Quarterly Briefing

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The Audit Committee’s Responsibility to the Auditor

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EXECUTIVE SUMMARY

- Audit failure may occur due to two major reasons: (i) the auditor misjudges a financial risk, and/or (ii) he succumbs to management influence.
- The audit committee must ensure that the auditors and other experts they work with are independent of the influence of management or the controlling shareholders and are competent to execute the task they are charged with.
- The audit committee must obtain enough information to reach its own conclusion in matters of difficult areas of judgment brought to its attention by its auditors.
- The auditors and the management should be encouraged to develop adequate trust in the audit committee’s fairness, balance, judgment and above all its independence.

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I. Introduction

Audit committees work by hearing managements represent to them on matters in their remit, by using inputs from independent parties and by discussing all of these in meeting to arrive at decisions or recommendations to the board. The work committees do is confined to the meetings they hold though that could be supplemented by the more diligent of a committee's members (usually, the chair) doing preparatory work outside meetings. Between the Companies Act, the Listing Obligations & Disclosure Requirements plus some good practices, an audit committee of a listed company needs to perform about 50 tasks., many of which require substantial time and resources as also expert knowledge. It must, perforce, depend on others to undertake many of these tasks for it and use their work to reach conclusions that are *its* responsibility.

II. The Audit Committee's "Agents"

There are several third parties to whom the committee turns to discharge its responsibilities. Principal amongst them are the external independent auditors who, apart from forming an opinion on the fairness of financial statements, also assist the audit committee in forming its opinion on compliance with GAAP, the selection of appropriate accounting policies, the making of reasonable assumptions in the preparation of the financial statements, the controls in the financial statements closing process, the maintenance of accounting records as required by the Companies Act and other responsibilities. Similarly, external valuation experts assist the committee in the valuation of specific assets or liabilities. Others who assist the committee are the company secretary or compliance officer, the chief risk officer and, most importantly, the internal auditor, who provides the committee with assurance that controls for the management of risks and for efficient and economic operations are adequate and effective. Whilst these responsibilities are discharged in the case of the external auditor as their primary responsibility under the law, they also act as "agents" of the committee in enquiring into matters that are also in the latter's remit. The other "agents" provide assurance or opinions to senior management just as much as they do to the committee.

III. Selecting and Chartering the Agents

The "Agents" are required to either assess the process and the outcome of management's activities (e.g., internal control evaluation or financial statements) or to provide inputs that management uses for an activity it will undertake (E.g., valuations used for a transaction). It is important that the agents are independent of management and the controlling shareholder. This would likely reduce the probability of their being influenced to conceal from the audit committee matters they need to know. Where the management relies on original work by a third party, viz., a valuation expert, independence is equally important because the management may want the opinion of that individual to subserve its intentions that may not be in the company's interest.

The second important consideration is competence. Most "agents' now require a license to undertake their practice. Independent auditors, Company Secretaries, valuation experts, and actuaries are licensed by their respective regulatory professional bodies; Whilst there are no specific qualifications mandated for internal auditors, they are often Chartered Accountants or members of the Institute of Internal Auditors. In judging the competence specific to the company and its business, it is the committee that must take a call, judging on the basis of industry experience and knowledge and scale of the work. Further, as most professions are now carried on in some corporate format, when contracting the "agent", an audit committee would do well to ascertain the experience based competence of the engagement partner.

The principle challenge for a committee (and the board) is not only to address matters that are presented to it but to also be aware of other matters that it ought to address in its responsibilities. The uncovering of such matters is a very important task of the "agents" and the committee must ensure that they are empowered to do so. The audit committee and/or the board must take all steps to make the "agents" understand this responsibility and enable them adequately to execute their work; any failure to do so may well render the directors in breach of what they are now expected to do. The existing corporate scandals, most of which have Related Party Transactions at their heart, would indicate one area in which the audit committees appear to be floundering because they have no clear "agents" to assist them in this task or have agents who have failed to give good advice.

