

**SWP 17/97 AUDIT COMMITTEES IN PRIVATE AND PUBLIC
SECTOR CORPORATES IN NEW ZEALAND:
AN EMPIRICAL INVESTIGATION**

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AN EMPIRICAL INVESTIGATION**

by

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ABSTRACT

Audit committees are a legal requirement for public companies in Canada and Singapore, a listing requirement of the New York and Kuala Lumpur Stock Exchanges, and a normal feature of corporate life in the United States. They are also becoming commonplace in the United Kingdom and Australia. Until 1997 they were regarded as a means of strengthening external financial reporting; since then they have become valued for fulfilling a broad corporate governance role.

In New Zealand (NZ), there was little interest in audit committees until the 1990s. However, stimulated by unexpected corporate failures (often amid malpractice by senior officials) in the wake of the 1987 sharemarket crash, and a requirement, introduced in 1989, for the Chief Executive and Chief Financial Officer of most public sector entities to acknowledge in the financial statements their responsibility for those statements and for maintaining an effective system of internal control, audit committees are being adopted at a rapid rate.

This paper reports on a survey designed to ascertain the incidence of audit committees in significant private and public sector entities in NZ; the reasons for their adoption; their composition, organisation and functions; the attributes required in order for audit committees to function effectively; and their perceived advantages and disadvantages. The survey found, inter alia, that in mid-1993, 61% of both listed companies and significant public sector entities in NZ had audit committees; that they are expected to play a broad corporate governance role; and that internal and external auditors, corporate chairpersons and financial statement users all favour these committees. It also found that audit committee effectiveness could be improved by (i) ensuring that the committees have clearly defined, written terms of reference, (ii) routinely providing all relevant parties with minutes of audit committee meetings, and (iii) disclosing the existence, membership and functions of audit committees in corporate annual reports.

INTRODUCTION

Interest in corporate audit committees¹ appears particularly appropriate at this time. Directors, business executives and business-related professionals are continually being held to higher standards of accountability and responsibility ... The corporate audit committee has been suggested as offering significant assistance to a number of groups in meeting their business responsibilities ... [in particular] non-officer directors, corporate executives and independent CPAs. (Mautz and Neumann, 1970, p.1)

These observations are as pertinent today as when they were written 27 years ago. Indeed, it is surprising to realise that, in 1970, audit committees were “virtually unheard of” (CICA, 1981, p.1). Today, they are a legal requirement for public companies in Canada and Singapore, a listing requirement of the New York and Kuala Lumpur Stock Exchanges, and a normal feature of corporate life in the United States (US). Further, encouraged by reports such as the Cadbury Report (CFACG, 1992) in the United Kingdom (UK) and the Bosch Report (BCA, 1991) in Australia, which recommend that audit committees be a regulatory requirement for all public companies, they are becoming commonplace in the UK and Australia.

A review of relevant literature suggests that, in all of the countries where they have become established, audit committees have been stimulated by unexpected company failures and/or corporate malpractice. Further, once they begin to gain acceptance, they are established at a rapid rate. This was seen, for example, in Canada² and the US³ in the 1970s, and in the UK⁴ and Australia⁵ in the 1980s. The literature also shows that during the early 1970s audit

¹ An audit committee is defined as a subgroup of an entity's governing body (board of directors or equivalent) which has responsibility for overseeing the entity's external financial reporting process and/or its internal audit function.

² Lam and Arens (1975) found that just under 6% of major corporations in Ontario had audit committees prior to 1970 when the Ontario Business Corporations Act was passed. (This Act requires all public companies incorporated in Ontario to establish audit committees). In 1981, a study conducted by the Canadian Institute of Chartered Accountants (CICA, 1981) found that 80% of public companies in Canada had audit committees.

³ In 1970, Mautz and Neumann (1970) found that 32% of large public companies in the US had audit committees. Six years later they found the proportion had increased to 87% (Mautz and Neumann, 1977).

⁴ In 1985, in a survey of the Times Top 1000 industrial companies in the UK, Marrian (1988) found that fewer than 17% of his 451 respondents had audit committees. Collier (1992) reported that, in 1991, 66% of UK listed companies included in the top 250 industrial firms in the Times 1000, and 88% of Britain's major financial institutions, had audit committees.

committees were regarded, almost exclusively, as a means of strengthening the external audit function and ensuring that external financial reports were reliable. However, since about 1977 (encouraged by the revelations which led to the US Foreign Corrupt Practices Act 1977), there has been a discernible and increasing shift in their orientation, away from the external audit function and external financial reporting towards the internal audit function and more general corporate governance matters (Porter, 1993).

In New Zealand (NZ), until recently, there was little interest in audit committees. In 1981, Chandler (1982) found that about 15% of public listed companies in NZ had audit committees. This was not dissimilar from the findings of surveys conducted in the UK and Australia at about the same time⁵. However, in 1989, Lukkassen (1989) found the proportion of NZ public listed companies with audit committees had risen only to about 22% - well below the levels then pertaining in North America, the UK and Australia. Further, until the NZ Institute of Directors recommended the adoption of audit committees in its Code of Proper Practice for Directors (IOD, 1993), audit committees were not strongly endorsed in NZ by either relevant professional bodies or regulatory agencies.

Given the experience of other Anglo-American countries, and given the large number of unexpected company failures which occurred in NZ in the wake of the 1987 sharemarket crash, all too frequently amid allegations of fraud or other malpractice by senior company officials, it seemed likely that audit committees would be established rapidly in NZ, at least by public listed companies, during the early to mid-1990s. Additionally, under public sector legislation, such as the Public Finance Act 1989, the financial statements of all significant public sector entities in NZ must be accompanied by a statement signed by the entity's Chief Executive and Chief Financial Officer. This must acknowledge the Chief Executive's responsibility for (a) the financial statements and judgements used therein, and (b) establishing and maintaining a system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial reporting. The statement must also state that, in the opinion of the Chief Executive, the financial statements fairly reflect the financial position and

⁵ Surveys by Christofi (1978) and Davison (1984) indicate that in the mid-1980s about 27% of large public listed companies in Australia had audit committees. A survey by Ernst & Young in 1990 found that the proportion had increased to 66% (Companies and Securities Bulletin, 1990).

⁶ See footnotes 4 and 5.

operations of the entity. Faced by these statutory requirements, Chief Executives need assurance that their obligations have been met. Audit committees seem to provide a means to meet this need.

Against this background, research was conducted in NZ in 1993 to ascertain the incidence of audit committees in significant private and public sector corporate entities; the reasons for their adoption; their composition, administration and functions; the attributes interested parties consider necessary for audit committees to function effectively; and the perceived advantages and disadvantages of these committees. The research also sought to identify differences in the audit committees (and attitudes thereto) of private and public sector entities. This paper reports the methodology and findings of this research.

RESEARCH METHODOLOGY

In order to obtain a wide range of views on audit committees in NZ, a mail survey was conducted. Four broad groups of respondents were surveyed, namely:

- external auditors - partners of 'Big 6' and 'middle tier' firms of chartered accountants and senior personnel from Audit New Zealand (NZ's public sector auditors);
- internal auditors - from both private and public sector entities;
- chairpersons of the governing bodies of public listed companies and significant public sector entities (including Government Departments, Local Authorities, State Owned Enterprises, Regional Health Boards and Tertiary Education Institutions);
- financial statement users - financial analysts, stockbrokers, corporate/commercial division bankers and financial journalists.

The members of each survey group were selected by equal interval random sampling from populations identified primarily from lists of names obtained from relevant firms, professional organizations and government agencies. As is shown in Figure 1, 540 questionnaires were mailed and 364 usable responses were returned (an overall usable response rate of 67%). The response rates range from 82% for external auditors to 62% for the corporate entity chairpersons.

Figure 1: Groups included in the survey and their response rates.

