

Audit Committees

A Study in European Corporate Governance

There is a growing recognition by the business community, the accountancy profession and regulators that, if companies are to be able to communicate with global investors, they will need to be increasingly receptive to the demands of those investors for information about their activities.

Already we are witnessing a trend towards convergence in the areas of accounting and auditing as financial reporting is increasingly adopting a common international language. Governance practices too are taking on an international flavour, as European companies look to recent developments in the business environment in the USA.

Of course, such practices cannot simply be exported from one country to another; they must respect national cultural and economic differences. However, many companies in Europe are following the trend towards a recognition that the prime responsibility for some governance responsibilities should be taken out of the hands of operational management. We are seeing an enhanced focus on the role of the independent director, in particular in the formation of audit committees.

In this publication we look in detail at audit committees. As part of our work in compiling this booklet, we contacted a sample of companies in the major European countries. The experience of 65 major companies from eight countries, gathered by written survey and interview, has enabled us to provide some practical guidance for those (especially independent directors) charged with promoting audit committees.

Professor François Degeorge
Department of Finance & Economics
HEC School of Management, Paris

Mary Keegan
Director of Professional Standards
Price Waterhouse Europe

September 1997

**EUROPE'S GOVERNANCE
DEBATE**

The audit committee in context

Market forces are responsible for the unprecedented pressures for change which have opened up the governance practices of companies to external gaze. Audit committees can play an invaluable part in improving companies' accountability and governance structures. Used effectively, they may provide a "bridge" between management, the directors, the shareholders and external auditors.

1

**ESTABLISHING AUDIT
COMMITTEES**

Experience in practice

Many large companies in major European countries already have audit committees. In some cases, these have been established for many years. We believe that best practice is for audit committees to be composed solely of independent directors, and most have three to four members.

3

**MEETINGS AND
ADMINISTRATION**

It is advantageous to have written terms of reference, such that powers are delegated to the committee, but with the main Board retaining ultimate responsibility for financial reporting and internal control. In this section we offer some suggestions to assist administration.

6

HOW WIDE IS THE REMIT?

Should audit committees restrict themselves to issues relating to financial reporting and audit, and internal controls? Many seem to monitor the effectiveness of internal financial control systems, but should they consider wider operational risks (for example environmental and litigation risks) which could have a material financial impact? Our survey also shows differing perceptions of responsibilities in relation to published financial information.

13

**PROVIDING A LINK WITH
AUDITORS**

What are the benefits?

Audit committees have an important role to play in enhancing the perceived independence of internal and external audit from operational management. As more large companies outsource their internal audit functions, audit committees may assume responsibilities for reviewing the terms and cost-effectiveness of such outsourcing arrangements.

15

		Page
INTERNAL ACCOUNTABILITY	Committees can play a positive role in improving the quality of management and financial information in the company, and hence lead to more informed decision-making. Most companies with audit committees agree that the benefits of improved governance and control consciousness outweigh the modest costs.	18
A NEED FOR TRAINING?	<p>The future</p> <p>As audit committees gain in importance, the need for independent directors with adequate skills, particularly financial or accounting skills, will grow. Companies may need to consider whether provision should be made for formal training of independent directors. We provide some suggestions for meeting training needs.</p>	19
REGULATION OR A VOLUNTARY APPROACH?	Many companies believe that stock exchanges around Europe may act to make audit committees a requirement for listed companies. However, a stock market led “voluntary” approach to establishing audit committees, based on adopting the practices of the better companies, is to be preferred to government legislation. Prompted by local stock exchanges, business can find its own solutions.	21
ASSISTING EXTERNAL COMMUNICATION	Increasingly, companies will be expected to demonstrate good governance in order to access the world’s capital markets. The fact that a company has an audit committee may boost investor confidence in its governance practices.	22

On the following pages, the survey results are shown in shading.

Companies should have the right governance structures to underpin accountability

Corporate governance is about two things – accountability and communication. It is about how those entrusted with day-to-day management of a company's affairs are held to account to shareholders and other providers of finance; and whether the organisation has the appropriate corporate structures to underpin accountability. It is also about how the company presents itself to the wider world: to shareholders; to potential investors; to employees; to regulators; and to other interest groups with a legitimate interest in its affairs.

As companies increasingly look beyond their national boundaries, selling their products internationally and seeking to raise finance on the global capital markets, these processes of accountability and communication become crucial. International investors have become more discriminating in their demands for information, and in relation to the standards of governance which they expect companies to adopt.

