and techniques". His emphasis seems to be on directors keeping themselves fully informed.

However, he appears to give less importance to an active monitoring function for the board when he goes on to clarify his position: "While the board must ensure that there is a functioning management and internal information system to keep management informed, the board of a large corporation is not required to design, install, operate or monitor the operation of such systems, but rather to call for periodic assurances that they are in place and are being maintained." The AWA case illustrates the consequences of the failure of boards to monitor the quality of a corporation's information and recording systems.

According to the American Law Institute (1992), "the duty to monitor is satisfied not, or not primarily, by direct observation, but by installing and reviewing the adequacy of information systems by which salient information concerning the conduct of a corporation's business will flow to the board, or to reliable executives or third-party professionals acting on the corporation's behalf and subject to the ultimate responsibility of the board".

Taking this view, the duty to monitor "becomes part of the general duty of care applicable to different corporate types and distinct director and officer roles" (Redmond 1992). The second limb of the duty of care, in the American Law Institute model, is a duty to follow up information that raises concerns. This obligation (the duty of inquiry) is additional to the supervision obligation. In Australia, according to Harding, the duty to inquire if put on notice "has probably been the most important single expectation imposed on both executive and non-executive directors in recent cases".

Circumstances which could put directors "on notice" will be a matter of judgment. They could include, for example, the failure of the corporation to produce statutory reports or other documents on time, the inexplicable alteration of the dates of board meetings (particularly to avoid highlighting deadlines that may not have been met) or an unwillingness by executive officers to facilitate detailed inquiry by non-executive board members. In addition, internal and external auditors may report the failure of internal control and recording systems or highlight unacceptable risk exposure.

In the American Law Institute's model, the duties to monitor and inquire are complemented by a specific right of delegation to committees or other members of the board, officers, employees, experts or other persons, and a right to rely upon such persons where the director reasonably believes that such reliance is warranted and that the person relied upon merits confidence.

These ideas are echoed in recent Australian judgments. In the AWA case, Justice Rogers confirmed the long-standing view that directors are entitled to rely on management to manage the corporation and not to expect to be informed of the details of that management. It was held that such reliance would be unreasonable only where the director was aware of "circumstances of such a character, so plain, so manifest and so simple of appreciation that no person with any degree of prudence acting on his behalf would have relied on the particular judgment, information and advice of the officers". However, that reliance does not absolve boards from taking active steps to ensure that their policies are in place and operating effectively. This analysis is reflected in the findings of the Tricontinental Royal Commission.

Statutory duties

Directors have long been required to take all reasonable steps to ensure that the corporation maintains adequate accounting records and to prepare the financial statements required by the law. The Corporations Law (s588G) also imposes a duty on a director to prevent insolvent trading. Recent amendments introduced a more stringent test and narrowed the available defences.

If there are reasonable grounds for suspecting that the company is insolvent, directors are liable for failing to prevent the company from incurring the debt where the director is aware of these grounds, or where a reasonable person in a like position would have been aware of the impending insolvency. Directors no longer have available as a defence argument that the debt was incurred without their express or implied authority or consent. These amendments appear to be grounded on the presumption that directors ought to be properly informed of potential financial difficulties — that is, that systems are capable of delivering the information to directors.

The objective of the new related-party provisions (which come into effect in February 1994) is to protect a public company's resources and the interests of its members by requiring that financial benefits to related parties that could diminish and endanger those resources, or that could adversely affect those interests, be disclosed and approved by a general meeting before they are given (Koeck 1993).

The proposed enhanced disclosure regime involves both ongoing (or continuous) reporting obligations, triggered by the happening of certain events, and revamped regular reporting obligations, namely the introduction of half-yearly reporting and some modification to annual reporting requirements (Koeck and Ramsay 1992).

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Continuous disclosure provisions are contained in the Corporate Law Reform Bill (No. 2) 1992 which has lapsed. Under the bill, all listed companies (and other entities whose securities are offered or traded in securities markets) would be required to lodge with the ASC, within three business days, information about any event or change in circumstances which investors and their professional advisers would reasonably require for the purpose of making an informed assessment of the entities' financial position.

The practical implications of the related-party and continuous-disclosure provisions is that companies will need to modify information systems to ensure that the prescribed information is available within the designated time-frame. This in turn implies that boards should design new monitoring systems to minimise their potential liability.

Why an audit committee?

The Arthur Andersen survey provides evidence that the independent, board-level supervision of financial reporting functions is widespread, irrespective of the existence of audit committees. This finding suggests a high degree of acceptance in the business community of the importance of board-level communication with the external auditor and the necessity for directors to familiarise themselves with financial reporting issues. Evidence suggests there is less appreciation of the wider role audit committees can play in corporate governance.