Survey Group¹	No. in Survey	No. of usable responses	% usable responses
<i>External Auditors</i>			
CA Firms	60	44	73
Audit New Zealand	40	38	95
Total	100	82	82
<i>Internal Auditors</i>			
Private sector entities	50	38	76
Public sector entities	50	43	86
Total	100	81	81
<i>Chairpersons of Corporate Entities</i>			
Private sector	100	52	52
Public sector	100	72	72
Total	200	124	62
<i>Financial Statement Users</i>			
Financial analysts	40	18	45
Stockbrokers	40	15	38
Bankers	40	34	85
Financial Journalists	20	10	50
Total	140	77	55
Combined Totals	540	364	67

The questionnaire was designed to seek information about:

- the current and planned existence of audit committees;
- reasons for establishing/not establishing audit committees;
- membership and administrative aspects of audit committees;
- the functions of audit committees;
- disclosures in corporate annual reports relating to audit committees.

Additionally, respondents' views were sought regarding:

- attributes of audit committees and audit committee members which enhance the effectiveness of audit committees;
- arguments advanced in the literature in favour of, and against, audit committees.

Three versions of the questionnaire were prepared - one for external auditors, another for internal auditors and corporate chairpersons, and a third for financial statement users. Although differing in detail, the content of the questionnaires was essentially the same. The external auditors were asked to respond to questions relating to the existence and functions of audit committees in either (a) private or (b) public sector entities, based on their knowledge of such committees - obtained from auditing relevant entities. They were also asked to indicate the disclosures relating to audit committees they consider should be made in corporate annual

reports. The internal auditors and corporate chairpersons were asked to provide similar information based on the existing situation in their organisation. As there was no overlap in the entities represented by the internal auditors and corporate chairpersons, conclusions about the current existence, membership, administration and functions of, and disclosures relating to, audit committees in private and public sector entities respectively, were derived from the average of the responses of the relevant subgroups of these two survey groups. The financial statement users were asked to indicate whether knowledge of the existence or absence of an audit committee affects their assessment of an entity and/or the reliability of its financial statements and also to express their views on the 'ideal' composition and functions of audit committees and the disclosures about audit committees which should appear in corporate annual reports.

In analysing the survey results, simple t-tests of the differences between the proportions or means of the survey groups' responses were used. A significance level of 0.05 was adopted.

SURVEY RESULTS

a) Incidence of, and reasons for establishing/not establishing audit committees

From Figure 2 it may be seen that, at the time of the survey (mid-1993), approximately 61% of public companies and significant public sector entities in NZ had audit committees. The proportion was slightly higher in the private than public sector (63% compared to 59%) but the difference was not significant. About two-thirds of these committees were established during the previous four years and a number of other entities in both sectors planned to establish audit committees in the following two years. The youthfulness of audit committees in public sector entities was particularly striking. Around 80% of public sector audit committees were established in the four years prior to the survey compared with about 50% of those in private sector corporates: about 50% of private sector audit committees had been in existence for five years or more.

Regarding the reasons for establishing audit committees, Figure 2 shows that 65% or more of each of the broad survey groups signified that the following are important reasons:

Figure 2: Incidence of, and reasons for establishing/not establishing, audit committees

No. of respondents in survey group:	Broad Survey Groups ¹				External Auditors ¹		Internal Auditors ¹		Corporate Chairpersons ¹	
	External Auditors 82	Internal Auditors 81	Corporate Chairpersons 124	Financial Statement Users 77	Private Sector 44	Public Sector 38	Private Sector 38	Public Sector 43	Private Sector 52	Public Sector 72
Existence of audit committees	% ²	% ²	% ²	% ²	% ²	% ²	% ²	% ²	% ²	% ²
Respondents from (or who have audited) entities with an audit committee	77	63	60	N/A	82	87	58	64	67	54
No of years audit committees have been established:	Majority estab. about 2 years	18	25	N/A	Majority estab. 2-5 years	Majority estab. 1-2 years	17	19	13	37
• less than 2 years	49	38					35	62	36	41
• 2-4 years	33	37					48	19	51	22
• 5 years or more										
Plan to establish audit committee in next 12-24 months	80 entities	20	26	N/A	26 entities	54 entities	9	29	29	24
Reasons for establishing audit committees	% ³	% ³	% ³	% ³	% ³	% ³	% ³	% ³	% ³	% ³
Regarded as good corporate practice	85	86	93	89	88	86	92	81	92	94
To facilitate examination of entity's internal controls	92	94	77	69	88	96	100	90	74	79
To facilitate effective examination of external financial reports	93	69	84	65	93	94	75	63	87	81
To strengthen role and independence of non-executive directors	51	36	60	68	65	41	46	28	82	44
To strengthen independence of internal auditors	39	76	38	49	35	41	85	69	36	43
To monitor compliance with entity's code of conduct	33	64	47	47	40	31	72	57	40	53
To strengthen independence of external auditors	43	40	53	35	38	43	48	33	64	43
Legislation requiring large corporates to establish audit committees is likely	82	1	6	21	80	71	4	0	6	7
To reduce directors' legal liability	20	10	19	N/A	15	20	13	7	29	11
To comply with requirements of overseas Stock Exchange or other regulator	9	12	7	N/A	17	0	22	3	14	6
Reasons for not establishing audit committees	% ³	% ³	% ³	% ³	% ³	% ³	% ³	% ³	% ³	% ³
Governing body fulfils duties an audit committee would perform	77	13	63	N/A	82	66	15	10	93	50
Absence of legal requirement for an audit committee	61	25	51	N/A	72	47	23	26	60	47
'Quasi' audit committee fulfils the functions of a formal committee	60	15	42	N/A	64	51	15	15	39	44
Costs of an audit committee would outweigh its benefit	45	8	31	N/A	33	52	8	8	40	27
Audit committee is not needed as entity has no internal audit function	46	11	18	N/A	34	56	4	18	31	13
Insufficient suitable non-executive directors are available to form an audit committee	34	6	18	N/A	31	37	8	5	36	9
Corporate culture is not ready for an audit committee	34	15	7	N/A	33	32	15	15	7	7
Not appropriate to have audit committee at subsidiary company level (or equivalent)	28	7	5	N/A	59	0	12	3	15	0

1 Respondents were asked to complete the questionnaire as follows:

- External auditors - based on entities they audit with/without audit committees.
- Internal auditors and corporate chairpersons - based on the existing situation in their organisation.
- Financial statement users - based on their opinions.

2 Percentage of respondents in the survey group responding to the question.

3 Percentage of the survey group signifying the reason is important in an entity's decision to establish/not establish audit an committee.

N/A signifies the survey group was not asked this question.

- establishing audit committees is regarded as good corporate practice;
- audit committees are able to facilitate effective examination of the entity's
 - internal controls,
 - external financial reports.

Although these reasons were supported strongly by all of the groups, their ranking differed - apparently reflecting each group's understandable bias. While the corporate chairpersons and financial statement users identified 'recognition as good corporate practice' as a particularly important reason, the internal and external auditors gave greater support to 'facilitating effective examination of internal controls'. The internal auditors (particularly those in private sector entities) also recognised as important the ability of audit committees to strengthen the independence of internal auditors (identified as important by 76% of this group, compared with 49% of financial statement users, 39% of external auditors and 38% of corporate chairpersons). However, somewhat unexpectedly - given the former role of audit committees in strengthening the external audit function - none of the groups identified 'to strengthen the independence of external auditors' as a particularly important reason for establishing audit committees: this was recognised as important by 53% of corporate chairpersons, 43% of external auditors, 40% of internal auditors and 35% of financial statement users. Of greater significance to all of the groups except the internal auditors is the ability of audit committees to strengthen the role and independence of non-executive directors (or their equivalent): 68% of financial statement users, 60% of corporate chairpersons and 51% of external auditors identified this as an important reason.