At the same time, some recent spectacular and well-publicised business failures in Europe have prompted discussion about the shortcomings of existing models of corporate accountability, and some possible remedies. Amongst other changes, many leading companies have increased the representation of independent directors on their boards and established audit committees as a way of enhancing a focus on internal controls.

Involvement of quality independent directors can improve business performance, as well as strengthening governance structures

There has been much discussion in some countries about the relative merits of unitary and two-tier structures for boards of directors. What is important is that, regardless of what formal board structure is in place, there should be adequate representation of "independent" directors. These may be labelled "non-executive" directors as in Britain, but the key requirement is that they should be truly independent of the day-to-day operations of the enterprise.

Independent directors should not be regarded as policemen who check and ratify every decision of operational management, but they can usefully act as guardians of the interests of shareholders and other stakeholders in the enterprise. They should have sufficient access to financial and other business information in order to bring their experience and expertise to bear, and thus "add value" to the company's strategic decision-making.

There is, in particular, a key role for independent directors in providing a bridge between management and shareholders, notably in the areas of external financial reporting and internal controls. The existence of an audit committee to take prime responsibility for such matters can ease the pressure on management and on a busy Board of Directors. It can also provide an important focus for discussions with the company's internal and external audit functions.

Audit committees are assuming increasing importance

Audit committees have become an increasingly common feature of European companies. This trend reflects the voluntary approach adopted by the business community to improving governance structures in a number of countries. The Cadbury Code of Best Practice in Britain, the Viénot report in France, and the report of the Peters Committee in the Netherlands all include recommendations relating to the establishment of audit committees. As leading companies in these countries implement the recommendations, measures such as the creation of audit committees may be expected to spread to those territories and those companies not yet covered by similar codes of practice.

In its 1996 Green Paper "The Role, Position and Liability of the Statutory Auditor in the European Union" the European Commission shows that it views audit committees as a potentially powerful tool which can reinforce the independence of external auditors and strengthen the auditors' hand when dealing with operational management. In the Commission's own words "experience has shown that, even where audit committees have been set up mainly to meet listing requirements, they have proved their worth and developed into essential committees of boards of directors".

Given the twin pressures of international market forces, and the interest of authorities and regulators in governance issues, the significance of audit committees can only be expected to grow.

"experience has shown that... audit committees have developed into essential committees of boards of directors"

[European Commission – 1996 Green Paper on Auditing]

Is there a legal requirement, or a stock exchange requirement, for an audit committee in your country?

Audit committees are not currently a requirement of company law in any of the surveyed countries. However, there is effectively a requirement for such committees in Britain, as the London Stock Exchange requires UK listed companies to give in their annual reports a statement of compliance with the Cadbury Code of Corporate Governance. The establishment of an audit committee is one of the recommendations contained in the Code.

The voluntary codes of practice and recommendations issued by new governance committees in other countries, notably in France, are not yet supported by a mandatory requirement to give a statement of compliance.

Is there an audit committee, or an equivalent body, in your company?

Despite the absence of formal legal or stock exchange requirements in almost all countries, the survey indicated a high rate of voluntary adoption, with over 60% of the companies having audit committees. Adoption rates were, not surprisingly, highest in Britain (100%), followed by France and Switzerland.

Countries with the lowest incidence of audit committees were Sweden, where there appears to be a greater culture of openness in business (and where the auditors enjoy greater access to all the board directors); and Italy, where governance practices have perhaps been slower to change.

A number of German company representatives noted that, although they did not have a formally constituted audit committee, many of the functions in relation to review of financial statements were performed by another committee of the board. For example, both Mannesmann AG and Volkswagen AG have a "balance sheet committee". At many other German companies the financial statements and financial position of the company are discussed by the Supervisory Board. One company representative noted that improved co-operation between the Supervisory Board and the auditors can contribute to a more effective governance system.

Some holding companies appear to have adopted a policy of creating an audit committee in each large subsidiary. For example, Belgian company Union Minière, a subsidiary of French group Compagnie de Suez, recently set up an audit committee.

For how many years has the audit committee been in operation?

The survey found that there is considerable variation in the length of time for which companies have had audit committees.

In the USA, audit committees have been a common feature of the corporate landscape for two decades. This Anglo-Saxon influence may be responsible for the fact that some British companies in the survey have had audit committees for over ten years.