To summarise, audit committees must ensure that the auditors and other experts that they work with are independent of the influence of management or the controlling shareholders and are competent to execute the task they are charged with.

It is equally the responsibility of audit committees to make clear to the agents what is expected of them – their charter. It is insufficient to assume that an agent will carry out all tasks that the law specifically or implicitly mandates of them. It is only by carefully drafting and agreeing the terms of a charter that both sides become clear of expectations, abilities and limitations of the "agent". For example, an internal auditor may be appointed "to conduct an internal audit". The committee might assume that the internal auditor will report weaknesses in the efficiency of operations (as required in section 134(5)(e) of the Companies Act) whilst the "agent" may think that his remit is limited to financial and commercial matters. Whether the activity is legally mandated or is not, the committee must agree with the "agent" a clear charter. Where the "agent" also serves management, the charter will need to be agreed by all three parties and the execution of the service also so accepted.

IV. The Responsibility of Audit Committees for Effective Execution of Tasks by its "Agents"

The next major responsibility of the audit committee commences after it has appointed its "agents" to their positions and clarified its expectations of them. That is to ensure that the appointed agents understand and deliver upon these expectations. In the past few years the large number of alleged audit failures and actual resignations of incumbent auditors mid-term, has drawn attention to a critical area in which such responsibilities of the committees may not have been adequately discharged. Similar "failures" by other "agency" functions have not, so far, surfaced to the same extent but that should be no comfort to the audit committee. Therefore, the example of auditors is useful to bring-out audit committee responsibilities.

That many of the recently reported alleged failures have involved "Big Four" audit firms with a reputation for competent and independent performance is a warning to audit committees that they should never let down their guard.

There are two ways in which audit failures may occur: The auditor misjudges a financial risk or he succumbs to management influence. In mitigating the risk of either situation, the audit committee has a big role to play in exercise of their fiduciary duty of care. The audit committee is responsible for overseeing the fairness of the financial statements for which it must substantially rely upon the auditors. But to do so, it must ensure that the auditors are in possession of the same facts and information as the committee and that they have reached their opinion independent of any influence. Almost always, an audit committee will have a better understanding of substantial business issues than the auditor; if they conceal those from the auditor when they believe that the auditor might change his opinion if in possession of them, they do so at their and the board's peril. A committee cannot connive with management to mislead or blind-side the auditors; they must make every effort to ensure that auditors are in possession of full information and explanations.

Where the auditors draw the committee's attention to difficult areas of judgment, the committee must obtain enough information to reach its own conclusions in that matter; the committee cannot abdicate this responsibility to the auditors or management. The committee must also share with the auditors all the relevant information in its possession. Ideally, the committee must anticipate audit difficulties and guide the auditor in obtaining the relevant facts and letting him know its own views or, where necessary, the board's views on a matter. For example, the auditor may warn of a potential impairment of an investment in forthcoming quarters. But the board might have discussed the matter with management in an earlier meeting, which indicates that the investment is already impaired. It is then incumbent on the committee to reach that conclusion and to inform the auditor accordingly. Similarly, the management might have used certain assumptions when judging the value of an asset or liability. The auditor may caveat his responsibility, stating that he has relied on them. It is for the committee, using its knowledge of the business and in discussion with management, to either endorse those assumptions or to ask for them to be changed. The committee is expected to have agreed with all significant assumptions and estimates used in the drawing up of financial statements. The committee should not play a cat-and-mouse game with the auditor, even if the management wants it to. The committee, the board and the auditor are all in the same boat.

In brief, every matter communicated by the auditor should be carefully considered by the committee. One audit committee chair would call the opening and concluding pages of an auditor's presentation in which they identified the extent of their coverage, major assumptions and estimates, risks, etc. as "embroidery". That is a dangerous trivialisation because concealed within the "embroidery" may be a very pointy needle that pierces the directors at some later date.