The reasons identified by respondents for establishing audit committees in private, compared with, public sector entities appear to be broadly similar. However, some marked differences are evident. For example, a significantly greater proportion of private than public sector external auditors, internal auditors and, in particular, corporate chairpersons, identified strengthening the role and independence of non-executive directors as an important reason for establishing audit committees. (The private to public sector proportions are 65% to 41% for external auditors; 46% to 28% for internal auditors; and 82% to 44% for corporate chairpersons: see Figure 2). Given the traditional absence of non-executives on the governing bodies of public sector entities and the youthfulness of these entities' audit committees (which generally include non-executives) the disparity in the sector group responses is not difficult to understand. However, other differences, and more particularly inconsistencies, in the

responses are perplexing. For example, the ability of audit committees to monitor compliance with the entity's code of conduct was identified as an important reason for establishing audit committees by significantly more private than public sector external and internal auditors (the comparative proportions are 40% to 31%, and 72% to 57%, respectively). However, the reverse picture is provided by the corporate chairpersons: 53% of those in public sector entities identified this as an important reason but only 40% of those in public companies did so. Similar differences and inconsistencies are evident in sector group responses relating to audit committees' ability to strengthen the independence of external auditors. While more public than private sector external auditors (43% compared to 38%) identified this as an important reason for establishing audit committees, the position was reversed in the case of the internal auditors and, more particularly, the corporate chairpersons: 33% and 43%, respectively, of public sector internal auditors and corporate chairpersons cited this reason as important compared with 48% and 64%, respectively, of their private sector counterparts.

As regards the reasons for entities *not* establishing audit committees, Figure 2 reveals that the survey groups whose views were sought⁷ identified as important reasons the fact that the full governing body or a 'quasi' audit committee fulfils the functions normally assigned to audit committees, and the absence of a legal requirement for audit committees to be established. In relation to the latter, it is pertinent to note that, in answer to another question, all four survey groups strongly agreed that there should be such a requirement for companies listed on the Stock Exchange and for major public sector entities (see Figure 6).

Notable features attaching to the reasons for entities not establishing audit committees are the small percentage of internal auditors identifying the reasons as important and the disparity in the responses of the survey groups. For example, while 34% of the external auditors recognised as important the corporate culture not being ready for such a move, only 15% of the internal auditors and 7% of the corporate chairpersons did so. Similarly, 45% of the external auditors and 31% of the corporate chairpersons identified as an important reason, the costs of an audit committee outweighing the benefits, but only 8% of the internal auditors concurred with this view.

⁷ The relevant question was omitted from the financial statement users' version of the questionnaire.

Turning attention to differences in the reasons for private and public sector entities not establishing audit committees, Figure 2 reveals that the sector group responses are, in general, conflicting. All three survey groups indicated that the governing body fulfilling the duties of an audit committee, and audit committees not being appropriate at subsidiary company level, are more important reasons in private than in public sector entities but, beyond this no general conclusions can be drawn.

b) Composition, administration and disclosure of audit committees

From Figure 3 it may be seen that the size of audit committees in NZ corporates varies widely - from about two to 14 members. However, most commonly, in both private and public sector entities, these committees have between four and seven members and include at least one executive and three non-executive directors (or their equivalent). This size and composition corresponds quite closely with the 'ideal' identified by financial statement users. As Figure 3 shows, members of this group signified that audit committees should have about five members and include two executive and two non-executive members. The last finding is surprising. Given the perceived value of audit committees in fulfilling a broad corporate governance role, and given the recent increase in audit committees in NZ - in an era of unexpected corporate failure and alleged misconduct by senior executives - financial statement users might have been expected to seek a higher ratio of non-executive to executive directors in their 'ideal' audit committee.

With respect to audit committee members, the survey indicates that significantly more Chief Executive Officers (CEOs) than Chief Financial Officers (CFOs) are members of audit committees, especially in the public sector. (CEOs are members of about 75% and 60% of audit committees in public and private sector entities, respectively, compared with CFOs who are members of about 39% of audit committees in each sector.) The results also indicate that more Chief Internal Auditors (CIAs) than external auditors are members of audit committees in public sector entities but the reverse applies in the private sector. (CIAs are members of about 40% of public sector audit committees but of only about 18% of those in the private sector; external auditors are members of about 27% of audit committees in each sector). The existing position differs quite markedly from that which financial statement users signified should exist: 69% and 55% of this group indicated that CFOs and CIAs, respectively, should be audit committee members but only about 45% expressed this view in relation to CEOs and

Figure 3: Composition, administration, and disclosure of audit committees

	Broad Survey Groups				External Auditors		Internal Auditors		Corporate Chairpersons	
	External Auditors 82	Internal Auditors 81	Corporate Chairpersons 124	Financial Statement Users 77	Private Sector 44	Public Sector 38	Private Sector 38	Public Sector 43	Private Sector 52	Public Sector 72
<i>Respondents in survey group:</i>										
Membership	<i>Most commonly occurring responses</i>				<i>Most commonly occurring responses</i>					
No. of: Executives	N/A	1, 2, or 3	1	2	N/A	N/A	1	4	1	1
Non-executives		3	3	2			3	2	3	2
Total membership: mean		6.0	4.6	4.7			6.2	5.8	4.4	4.8
mode	N/A	5	3	5	N/A	N/A	5	6	3	4
range		3-14	2-11	3-8			3-14	3-12	3-9	2-11
Audit committee members:		% ¹	% ¹	% ¹			% ¹	% ¹	% ¹	% ¹
Chief Executive Officer	N/A	72	65	44	N/A	N/A	64	79	57	72
Chief Financial Officer		37	41	69			42	32	32	49
External auditor		30	23	45			23	38	25	21
Chief Internal Auditor		43	14	55			32	55	3	24
If not members can attend meetings:										
External auditor		94	100				94	93	100	100
Chief Internal auditor		93	77				93	92	82	75
Chief Executive Officer	N/A	80	100	N/A	N/A	N/A	89	71	100	100
Chief Financial Officer		88	98				89	90	96	100
Audit committee membership debarred if:										
Substantial amount of entity's shares or loan stock held		2	0	69			5	0	0	0
Some of entity's shares or loan stock held		0	0	12			0	0	0	0
Hold particular position in entity (eg chairperson)	N/A	2	0	36	N/A	N/A	5	0	0	0
An executive in entity/related entity		15	21	16			26	4	34	5
Lack financial, accounting or auditing knowledge		0	10	51			0	0	9	11
Means of appointment:										
Executives by:										
Governing body		33	66				35	32	84	53
Chairperson of governing body	N/A	13	10	N/A	N/A	N/A	5	18	8	12
Committee of governing body		10	2				20	4	0	3
Rotation or automatic appointment by position		38	22				30	43	8	32
Non-Executives by:										
Governing body		56	77				48	65	82	72
Chairperson of governing body	N/A	14	11	N/A	N/A	N/A	18	10	11	11
Committee of governing body		9	3				13	5	2	3
Rotation or automatic appointment by position		19	9				22	15	5	14
Term of appointment										
1-2 years		5	5				5	4	3	7
3 years	N/A	18	7	N/A	N/A	N/A	24	13	0	14
4 years		0	1				0	0	0	4
No specified time		77	87				71	83	97	75
Meetings: Regular meetings		Mean ²	Mean ²				Mean ²	Mean ²	Mean ²	Mean ²
Mean	N/A	4.4	3.7	N/A	N/A	N/A	3.4	5.3	3.2	4.2
Range		1-9	1-9				2-6	1-9	1-9	1-9
Special meetings: Mean		1.9	2.2				1.3	3.5	2.6	2.0
Range		1-4	0-5				1-2	3-4	1-3	0-5
Minutes of Meetings		% ¹	% ¹	% ¹			% ¹	% ¹	% ¹	% ¹
Produced		91	86				100	83	88	85
Circulated to:										
Audit committee members	N/A	100	93	N/A	N/A	N/A	100	100	100	87
Full governing body		65	36				59	71	90	66
External auditors		64	69				57	73	87	55
Chief internal auditor		83	53				67	100	58	48
Senior executives		29	37				11	47	30	41
Those attending the meeting		75	72				67	84	83	62
Means of specifying audit committee responsibilities		% ¹	% ¹				% ¹	% ¹	% ¹	% ¹
Written terms of reference	N/A	55	43	90	N/A	N/A	59	50	41	46
Resolutions of governing body		22	28	57			22	22	25	30
Informal agreement		14	27	1			13	16	34	20

Cont ...