Delegation of responsibilities to sub-committees is a well-established device to enable any governing body to focus efficiently on particular issues. In the board of a corporation, the mere delegation of responsibility signals that the matters delegated are important. Using the committee structure ensures that committees report back to the board on a regular basis. Further, members of the committee become experts in the area over which they have been given responsibility. This ensures that the board will receive advice from people who are on top of their portfolio.

Making audit committees work

Given the complications of modern business, the size of corporations, continuing evidence of the breakdown of ethical standards and monitoring or other supervision of senior management by boards of directors, and the increasing array of legislation with which corporations and directors must comply, it is time to question the traditional role of audit committees. It is surely no longer realistic to suggest that the functions of an audit committee should be confined to overseeing the financial reporting and auditing process.

The value of audit committees is directly related to the calibre of their members, the status of the committee in the eyes of the board and senior management and their charter. The existence of an audit committee does not relieve directors of their individual legal and fiduciary responsibilities. However, delegation of wide and explicit powers to an audit committee with competent members can go a long way towards assuring directors that nasty surprises are not around the corner.

It is generally agreed that effective audit committees require a charter clearly setting out their powers and responsibilities and that those powers include direct access to both the company's auditors (internal and external) and to senior management, and the ability to consult independent experts whenever necessary. It follows that audit committees require sufficient resources to enable them to carry out their duties, and some mechanism to facilitate accountability to shareholders.

Accountability to shareholders should be discharged through a statement in the annual report from the audit committee chairman detailing members (including whether they are executive or non-executive directors), committee responsibilities and activities, including mention of meetings with internal and external auditors[6].

For accountability purposes it is important that shareholders have a clear understanding of the scope of audit committee responsibilities and powers, and the extent to which the committee uses its powers to monitor information systems and ensure reliable financial reporting. The chairman of the audit committee should have the authority to address, and take questions from, shareholders directly at the annual meeting. Routine disclosure of audit committee members and the number of meetings attended during the accounting period, such as currently appears in annual reports (Simnett *et al* 1993), is an inadequate demonstration of the effective discharge of audit committee responsibilities.

Emphasis on the role of the board in monitoring, rather than in day-to-day management, makes imperative the receipt of relevant, timely and accurate information by the board and senior management. Similarly, the thrust of recent statutory reform highlights a legislative presumption that directors are privy to relevant information. Given that assumption, it is incumbent on boards to ensure corporate information systems (of which the financial information system is merely a subset) are capable of delivering them untainted information. It is in monitoring information systems (in conjunction with internal and external auditors) that directors play a vital role in corporate governance and ensure compliance, by themselves and their companies, with the law.

As for assurance at board level that its policies and directives are being carried out as intended, and that intended policy is, in fact, resulting in operational and managerial efficiency and effectiveness, boards should look to a strong internal audit function which reports directly to them and whose performance is, in turn, monitored by the external auditor at the behest of the audit committee. ■

NOTES

1. Aspects of corporate governance have been scrutinised, for example, by the Senate Standing Committee on Legal and Constitutional Affairs 1989 (The Cooney Committee); the NCSC 1990; and the House of Representatives Standing Committee on Legal and Constitutional Affairs 1991 (the Lavarch Committee). In addition, the Companies and Securities Advisory Committee has issued a number of reports as did its predecessor, the Companies and Securities Law Review Committee.
2. The Corporate Law Reform Act 1992 was passed by parliament in December 1992. The principal areas of new law relate to duties of directors and officers, related-party transactions and corporate insolvency. Corporate Law Reform Bill (No 2) 1992, proposing an enhanced disclosure regime and associated fund raising relief, was introduced into the Senate in November 1992, but lapsed with the dissolution of parliament before the March 1993 general election.
3. Reviews by the Cooney Committee (1991) and the Lavarch Committee (1992) have canvassed the compulsory introduction of audit committees as a means of strengthening corporate accountability. The Joint Statutory Committee on Corporations and Securities published an issues paper on audit committees in December 1992 in anticipation of its inquiry into audit committees to be completed this year.
4. Given a response rate of 19 per cent, concern needs to be expressed about the representativeness of respondents. Companies with audit committees were more likely to have responded.
5. See note 2.
6. AUP 31 suggests that the benefits of having an audit committee are enhanced by publishing details of committee membership, including information about whether members are executive or non-executive directors. AUP 31 indicates that a letter from the audit committee chairperson could be attached to, or included in, the company annual report. It fails to make a formal recommendation to this effect.

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