

A photograph of a lighthouse with a black base, a red middle section, and a white top section, situated on a rocky pier overlooking the ocean under a blue sky with scattered clouds.

# Viewpoint

Risk advisory

*The independent audit committee fulfils a vital role in corporate governance for public companies and is coming under increased scrutiny....*

## **Strong audit committee essential for good corporate governance**

*Wayne Basford, Partner, BDO Kendalls*

### **Challenge area**

Five years after a spate of high-profile corporate collapses, the spotlight is on audit committees for the probity of financial reporting and rigorous assessment of a company's practices according to chartered accounting and advisory firm BDO.

### **New perspectives**

While the high profile collapses of HIH, Ansett and Harris Scarfe were becoming a dim memory for many investors, the need for tough-minded and independent audit committees are needed more now as never before.

The independent audit committee fulfils a vital role in corporate governance for public companies and is coming under increased scrutiny.

The audit committee can be a critical component ensuring quality reporting and controls, as well as the proper identification and management of risk.

Its critical role as guardian of the company's integrity puts the audit committee at the core of the challenge of governance.

Since the 1970s, the nature and prevalence of audit committees have been in a constant state of evolution.

The financial world of the 1970s was rocked by slush funds and foreign bribes that forced a large number of companies to form audit committees.



*Effective audit committees are, however, not merely creatures of government and industry-sponsored initiatives.*

In the 1980s, the National Commission on Fraudulent Financial Reporting (Treadway Commission) in the USA and the Cadbury Committee in the UK were set up, amongst others, in response to a rash of well publicised cases of fraudulent financial reporting.

In Australia greater audit committee responsibilities and more timely, frequent and open contacts with the external auditors became increasingly common during the early 1990s.

In the late 1990s further recommendations were made internationally to improve the effectiveness of audit committees and as a result, the major stock exchanges adopted rules expanding audit committee requirements.

More recently corporate collapses involving Enron and WorldCom have given rise to a significant overhaul of US corporate governance with the passing of the Sarbanes-Oxley Act 2002, which in itself has had a huge impact on Australian reporting standards.

Effective audit committees are, however, not merely creatures of government and industry-sponsored initiatives.

You cannot legislate against stupidity or poor judgement, but you can move towards establishing a spectrum of triggers and a regime of measures designed to protect stakeholders such as investors and employees from sheer mismanagement.

There are other persuasive reasons for boards of directors to perform effectively their oversight role in ensuring reliable financial reporting and maintaining investor confidence (for example, avoiding class action lawsuits and criminal prosecution, and preventing the delisting of the company's stock that may result from financial fraud).

While it is clear that informed and vigilant audit committees are an essential element of an efficient securities market, an audit committee's duties and responsibilities are diverse and may need elaboration.

### **There are eight essential attributes for an effective audit committee:**

#### **1. Create the Right Tone at the Top**

The message to all personnel should be loud and clear: financial misreporting is totally unacceptable. If any misreporting is noted, it must be dealt with quickly and appropriately.

#### **2. Be Independent**

The audit committee, to be truly effective, must be able to resist management's attempts at compromising financial reporting.

#### **3. Reflect a Balance of Skills**

To be effective the audit committee must have a number of members who are "financially literate." To obtain a balanced perspective, we recommend three to six members with diverse backgrounds.

*To create an effective audit committee, it is best to attract members who have a special blend of qualifications and abilities.*

#### **4. Make a Time Commitment**

Being an audit committee member is not a full-time job. However, committee members must be informed, diligent and probing. This requires a significant time commitment, usually more than typical board service.

#### **5. Develop a Clear Charter**

To operate properly, a formal written charter strongly backed by the full board should be adopted and annually reassessed.

#### **6. Develop Specific Committee Duties**

Once a charter has been developed, the audit committee needs to decide which specific regular assignments it will undertake and then have them approved by the board.

#### **7. Plan the Year's Agenda**

At least four meetings a year should be considered, although this would depend on the company's particular circumstances. Additional meetings may be necessary if special matters arise.

#### **8. Document the Committee's Work**

Regulators may require audit committees to document/report on a range of issues. Correct and detailed record keeping including minutes of meeting is essential

## The way forward

To create an effective audit committee, it is best to attract members who have a special blend of qualifications and abilities.

The audit committee's efforts will be bolstered if its members truly have in mind the best long-term interests of the company and its shareholders. Individuals who cannot share this vision are probably not the best candidates for committee membership.

While a strong audit committee is important for all companies, it is particularly critical for growing companies, which may often have fewer effective internal controls.



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## About the author

Wayne has over thirteen years experience in audit and advisory services, having worked with other major accountancy firms on three continents. In addition to his external audit roles, Wayne has also worked as senior manager within a multinational internal audit division and was a senior accountant on a major international automotive assignment. Prior to joining BDO Wayne had national responsibility within another major accounting group for a range of technical advisory issues including:

- Advising on auditing standards, accounting standards (Australian, International and US), UIGs and related exposure drafts
- Management of the firm's quality control procedures
- Administration and upkeep of risk management manuals and policies
- Support for technical training

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