	Broad Survey Groups				External Auditors		Internal Auditors		Corporate Chairpersons	
	External Auditors	Internal Auditors	Corporate Chairpersons	Financial Statement Users	Private Sector	Public Sector	Private Sector	Public Sector	Private Sector	Public Sector
<i>Respondents in survey group:</i>	82	81	124	77	44	38	38	43	52	72
<i>Disclosures in annual reports³</i>	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹
Existence of audit committee	61	17	22	96	70	50	9	26	18	25
Members of audit committee	53	7	12	76	55	50	9	5	12	13
Members' qualifications	37	5	5	61	41	31	4	5	9	0
Objectives of audit committee	53	13	5	79	52	53	0	26	3	7
Functions of audit committee	52	13	4	61	43	61	0	26	3	3
¹ Percentage of respondents in survey group responding to the question. ² Average of responses ³ Internal auditors and corporate chairpersons indicated the disclosures which are made in their entity's annual report; external auditors and financial statement users indicated the disclosures they considered should be made.										

external auditors. Given the accepted importance of audit committees in strengthening the external financial reporting process, the financial statement users' responses are surprising: it might be expected that a significantly smaller proportion would support CFOs being audit committee members but a larger proportion would consider external auditors should be members.

A further disparity between the existing and desired situation in major NZ corporates (as reported by the internal auditors and corporate chairpersons on the one hand and financial statement users on the other) is evident in relation to reasons for debarring audit committee membership. As Figure 3 reveals, the only reason of significance which currently debars membership is being an executive in the entity or a related entity. (This applies in about 30% of public companies and 4% to 5% of public sector entities). A secondary reason, reported by about 10% of corporate chairpersons, is that of a lack of financial, accounting or auditing knowledge. However, 51% of financial statement users considered the latter reason *should* debar audit committee membership. Financial statement users were even more agreed that holding a substantial amount of the entity's shares or loan stock should preclude membership of the entity's audit committee: 69% expressed this view. Two percent of internal auditors (all from private sector entities) and no corporate chairpersons reported that membership is, in fact, debarred for this reason. Thirty six percent of financial statement users also signified that holding certain positions within the entity (eg Chairperson) should preclude audit committee membership.

Regarding members' appointment to an audit committee, the survey indicates that in most cases appointment is for an unspecified period. Where appointment is for a limited term, three

years is the most usual. The most common means of appointment of both executive and non-executive members (especially executive members in private sector entities) is by the full governing body. The next most common method (particularly for executive members in public sector entities) is by rotation or by virtue of position (that is, by automatic appointment).

With respect to audit committee meetings, the survey indicates that most committees hold about four regular and two special meetings a year but some meet as infrequently as once a year whilst others meet about once a month. In general, audit committees in public sector entities tend to meet a little more frequently than those in private sector entities (see Figure 3). In some 90% of cases (with a slightly higher frequency in the private than public sector) minutes of meetings are taken and these are circulated to audit committee members in virtually all entities. However, the minutes are circulated to all meeting attendees in only about 73% of cases and to the full governing body, external auditors and senior executives in about 50%, 66% and 33% of entities, respectively. It is noted below that one of the arguments cited against audit committees is that they can create conflict within an entity. This arises, in particular, when senior executives, auditors (internal and external) and others believe that matters concerning them are discussed at audit committee meetings when they are not present to defend themselves. It is submitted that, if audit committee meeting minutes were distributed routinely to all interested parties, much of the potential suspicion - and resultant conflict - could be avoided.

As regards specifying audit committees' responsibilities, it appears that only about 50% of audit committees have written terms of reference. In about 25% of cases, their responsibilities are defined by resolutions of the governing body but the duties of some 20% of committees are arranged through informal agreement. The responses of the financial statement users suggest that, to them, the *status quo* is not satisfactory. Ninety percent of this group expressed the view that audit committees' responsibilities should be defined in written terms of reference and 57% indicated that they should be specified by resolutions of the governing body. (It is clear that a significant number of this survey group believe that audit committee responsibilities should be determined by resolutions of the governing body and then incorporated in written terms of reference).

The survey results suggest that only minimal disclosures about audit committees are made in corporate annual reports but rather more public than private sector entities disclose such information. Overall, about 20% of entities disclose the existence of their audit committee, about 10% identify their audit committee members, 5% disclose the members' qualifications and around 8% or 9% disclose their audit committee's objectives and/or functions (see Figure 3). The responses of the external auditors and financial statement users suggest that this level of disclosure is not satisfactory. Ninety six percent of financial statement users and 61% of external auditors indicated that the existence of an audit committee should be disclosed; 76% of users and 51% of external auditors expressed the same view in respect of the identity of audit committee members; and 79% of users and 53% of external auditors indicated that the audit committee's objectives should be reported. In view of the finding that some 80% of financial statement users have increased confidence in the reliability of financial information if they are aware that an entity has an audit committee (see Figure 6), it is suggested that greater disclosure about audit committees in corporate annual reports would be beneficial for both financial statement users and the corporate entities concerned.

c) Functions of audit committees

As part of the survey, respondents were asked to indicate in relation to (i) external financial reporting, (ii) external auditing, (iii) internal auditing, and (iv) other matters, the functions audit committees perform or, in the case of financial statement users, the functions they should perform. The results are presented in Figure 4a. Respondents were also asked to indicate, for each group of functions, (a) the most and (b) the least important function. The number of 'least important' responses for each function was deducted from the number of 'most important' responses to generate a 'net importance' figure. This, in the form of a percentage, provided a weighted ranking for each audit committee function. These are presented in Figure 4b. The closer a ranking is to +100 (-100), the more important (unimportant) the group considered the function to be.

(i) External financial reporting: All four broad survey groups indicated that particularly important external financial reporting functions of audit committees are:

- reviewing the entity's audited financial statements;

Figure 4a: Functions performed by audit committees

No. of respondents in survey group:	Broad Survey Groups				External Auditors		Internal Auditors		Corporate Chairpersons	
	External Auditors	Internal Auditors	Corporate Chairpersons	Financial Statement Users	Private Sector	Public Sector	Private Sector	Public Sector	Private Sector	Public Sector
	82	81	124	77	44	38	38	43	52	72
External Financial Reporting	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹	% ¹
Review audited financial statements	98	74	89	87	98	98	87	60	88	91
Review accounting policies	94	71	87	93	95	92	83	60	91	86
Monitor compliance with statutory requirements	65	83	73	86	69	61	91	76	76	69
Review interim financial statements	67	67	73	89	67	73	83	52	84	64
Review entire annual report	55	69	51	52	48	63	74	64	33	67
Review public statements re financial matters	52	23	32	63	71	37	46	0	55	9
Review circulars re non-routine transactions (eg takeovers)	18	17	16	59	21	18	35	0	24	7
External Audit										
Review management's response to auditors' internal control recommendations	94	86	96	94	92	98	100	69	94	97
Review auditors' internal control evaluation & recommendations	95	86	97	91	97	95	96	76	97	97
Discuss with external auditor:										
- conduct and problems of the audit	100	82	93	96	100	100	96	68	97	89
- audited financial statements	84	74	81	90	92	82	92	56	91	70
- scope and timing of audit	84	76	77	73	77	96	83	68	79	74
Review proposed audit fee	85	74	61	47	82	90	83	64	71	51
Arbitrate in disputes between management and auditors	65	48	71	71	62	65	48	48	73	70
Review independence of auditors	48	58	58	87	51	47	70	48	77	39
Nominate external auditors	38	39	27	38	54	31	54	24	32	22
Approve external auditors	42	37	20	34	54	35	54	20	21	19
Internal audit										
Review management's response to internal auditors' recommendations	88	94	68	93	89	88	100	88	67	69
Discuss with Chief Internal Auditor (CIA):										
- internal audit findings and reports	88	96	65	97	87	90	100	92	67	65
- effectiveness of internal controls	83	92	64	97	81	86	100	84	67	63
- problems in performing the internal audit	84	92	61	93	84	86	96	88	62	59
Review internal audit objectives and plans	83	94	60	93	84	82	100	88	57	64
Review organisation and independence of internal audit function	73	84	58	89	73	73	88	80	63	53
Review relationship between internal and external auditors and co-ordination of their work	75	80	53	82	73	78	75	84	56	52
Evaluate adequacy of resources for internal audit function	54	69	59	79	54	59	74	63	63	55
Appoint CIA	35	37	20	44	30	29	38	36	20	19
Dismiss CIA	35	37	20	38	32	35	44	32	20	19
Other Functions										
Initiate special projects or investigations within terms of reference	83	74	68	N/A	67	90	71	77	65	71
Enquire into illegal or unethical activities within the entity	76	74	62	80	71	78	83	65	59	65
Review adequacy of management information systems	77	60	56	77	67	84	58	62	44	67
Monitor adherence to corporate code of conduct	31	44	27	42	34	29	42	46	24	29
Review significant transactions outside entity's normal business	36	17	22	60	29	37	30	4	21	24
Review entity's efforts to comply with social obligations to employees, community, etc	16	17	22	16	8	20	30	4	21	24

