AUDIT COMMITTEE PROFILE OF AUSTRALIAN STOCK MARKET LEADERS

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ABSTRACT

In light of new Australian Stock Exchange (ASX) Listing rules and ASX best practice recommendations for corporate governance the profile of audit committees was examined through a study of the top 150 entities listed on Australian Stock Exchange. The study focuses on establishing an audit committee profile for listed companies. The results showed that the typical profile of the audit committee is in line with best practice processes.

Introduction

The issue of corporate governance has been a fertile area of research for decades and has largely focussed on the roles, responsibilities and relationship between the board of directors, management and shareholders. Shleifer and Vishny (1997) observed that research into corporate governance was an area of practical importance and also noted that corporate governance mechanisms provided shareholders with some assurance that managers will strive to achieve outcomes that are in shareholders' best interests. This proposition emanates from the agency theory perspective, the overwhelmingly dominant theoretical construct discussed in much of the corporate governance research [10][19][9]. Indeed, Walsh and Seward (1990) suggest that shareholders have both internal and external governance mechanisms to help align the interests of shareholders and managers. Dalton, Daily and Cannella (2003), note that the internal mechanisms include effective board structure, shareholder oriented compensation and concentration of ownership, all of which have been the subject of much research [7][16][11][4]. Four basic categories of individual corporate governance mechanisms were outlined by Jensen (1993): 1.Legal and regulatory mechanisms, 2.Internal control mechanisms, 3.External control mechanisms, 4.Product market competition. Denis (2001) raises the issue of whether these mechanisms serve to narrow the gap between managers' and shareholders' interests and whether the mechanism in question has a significant impact on firms' performance. In relation to the legal mechanisms aimed at improving corporate governance, La Porta et al (1998, 2000) show that US shareholders and creditors are among the most protected in the world and this has been further strengthened by the passing of the Sarbanes Oxley Act 2002. What has been highlighted post-Enron, is that the supposed governance mechanism of externally audited accounts failed to protect shareholders [17] and has therefore called into question the effectiveness of the board oversight role.

This paper focuses on a key governance mechanism, the Audit Committee, which was recently introduced in Australia as a result of a new Australian Stock Exchange Listing Rule. Audit committees which are effectively sub-committees of the board of directors, originally began as unregulated bodies with few defined responsibilities, but now have become a highly regulated group that play a key role in upholding corporations' accountability to their shareholders. Thus the audit committee is seen as holding an important role in corporate governance with its primary responsibility being monitoring the financial reporting process, reviewing the integrity of the financial reports of the company and overseeing the external auditor [6]. Most of the research conducted on Audit Committees has focussed on the composition or effectiveness of the Committee and has intensified post-Enron. Spira, (2003) suggests that the issues of auditor independence and the independence of audit committee members has, to date, dominated the research. She further suggests that there is little point in evaluating the effectiveness of audit committees without an understanding of what they do. This paper extends the previous work of Barut, Foreman and Richardson (2003) on board processes, by profiling the audit committee of the top 150 companies listed on the Australian Stock Exchange. The authors accept that research into audit committees is consistent with an agency theory approach but make no attempt to evaluate the effectiveness of audit committees in discharging their presumed role of constraining managers self interest.

Audit Committees

The main objectives of this study are to examine and establish a profile of the audit committees which are currently undertaking the role of safeguarding the integrity of the financial reporting of the leading Australian companies. Under the Australian Stock Exchange (ASX) Listing Requirements a company is required to establish an audit committee. The ASX Principles of Good Corporate Practice and Best Practice Recommendations note that: "an audit committee can be a more efficient mechanism than the full board for focussing the company on *particular issues relevant to verifying and safeguarding the integrity of the company's financial reporting"[2]* This paper will focus on the following three authoritative pronouncements on the composition and conduct of audit committees: 1. ASX Principles of Good Corporate Practice and Best Practice Recommendations (2003), 2. The Blue Ribbon Report (1999), and 3. The Sarbanes-Oxley Act 2002.

Research Methodology

This paper is based on the findings of a sample representing the top 150 entities listed on the Australian Stock Exchange based on market capitalization as reported in the Australian Financial Review on the 4th July 2003. This ranking of the companies is based mostly on perceptions of the stockmarket rather than on actual revenues and profitability derived by the company. Sourcing publicly available data was imperative based on the deductive conclusion that as this information was publicly available it would be representative of what the company wanted to 'show' the world. As such this type of data sourced from general-purpose financial reports is the information made available to a wide range of stakeholders including those which are financially literate and those who are not. According to the 2002 Share Ownership Study commissioned by the Australian Stock Exchange, half of the Australian adult population own shares (as opposed to 46% in Canada, 25% in Switzerland, 18% in Germany, and 22% in the UK), thereby representing 7.3 million people in Australia [3]. Where information is sourced from the company annual reports, it would be testament to the notion that the content of annual reports has changed over time and they contain more voluntary information than ever before. Although there is some requirement for the existence of an audit committee as is nominated by the ASX Listing Rules, it was considered that in light of only minimal guidance as to the disclosure requirements, this item will vary greatly in quantity and quality of disclosure. Unfortunately annual reports may be vehicles to manipulate opinions as they tend to include messages designed to "construct reality" by communicating managers' interpretations of reality [12]. For each company in the sample, the relevant data was hand collected using the listed entity's published financial statements from the Connect4 Database. The key documents referenced were the Corporate Governance Statements, the Directors' Reports, the Directors' Profile and in some cases the Remuneration Report. As the Connect4 Database did not have a sufficiently complete listing of the annual reports for the 2003 financial year, the sampled annual reports were sourced from 2002 data. For the year 2002 there were 150 listed entities in the sample and of these 120 had usable data. From each of the listed entities in the selection, the audit committee data was collected and scrutinised for four features:

1. The number of directors on the company's audit committee,
2. The number of independent directors on the company's audit committee,
3. The number of meetings held by the audit committee in the financial year, and
4. The number of directors in the audit committee who had financial expertise.

The four facets of audit committee disclosure used in this study are not mandated under any existing Australian Accounting Standards, or the Australian Corporations legislation, but they are required in some detail for listing on the Australian Stock Exchange. Australian listed companies are also required to disclose information about various features of their corporate governance practices in their annual report or in a separate corporate governance report [1]. Thus an investigation of the four areas proves important in determining the extent of compliance amongst Australia's leading corporates as well as establishing a benchmark for the structure of audit committees. This requirement is elucidated in the ASX Recommendations and is given considerable import. Ideally all members of the audit committee should be financially literate, and the recommendation is that at least one member have professional financial expertise. That a director of a company has the fiduciary duty to act in good faith in the best interests of the company is a basic common law requirement. This is then extended into statute under Section 588G(1) of the

Corporations Act where directors are charged with the duty to prevent insolvent trading by the company. As such the requirement for financial literacy exists for all directors not merely those on the audit committee would make good sense and fulfil statutory duties. In determining financial expertise for this study the criteria used by the authors was for the audit committee member to have an undergraduate qualification in accounting, commerce or economics, or be a member of either of the two professional accounting bodies. This would be in line with ASX recommendations but is a tighter criterion to that imposed by the Sarbanes-Oxley Act for "audit committee financial expert" as a person who has a thorough understanding of the audit committee's oversight role, expertise in accounting matters as well as understanding of financial statements, and the ability to ask the right questions to determine whether the company's financial statements are complete and accurate [18].

Analysis and Findings

The results of the study as listed below show the breakdown of the mean, standard deviation and the largest numbers in the sample as well as a listing of actual structures of the audit committees and meetings.

Number of directors on the company's audit committee:	*mean 3.49, std dev. 1.13, largest 7*
Number of independent directors on the company's audit committee:	*mean 3.18, std dev. 1.15, largest 6*
Number of meetings held by the audit committee in the financial year:	*mean 3.78, std dev. 2.68, largest 15*
The number of directors in the audit committee who had financial expertise:	*mean 1.43, std dev. 1.04, largest 6*

Actual structures of the audit committees and meeting:
Number of directors on the company's audit committee There are 101 companies which had at least three members on their audit committee in line with ASX best practice recommendations, and of these only 52 companies had 4 or more members. Only 19 companies had less than 3 directors on the audit committee with a sole company reporting that the full board performed the role of the audit committee.
Number of independent directors on the company's audit committee Even with the ASX recommendations that all members of the audit committee should be independent, our sample showed that there were 25 companies, which had members on the audit committee who were not independent directors.
Number of meetings held by the audit committee in the financial year Surprisingly, there was substantial variation in the number of meetings held, with 16 companies not disclosing the number of meetings held by the audit committee. The greatest frequency in the number of audit meetings was between 2 and 5 times per year. In the sample, only four companies met in excess of 10 times per year.
The number of directors in the audit committee who had financial expertise There were 98 companies that had at least one financial expert on the audit committee although 22 companies either had none or did not disclose the information.

Conclusion

This paper has shown that typically the audit committees of the Australian entities tend to be on the large size, with the majority of these shown attempting to comply with ASX recommendations. A typical profile for the audit committee of a listed entity would therefore be: 3 directors, all independent directors, meeting 4 times per year, with either 1 or 2 directors being financially qualified. There were several issues that became apparent from the study. Although the ASX listing requirements are reasonably clear on the audit committee structure, there was a lack of universal compliance. As indicated earlier, our expectation that disclosures would be varied was supported by the results of the study. Population of the study was also difficult due to the diverse placement of the disclosures and the non-standardisation of these disclosures, which would reflect an urgent need for reform in this area in the interest of uniformity and accountability. Despite this we conclude that from the sample in this study the Australian market leaders are generally in line with ASX recommendations for best practice in corporate governance procedures. In addition we recommend that even those organizations that are not compelled by ASX listing rule 12.7 to have an Audit Committee should seriously consider establishing one.
(References available on request from the authors.)