The other basic reason for audit failure is impairment of an auditor's objectivity. This might be induced by either tempting him with more revenue or by threatening to hurt his existing revenues or by doing him non-financial favours. Such pressure can be exerted by management or by the controlling shareholder, especially if the auditor has other relationships with either party. An audit committee must ensure that the auditor's relationship with the company is through the committee and that the auditor is never placed in a position where he can be pressurised or tempted to be unprofessional. Such a precaution begins with the appointment of the auditor. In addition to competence, the auditor should not have any significant (from his point of view) professional or other relationships with the controlling shareholder. Were that to be the case, the committee would never "own" the relationship. Further, the auditor selection process should be entirely run by the committee and seen to be so by the suitors to auditor-ship.

After the auditor takes office, the committee (principally, its chair) must invest much time and effort in the relationship so that it does not slip from its hands into those of the management. Some of the practices for this would include:

- Building strong trust between the audit partner and the committee chair. This would include regular sharing of information by the chair with the audit partner of business or other relevant developments.

- Executive sessions of the committee and the auditors at which the auditor is provided the opportunity to share concerns that cannot be voiced in open meeting, especially if they are subjective opinions or are lacking evidence.

- The committee openly demonstrating, in full meeting, its commitment to prudent accounting by its decisions on difficult points raised by audit.

- The committee carefully evaluating the impact on the financials of business strategy, plans, practices, policies, instruments and transactions. Too often committees focus on the revenue account and on business performance, ignoring the balance sheet. Because problems that are pushed into the future travel in the balance sheet, these committees fail to spot them and expend their energy on what is in the board's realm – management performance.

- Committees must ask the auditor about the quality of the evidence he has been provided, the quality of accounting judgments and explanations given him, adequacy of time for his work, the quality of other branch auditors or other experts such as actuaries, the quality and culture of the finance and accounting department and the quality of the other governance functions such as internal audit, compliance, secretarial and whistle-blowing. Some of these issues would need discussion also in the executive session.

- Some members of audit committees give the impression that they are not entirely independent of management or the controlling shareholder. Such impression is created by conduct and remarks. The auditor then believes that he cannot wholly depend on the committee to protect him against their coercion. Therefore, representatives of controlling shareholders are best left off audit committees. The committee must never create the impression that they are on the same side as management. To both sides they should give a clear impression of full independence with a wish only to ensure fair financial statements. During meetings auditors should not be rushed or treated in offhand fashion – a common practice.

- Committees must question significant assumptions, estimates, forecasts, valuations and management promises of setting things right. The committee needs to be fully satisfied that, if a matter is to be carried forward for future action, management is genuinely committed to it and that they have the resources and competence to act within the agreed timeframe. Too many companies have come to grief by committees giving managements too long a rope.

- Because having such a control over the relationship might appear threatening to the CFO, the chair of the committee must also invest substantially in his relationship with the CFO to assuage concerns of matters happening behind his back. Issues should be discussed between the two frankly and in confidence so that the CFO too is open about matters with the committee.

In brief, both, the auditors and the management, should be encouraged to develop adequate trust in the audit committee's fairness, balance, judgement, and above all its independence.

The chair of the committee should convey to the full board all significant concerns about the financials and of any "compromises" agreed to. Issues raised by the auditors and the committee should not be glossed over as the board is, ultimately, responsible for the financial statements and they should not be deceived into agreeing to approve them. Obviously, if a matter cannot be put in the minutes, it should not be agreed to.

V. Conclusion

Audit committees must, perforce, rely upon "agents" to do most of their work for them. A responsible committee will understand the symbiotic relationship between the two. As a major element of an audit committee's responsibilities is oversight of management, it must ensure that its agents are independent of management influence in addition to being competent for the task assigned. The committee needs to ensure that the independence is not merely in form but is also in substance and, for that, the committee needs to build trust between it and the "agent".