1 Percentage of respondents in survey group indicating the audit committee function is (or, for financial statement users, should be) performed

- reviewing the accounting policies used in preparing the financial statements and any changes in the policies;
- monitoring compliance with statutory requirements;
- reviewing the entity's entire annual report.

The internal and external auditors and corporate chairpersons indicated that at least 65% of audit committees perform these functions and 86% or more of the financial statement users signified that the functions should be performed by audit committees.

Looking at differences in the external financial reporting functions performed by audit committees in private and public sector entities, the internal auditors indicated that each function is performed by significantly more audit committees in private than public sector entities. The difference is particularly marked in respect of audit committees reviewing public statements on financial matters prior to their release and reviewing circulars relating to non-routine transactions such as takeover bids. The performance of these functions was reported by 46% and 35%, respectively, of internal auditors of private sector entities compared to 0% in each case by their public sector counterparts. Unlike the internal auditors, the external auditors and, more particularly, the corporate chairpersons signified that there is little difference in the functions performed by private and public sector audit committees. The most significant difference signalled by these groups pertains to audit committees reviewing statements on financial matters prior to their release: 55% and 71%, respectively, of corporate chairpersons and external auditors of private sector entities reported this function is performed, compared with 9% and 37%, respectively, of those of public sector entities (see Figure 4a).

As regards the most and least important external financial reporting function performed by audit committees, Figure 4b reveals that the external auditors, internal auditors and financial statement users all considered reviewing the entity's audited financial statements to be the most important function. However, the financial statement users adjudged reviewing the accounting policies adopted by the entity to be equally important, and this function was considered to be the most important by the corporate chairpersons. At the other end of the spectrum, all four survey groups identified reviewing circulars relating to non-routine transactions such as takeover bids as the least important function.

Figure 4b: Weighted rankings of functions of audit committees¹

	Broad Survey Groups				External Auditors		Internal Auditors		Corporate Chairpersons	
<i>No. of respondents in survey group:</i>	External Auditors 82	Internal Auditors 81	Corporate Chairpersons 124	Financial Statement Users 77	Private Sector 44	Public Sector 38	Private Sector 38	Public Sector 43	Private Sector 52	Public Sector 72
External Financial Reporting										
Review accounting policies	+42	+16	+33	+25	+54	+40	+22	+6	+43	+22
Review audited financial statements	+11	+12	+35	+25	+11	+10	+6	+17	+35	+35
Monitor compliance with statutory requirements	(-14)	+15	0	+4	(-14)	(-14)	+17	+11	+4	(-4)
Review entire annual report	+3	(-4)	(-11)	(-19)	(-14)	+21	0	(-6)	(-22)	0
Review interim financial statements	(-11)	(-7)	(-7)	(-2)	(-11)	(-12)	(-11)	0	(-4)	(-9)
Review public statements re financial matters	(-11)	(-11)	(-2)	(-8)	0	(-19)	0	(-17)	(-17)	(-26)
Review circulars re non-routine transactions (eg takeovers)	(-25)	(-23)	(-28)	(-25)	(-25)	(-26)	(-33)	(-11)	(-39)	(-17)
External Audit										
Review auditors' internal control evaluation & recommendations	+21	+46	+33	+46	+23	+16	+47	+45	+17	+48
Discuss with external auditor:										
- conduct and problems of the audit	+42	+12	+39	+12	+52	+39	+7	(-18)	+58	+20
- audited financial statements	+7	+4	(-10)	+10	+13	+2	+13	(-9)	0	(-20)
- scope and timing of audit	(-1)	+4	+4	(-6)	(-6)	+5	+7	0	+4	+4
Review management's response to auditors' internal control recommendations	+4	+12	+10	+4	+3	+5	+7	+18	+8	+12
Approve external auditors	(-3)	+4	(-4)	(-6)	0	(-5)	+7	0	(-4)	(-4)
Review independence of auditors	(-19)	0	(-12)	+6	(-23)	(-14)	0	0	(-8)	(-16)
Arbitrate in disputes between management and auditors	(-16)	(-15)	(-24)	(-10)	(-29)	(-11)	(-20)	(-9)	(-17)	(-32)
Nominate external auditors	(-21)	(-35)	(-16)	(-14)	(-19)	(-25)	(-40)	(-27)	(-33)	0
Review proposed audit fee	(-12)	(-31)	(-18)	(-47)	(-13)	(-11)	(-27)	(-36)	(-25)	(-12)
Internal audit										
Discuss with Chief Internal Auditor (CIA):										
- internal audit findings and reports	+26	+26	+21	+17	+24	+29	+27	+25	+20	+22
- effectiveness of internal controls	+23	+15	+29	+27	+21	+24	+20	+8	+20	+35
- problems in performing the internal audit	+3	(-15)	0	(-4)	+14	(-5)	(-7)	(-25)	+20	(-13)
Review internal audit objectives and plans	+6	+19	+16	+15	+7	+5	+13	+25	+20	+13
Review management's response to internal auditors' recommendations	+14	+15	+8	+6	+10	+22	+27	0	0	+13
Review organisation and independence of internal audit function	(-10)	(-4)	+5	+23	(-10)	(-10)	(-7)	0	+13	0
Review relationship between internal and external auditors and co-ordination of their work	(-5)	(-4)	(-18)	(-6)	(-10)	(-2)	(-7)	0	(-20)	(-17)
Appoint CIA	(-10)	(-22)	(-21)	(-25)	(-3)	(-12)	(-33)	(-8)	(-40)	(-9)
Dismiss CIA	(-28)	(-19)	(-16)	(-21)	(-28)	(-29)	(-27)	(-8)	(-20)	(-13)
Evaluate adequacy of resources for internal audit function	(-23)	(-11)	(-23)	(-31)	(-24)	(-22)	(-7)	(-17)	(-13)	(-30)
Other Functions										
Review adequacy of management information systems	+34	+30	+27	+31	+33	+35	0	+80	+23	+32
Enquire into illegal or unethical activities within the entity	+8	+26	+27	+48	+7	+9	+29	+20	+41	+11
Initiate special projects or investigations within terms of reference	+24	(-11)	+5	N/A	+19	+26	+6	(-40)	0	+11
Review significant transactions outside the entity's normal business	(-5)	(-11)	(-15)	(-8)	(-4)	(-7)	0	(-30)	(-9)	(-26)
Monitor adherence to corporate code of conduct	(-21)	(-11)	(-5)	(-15)	(-15)	(-26)	(-6)	(-20)	(-9)	0
Review entity's efforts to comply with social obligations to employees, community, etc	(-39)	(-22)	(-39)	(-56)	(-41)	(-37)	(-29)	(-10)	(-45)	(-26)

¹ The maximum and minimum possible weighted ranks figures are +100

(ii) **External auditing:** As Figure 4a shows, the functions most commonly performed by audit committees in relation to external auditing are:

- discussing with the external auditor the conduct of the audit and any problems encountered;
- reviewing the external auditor's evaluation of the entity's internal controls and related recommendations for improvement;
- reviewing management's response to the external auditor's recommendations with respect to internal controls.

More than 90% of the external auditors and corporate chairpersons and more than 80% of the internal auditors, reported that audit committees perform these functions. Additionally, more than 90% of financial statement users indicated that these functions should be performed by audit committees.

While the groups displayed significant agreement in relation to the functions noted above, a marked disparity is evident in relation to the other external audit functions. For example, 87% of financial statement users considered that audit committees *should* review the independence of external auditors but only 48% of external auditors and 58% of internal auditors and corporate chairpersons reported that audit committees perform this function. Along similar lines, only 47% of financial statement users signified that audit committees should review the proposed audit fee, yet 85% of external auditors, 74% of internal auditors and 61% of corporate chairpersons indicated that this function is performed.

Comparing the external audit functions performed by audit committees in private and public sector entities, Figure 4a suggests that, in general, the functions are performed more commonly by audit committees in the private sector. However, the external auditors and corporate chairpersons (unlike the internal auditors) indicated that more public than private sector audit committees review management's response to the external auditor's internal control recommendations. The external auditors also indicated that the functions of discussing the scope and timing of the audit with the external auditor, reviewing the proposed audit fee, and arbitrating in disputes between management and the external auditor, are more commonly performed by audit committees in public than private sector entities.

As regards the most important external audit function performed by audit committees, the external auditors and corporate chairpersons signified that it is discussing with the external auditor the conduct of the audit and any problems encountered; to the internal auditors and financial statement users it is reviewing the external auditor's evaluation of the entity's internal controls and related recommendations. It is suggested that these differences reflect the differing biases of the survey groups: it might be expected that, while the internal auditors and financial statement users are primarily concerned with the ability of the entity's internal controls to prevent and/or detect errors and irregularities, the external auditors and corporate chairpersons are more concerned with the ability of the auditors to perform their duties effectively and efficiently.

With respect to the least important external audit function performed by audit committees, the external and internal auditors considered it to be nominating the external auditor. However, the financial statements users and corporate chairpersons identified it, respectively, as reviewing the proposed audit fee and arbitrating in disputes between management and the external auditor. The last finding is surprising as it might be anticipated that corporate chairpersons would welcome a means, such as the audit committee arbitrating in disputes between management and auditors, to ensure that at least a sub-committee of the governing body was kept informed of serious disputes arising between these parties.

(iii) Internal audit: From Figure 4a it may be seen that the survey groups indicated that audit committees commonly perform five internal audit related functions, namely:

- discussing with the Chief Internal Auditor (CIA):
 - the internal audit findings and reports;
 - the effectiveness of the entity's internal controls;
 - problems encountered in performing internal audit duties;
- reviewing management's response to the internal auditors' recommendations;
- reviewing the internal audit function's objectives and plans.

The corporate chairperson's responses suggest that these functions are performed by some 60% to 68% of audit committees, however, the internal and external auditors indicate the figure is in the region of 80% to 95%. It is suggested that the latter finding may be more reliable as the corporate chairpersons are likely to be less aware than the auditors of the

relationship between the entity's internal audit function and audit committee. It is pertinent to note that at least 93% of the financial statement users signified that each of these functions should be performed by audit committees. This seems to reflect a desire by this group for audit committees to be concerned with broad corporate governance matters.

An interesting finding of the survey is the similarity of the internal audit related functions performed by audit committees in private and public sector entities. As may be seen from Figure 4a, unlike the functions in the other groupings, there is no significant difference in the proportion of audit committees in private and public sector entities performing the functions related to internal audit.

Considering the most and least important functions performed by audit committees in the internal audit arena, the external and internal auditors identified the most important function as 'discussing with the CIA the internal audit findings and reports'. However, the corporate chairpersons and financial statement users indicated that it is discussing with the CIA the effectiveness of the entity's internal controls (see Figure 4b). For the external auditors and financial statement users this finding is consistent with the most important function the group identified in relation to external audits. However, for the internal auditors and corporate chairpersons it reflects a different stance from that adopted in relation to external audits.⁸ It may be that the internal auditors, like the external auditors, look to the audit committee to ensure they are able to discharge their duties effectively and efficiently and they believe that discussing the audit findings and reports with the audit committee helps to achieve this objective. However, the corporate chairpersons may rely on the internal audit function to ensure the entity's internal controls are operating effectively to prevent and/or detect errors and irregularities. Thus, they consider the audit committee discussing with the CIA the effectiveness of these controls is more important than the committee discussing the internal audit findings and reports as a whole.

As regards the least important internal audit related function performed by audit committees, all of the survey groups, other than the internal auditors, identified this as evaluating the

⁸ As noted earlier, the external auditors and corporate chairpersons considered the most important external audit related function performed by audit committees is discussing with the auditor the conduct and problems of the audit; for the internal auditors and financial statement users it is reviewing the external auditor's internal control evaluation and related recommendations.

adequacy of resources allocated to internal audit. The internal auditors considered it to be appointing the CIA (see Figure 4b). The latter finding is surprising as it might be expected that internal auditors would perceive the appointment of the CIA by the audit committee (rather than by the CEO or other executives) as strengthening the independence and role of the internal audit function.

(iv) Other functions: Other important audit committee functions identified by the survey groups include:

- initiating special projects or investigations within the committee's terms of reference.⁹
- enquiring into illegal or unethical activities within the entity;
- reviewing the adequacy of management information systems.

Figure 4a shows that although these functions are performed by around 60% to 75% of audit committees they are not performed as commonly as many of the external financial reporting and external and internal audit related functions.

Looking at differences in the 'other functions' performed by audit committees in private and public sector entities, the functions of initiating special projects or investigations and reviewing the adequacy of management information systems are performed more commonly by public than private sector audit committees (see Figure 4a). However, as for the other functional groupings, the survey groups' responses do not portray a consistent picture and, apart from the two functions mentioned above, it appears that there is little difference in the 'other functions' performed by audit committees in the two sectors.

According to all of the survey groups, other than the financial statement users, the most important 'other function' performed by audit committees is reviewing the adequacy of management's information systems. This function was ranked highly by the financial statement users but they considered enquiring into illegal or unethical activities within the entity to be of greater importance. The corporate chairpersons also ranked this, together with the function noted above, as 'the most important' function. The importance accorded

⁹ This function was not included in the financial statement users' version of the questionnaire as it was envisaged they would not have knowledge of the nature of special projects and investigations likely to be initiated by audit committees.

‘enquiring into illegal or unethical activities’ by the financial statement users and corporate chairpersons lends support to the conclusion noted earlier, that these groups look to audit committees to be concerned with corporate governance matters.

The survey groups were unanimous in ranking ‘reviewing the entity’s efforts to comply with its social obligations to employees, the local community and others’ as the least important function of audit committees in this general area.

(d) Effectiveness of audit committees

One of the objectives of the survey was to ascertain respondents’ views on the attributes of audit committee members and audit committees *per se* which help to ensure, or enhance, the effectiveness of audit committees. In order to achieve this objective, respondents were asked to select from suggested attributes relating to (a) audit committee members and (b) audit committees, the attribute they considered to be (i) the most and (ii) the least important in ensuring the success of an audit committee. To obtain a single measure of the perceived importance of each attribute, its weighted rank was calculated in the same manner as the weighted rank of audit committee functions: the number of ‘least important’ responses was deducted from the number of ‘most important’ responses. The resultant ‘net importance’ figure, expressed as a percentage, provided each attribute’s weighted rank. These are presented in Figure 5.

(i) Attributes of audit committee members: Figure 5(a) reveals that all of the survey groups other than the external auditors considered the two most important attributes for audit committee members to possess are:

- a full understanding of the purpose and responsibilities of the audit committee;
- the ability to exercise sound judgement.

The external auditors concurred with the other groups regarding the importance of audit committee members understanding the purpose and responsibilities of the committee but, perhaps surprisingly, they considered independence from management to be a more important attribute than the ability to exercise sound judgement. The corporate chairpersons rated the latter attribute particularly highly (with a weighted ranking of +36) but the internal auditors

**Figure 5: Effectiveness of audit committees: weighted rankings¹ of desired attributes of
(a) audit committee members and (b) audit committees**

No. of respondents in survey group:	Broad Survey Groups				External Auditors		Internal Auditors		Corporate Chairpersons	
	External Auditors 82	Internal Auditors 81	Corporate Chairpersons 124	Financial Statement Users 77	Private Sector 44	Public Sector 38	Private Sector 38	Public Sector 43	Private Sector 52	Public Sector 72
(a) Attributes of audit committee members										
Full understanding of purpose and responsibilities of audit committee	+21	+29	+19	+30	+11	+33	+21	+36	+14	+23
Ability to exercise sound judgement	+13	+16	+36	+17	+14	+13	+21	+11	+49	+26
Personal qualities such as integrity and objectivity	+7	+11	+4	+15	+10	+3	+7	+14	0	+6
Knowledge of entity's business	+9	+16	+10	0	+5	+13	+29	(-4)	+8	+11
Independence from management	+19	+2	+5	+8	+35	0	+4	0	+5	+4
Ability to ask probing questions	(-1)	+2	(-4)	(-4)	(-3)	0	(-4)	+7	(-5)	(-2)
Sufficient time to devote to committee's affairs	(-9)	(-11)	(-10)	0	(-3)	(-17)	(-4)	(-18)	(-8)	(-11)
Knowledge of accounting practice	(-12)	(-34)	(-11)	(-8)	(-8)	(-17)	(-29)	(-39)	(-3)	(-17)
Experience at governing body or senior management level in range of business areas	(-7)	(-18)	(-20)	(-45)	(-14)	0	(-29)	(-7)	(-22)	(-19)
Knowledge of auditing practice	(-40)	(-13)	(-29)	(-13)	(-49)	(-30)	(-18)	(-7)	(-38)	(-21)
(b) Attributes of audit committees										
Objectives and responsibilities are clearly defined in written statement	+19	+22	+22	+12	+20	+18	+21	+23	+17	+25
Has ready access to relevant information	+5	+4	+13	+27	+3	+7	+3	+4	+17	+10
Is supported by senior management	+8	+15	+11	+8	+11	+4	+10	+19	+9	+13
Is promptly notified of problems by internal and external auditors	+8	+7	+13	+8	+3	+14	+10	+4	+9	+17
Is independent of full governing body	+6	+7	+4	+15	+9	+4	+7	+8	+3	+4
Chairperson is enthusiastic about committee's role within entity	+19	+7	+1	0	+26	+11	+3	+12	+9	(-4)
Has ready access to all levels of management	(-3)	+5	+5	+8	(-3)	(-4)	+7	+4	+6	+4
Audit committee members are carefully selected	+8	(-4)	+2	+8	+5	+11	(-7)	0	0	+4
Has ready access to external auditors	+6	(-2)	+8	0	+5	+7	0	(-4)	+11	+6
Has ready access to internal auditors	0	+2	+1	+4	0	0	+3	0	0	+2
Obtains prompt responses from management	+2	+2	+1	(-2)	(-3)	+7	+3	0	0	+2
Is promptly notified of problems by management	(-2)	0	+4	(-2)	(-3)	0	+3	(-4)	+6	+2
Audit committee members have varied backgrounds	(-8)	+5	(-6)	(-12)	(-5)	(-11)	(-3)	+15	(-3)	(-8)
Has regular meetings	(-3)	(-11)	(-13)	(-12)	(-5)	0	(-10)	(-12)	(-6)	(-19)
Agenda and related material are provided to members ahead of meetings	(-10)	(-7)	(-10)	(-15)	(-5)	(-14)	(-7)	(-8)	(-9)	(-10)
Has continuity of membership	(-14)	(-16)	(-14)	(-4)	(-14)	(-14)	(-14)	(-19)	(-17)	(-13)
Non-members attend meetings as required	(-11)	(-15)	(-13)	(-17)	(-9)	+14	(-7)	(-23)	(-14)	(-13)
Audit committee membership is rotated amongst members of governing body	(-30)	(-22)	(-29)	(-25)	(-34)	(-25)	(-24)	(-19)	(-37)	(-23)

¹ The maximum and minimum weighted ranks figures are +100.

ranked it in joint second place (with a weighted ranking of +16) along with 'knowledge of the entity's business'.

At the opposite end of the scale, the external auditors and corporate chairpersons identified knowledge of auditing practice as the least important attribute of audit committee members. These groups may believe that knowledge of auditing practice can be left to the auditors and that audit committee members can seek information or explanations about audit matters should they need it. The internal auditors and financial statement users indicated, respectively, that possessing knowledge of accounting practice and having experience at governing body or senior management level in a range of business areas are the least important attributes.

Analysis of Figure 5(a) reveals that, although there is a disparity in the weightings given by the broad survey groups to the various attributes of audit committee members, the groups are generally agreed as to the attributes' ranking. However, marked (but inconsistent) differences of opinion are evident between the public and private sector subgroups. For example, the external auditors of private sector entities ranked the attribute 'being independent of management' in first place (with a weighted ranking of +35) but their public sector entity counterparts placed it fifth (with a weighted ranking of 0). These rankings are significantly different but the internal auditors and corporate chairpersons in both private and public sector entities ranked the attribute in fourth or fifth place (with weighted rankings ranging from 0 to +5). Similarly, while the internal auditors in private sector entities considered 'possessing knowledge of the entity's business' to be the most important attribute (giving it a weighted ranking of +29), those in public sector entities placed it sixth (with a weighted ranking of -4). In contrast to this, the external auditors in public sector entities and corporate chairpersons in both private and public sector entities ranked this attribute in third place (with weighted rankings of +8 to +13) and the external auditors in private sector entities placed it fifth (with a weighted ranking of +5).

(ii) Attributes of audit committees: The broad survey groups were generally agreed about the most and least important attributes which audit committees *per se* need to possess in order to ensure their effectiveness. All of the groups, other than the financial statement users, considered the most important attribute is having the committee's objectives and

responsibilities clearly defined in a written statement. Given the finding (noted earlier) that only about 50% of audit committees in major NZ corporates have their responsibilities specified in written terms of reference, this result is of particular significance and suggests a means of increasing audit committee effectiveness.

To the financial statement users, the attribute of prime importance for audit committee effectiveness is having ready access to relevant information. (They gave this a weighted ranking of +27). The corporate chairpersons ranked this attribute in second place (with a weighted ranking of +13) but the internal and external auditors placed it seventh and eighth (with weighted rankings of +4 and +5), respectively. The external auditors ranked the attribute of the chairperson being enthusiastic about the committee's role within the entity in equal first place. However, the other groups gave it a relatively small weighted ranking (+7 by the internal auditors, +1 by the corporate chairpersons, 0 by the financial statement users, compared to +19 by the external auditors) (see Figure 5b). Other attributes the groups considered to be important for ensuring audit committee effectiveness include:

- being supported by senior management (ranked second by the internal auditors);
- being notified promptly by internal and external auditors of problems encountered (ranked in second place, along with having access to relevant information, by the corporate chairpersons);
- being independent of the full governing body (ranked second by the financial statement users).

Regarding the least important attribute of audit committees, all of the survey groups considered this to be rotating audit committee membership amongst members of the entity's governing body. To the external and internal auditors and corporate chairpersons, the second least important attribute is having continuity of audit committee membership; to the financial statement users it is having non-members attend committee meetings as required. All four survey groups also considered having agenda and related material provided to members ahead of committee meetings to be a relatively unimportant attribute (see Figure 5b). This is surprising as it might be expected that audit committee members could discuss issues more effectively if they had time to read and consider relevant information prior to meetings. This seems to apply, in particular, to non-executive director (or equivalent) members of audit

committees who could benefit from having the opportunity to identify, prior to the meeting, matters on which they need further information before forming a judgement or expressing an opinion.

Regarding differences in the relative importance of attributes pertaining to audit committee effectiveness in private and public sector entities, Figure 5b reveals that, as for the attributes which are pertinent to the effectiveness of audit committee members, no uniform picture is portrayed. For example, the external auditors of private sector entities considered the most important attribute to be the chairperson being enthusiastic about the audit committee's role within the entity. The external auditors of public sector entities ranked this attribute in second place but gave it a weighted ranking of +11 compared to +26 given by their private sector counterparts. Unlike the external auditors, the internal auditors of private sector entities placed the attribute sixth (with a weighted ranking of +3) compared to their colleagues in public sector entities which ranked it fourth (with a weighted ranking of +12). The chairpersons of private sector corporates regarded the attribute as of some importance (ranking it fourth with a weighted ranking of +9) but those of public sector entities considered it to be relatively unimportant - placing it twelfth with a weighted ranking of -4.

e) Perceived advantages and disadvantages of audit committees

As part of the survey, respondents were asked to signify (on a five point Likert scale) their agreement or disagreement with a series of statements which enshrined arguments advanced in the literature in support of, and against, audit committees. The means of the survey group responses are presented in Figure 6. The closer the means are to 5.0, the greater the agreement of the group with the relevant statement: the closer they are to 1.0, the more strongly the group disagreed with the statement.

From Figure 6 it may be seen that the opinions of the survey groups are very similar and that, in general, the respondents are very supportive of audit committees. They signified particular agreement with the statements that audit committees:

- assist internal and external auditors report to the entity's governing body serious deficiencies in internal controls and serious management weaknesses;

Figure 6: Perceived advantages and disadvantages of audit committees

No. of respondents in survey group:	Broad Survey Groups				External Auditors		Internal Auditors		Corporate Chairpersons	
	External Auditors 82	Internal Auditors 81	Corporate Chairpersons 124	Financial Statement Users 77	Private Sector 44	Public Sector 38	Private Sector 38	Public Sector 43	Private Sector 52	Public Sector 72
Audit Committees:	Mean ¹	Mean ¹	Mean ¹	Mean ¹	Mean ¹	Mean ¹	Mean ¹	Mean ¹	Mean ¹	Mean ¹
Assist internal and external auditors report to governing body:										
• deficiencies in internal controls	4.0	4.1	3.8	3.8	3.9	4.1	4.2	4.0	3.7	3.8
• management weaknesses	4.0	4.1	3.7	3.7	3.8	4.1	4.2	4.1	3.7	3.7
Improve communication between governing body and										
• external auditors	4.2	3.9	3.8	3.8	4.1	4.4	4.1	3.7	3.9	3.8
• internal auditors	3.9	4.0	3.7	3.8	3.8	4.1	4.1	3.9	3.6	3.7
Assist governing body discharge:										
• its external financial reporting duties	4.0	3.8	3.8	3.9	3.9	4.2	4.0	3.6	3.8	3.8
• its responsibilities re fraud and other illegal acts	3.5	3.8	3.5	3.5	3.5	3.6	3.8	3.7	3.4	3.6
Strengthen role and effectiveness of non-executive directors	3.7	3.7	3.6	3.7	3.8	3.6	3.9	3.5	3.8	3.5
Provide a forum for arbitration between management and internal and external auditors	3.7	3.6	3.5	3.6	3.7	3.8	3.7	3.6	3.6	3.5
Enhance the independence of:										
• internal auditors	3.5	4.0	3.7	3.3	3.5	3.6	4.2	3.9	3.7	3.6
• external auditors	3.3	3.5	3.4	3.1	3.4	3.3	3.7	3.3	3.5	3.4
Increase the confidence of financial statement users re the reliability of the financial statements	2.9	3.5	3.3	3.5	2.8	3.1	3.6	3.4	3.4	3.3
Are merely an additional layer of bureaucracy	1.9	1.8	2.3	2.2	2.0	1.8	1.7	2.0	2.2	2.4
Are generally ineffective	2.3	2.2	2.2	2.5	2.3	2.2	2.3	2.2	2.1	2.4
Create a barrier between the entity's governing body and external auditors	2.3	2.3	2.3	N/A	2.3	2.3	2.0	2.5	2.2	2.5
Can create conflict within an entity	2.4	2.5	2.6	N/A	2.4	2.5	2.3	2.7	2.4	2.7
Respondents opinions:										
Audit Committees should be a legal requirement for:										
• Companies listed on the Stock Exchange	3.9	4.2	3.6	3.7	3.9	4.0	4.5	3.9	3.4	3.8
• Major public sector entities	4.0	4.4	3.7	4.0	3.9	4.0	4.6	4.2	3.8	3.6
If financial statement users know an entity has an audit committee:				% agreeing						
• It increases their confidence re the reliability of the financial statements	N/A	N/A	N/A	80	N/A	N/A	N/A	N/A	N/A	N/A
• It affects their assessment of the entity	N/A	N/A	N/A	46	N/A	N/A	N/A	N/A	N/A	N/A

1 Means from 1.0 to 2.9 signify some level of disagreement with the statement; means from 3.1 to 5.0 signify some level of agreement.

- improve communication between the entity's governing body and its external and internal auditors;
- assist the entity's governing body discharge its external financial reporting responsibilities;
- strengthen the role and effectiveness of non-executive directors and the independence of internal auditors.

From the opposite perspective, respondents disagreed strongly with the assertions that audit committees:

- are merely an additional layer of bureaucracy;
- are generally ineffective;
- create a barrier between the entities' governing body and external auditors.

Respondents, especially internal auditors in private sector entities, also signified their support for audit committees by agreeing strongly with the statement that audit committees should be a legal requirement for listed companies and major public sector entities. Further, 80% of the financial statement users indicated that if they know an entity has an audit committee it increases their confidence in the reliability of the financial information (see Figure 6).

CONCLUSION

Experience in Canada, the US, UK and Australia (as elsewhere) suggests that, faced by unexpected corporate failures and instances of corporate malpractice, the attention of regulators, relevant professional bodies, and significant players in the corporate arena focuses on audit committees as a means of reducing corporate ills. Once these committees begin to be established, awareness of their potential for securing reliable financial reports and responsible corporate governance grows quickly and their adoption proceeds at a rapid rate.

NZ experienced a significant increase in unexpected company failures, often accompanied by reports of corporate malpractice, in the wake of the 1987 sharemarket crash. Added to this, in 1989, public sector legislation introduced a requirement for the CEO and CFO of all significant public sector entities to acknowledge in their entity's external financial statements their responsibility for those statements and for ensuring their entity has an effective system of internal control. Given this background, it could be expected that audit committees would be established rapidly in significant private and public sector entities in NZ in the early to mid-1990s.

The mail survey conducted in mid-1993 in NZ found that approximately 61% of public listed companies and significant public sector entities had audit committees. Many of these committees had been established since 1989 and plans were in place for further audit

committees to be established. The youthfulness of public sector organisations' audit committees was particularly marked. The survey also found that audit committees in NZ, like those in other Anglo-American countries, have a variety of functions and, in general, they are expected to fulfil a broad corporate governance role.

The survey results further indicate that external and internal auditors, corporate chairpersons and financial statement users are favourably disposed towards audit committees. However, the survey responses also suggest that the effectiveness of audit committees could be improved if governing bodies ensure that:

- i) the objectives and responsibilities of their entity's audit committee are clearly defined in a written statement;
- ii) all relevant parties (including senior executives) routinely receive the minutes of audit committee meetings; and
- iii) information about the existence, membership and functions of the audit committee is disclosed in their entity's annual report.

The survey findings support the evidence from Canada, the US, UK and Australia which indicates that a properly constituted audit committee, with realistic, clearly defined duties, is invaluable in helping both private and public sector entities secure reliable external financial reporting and responsible corporate governance. However, although audit committees can and do assist corporate entities meet the public's expectations with respect to external financial reporting and corporate governance, too much must not be expected of them. When circumstances arise which encourage assignment of additional responsibilities to an entity's audit committee, consideration needs to be given to the relationship between those responsibilities and the committee's terms of reference, and to the time and expertise committee members are able to devote to the committee's affairs. Audit committees are not, and cannot be, a panacea.

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