For most continental European companies, with a few exceptions, the establishment of audit committees has been a more recent phenomenon. For example, in Belgium and France, the surveyed companies had had such committees for between two and four years.

Some companies did however recognise the benefits early. Julius Bär Holding in Switzerland has had an audit committee for 20 years, whilst Banco Bilbao Vizcaya in Spain has had one for 13 years.

Are all the members of the audit committee non-executive directors?

Where companies in Belgium, France, Germany and the UK had audit committees, these were found to be composed solely of non-executive directors, independent of those responsible for day-to-day management. (In total, 80% of committees in respondent companies were comprised solely of independent directors.)

Exceptions to this trend were noted in Sweden and Switzerland, although in the latter case interviews revealed that involvement of members of the audit committee in management affairs tended to be for historical reasons. Swiss banking law has enforced greater separation of management and supervisory organs.

How many members does the committee have, and for how long are they appointed?

Committees were found to have between three and four members at 70% of those respondent companies which had audit committees. Generally, the survey indicated no fixed term of appointment for committee members.

Does the audit committee report its findings and recommendations to the board of directors or supervisory board?

This was the case in almost all surveyed companies.

“improved
co-operation
between the
Supervisory
Board and the
auditors can
contribute to a
more effective
governance
system”

The involvement of strong independent directors is important...

Britain's Cadbury Committee suggested that an audit committee should consist of at least three members and recommended confining this to independent non-executives. Our experience in the UK is that audit committees often have more than three members (a 1995 survey found an average committee size of four non-executive directors) and may also include one executive director.

Three-member committees work well in the British context, if the individuals' backgrounds are complementary. Such a committee is not so large as to become unwieldy, but does provide the necessary diversity of views and strength to ensure an appropriate balance of power. Against this, of course, three-member committees require regular full attendance for maximum benefit.

In countries where the role of the audit committee is discharged by the Supervisory Board (for example in Germany) it would not be appropriate to expect similar size criteria to be applied to the Board. What is important is that there should be strong independent directors on those boards who are able to consider audit matters objectively.

As to terms of appointment, these should be kept under review to ensure that non-executive directors retain an independent mindset and do not over time become too closely associated with company operations. Guidance issued by PRO-NED (a British lobby group which champions the role of non-executive directors) recommends an initial term of appointment of three years, with perhaps a further three-year extension period if appropriate.

...but their role and responsibilities must be clearly defined

In our experience, the specific matters reserved for consideration by the audit committee and the method of reporting to the board need to be set out clearly and understood by the board and operational management alike. The terms of reference should ensure that the committee has full access to information and can initiate special investigations on areas of concern.

On page 9 we provide specimen terms of reference for audit committees. These have been designed for general application, and borrow from best practice in the USA and from the UK's Cadbury Committee, but may need tailoring to suit the circumstances of different countries' business cultures.

Additionally, on page 8 we set out our recommendations for the administration of committee meetings.

Are there written terms of reference for the audit committee?

Nearly 80% of companies said their committees had written terms of reference. This trend was most pronounced in Britain, France and Switzerland. In the case of Britain this is perhaps unsurprising since the Cadbury Report, which recommended the setting up of audit committees, included specimen terms of reference.

Most committees had explicit authority to investigate any matters falling within their terms of reference and, where such investigations were necessary, access to resources to conduct them.

How often does the audit committee meet?

The survey showed that committees met, on average, between three and four times a year (though in some companies the frequency can be as high as nine times a year).

Who, other than audit committee members, can attend meetings?

In most companies, executive directors, internal auditors and external auditors are all permitted to participate in meetings (except in the case of executive directors, where matters relevant to them are being discussed).

In the French business environment, in particular, the power of the Président Directeur Général or Chief Executive Officer is, according to custom, very strong. In these circumstances, when the audit committee meets with the financial director or other executive managers, it would be unusual to expect the PDG or CEO not to attend such meetings also.

Where, unusually, external auditors were not invited to attend, this may be because the committee also has other, wider, monitoring responsibilities. In these circumstances, at one Swiss company, the President met with the external auditors before each meeting in the presence of management representatives.

Does the audit committee receive reports direct from the internal and external auditors?

Audit committees usually receive reports direct from the internal and external auditors, although, perhaps in deference to the strong historical influence exerted by executive management, this tendency was less marked in France.

“the Supervisory Board or audit committee should meet with the auditor at least once a year”

[Peters Committee report recommendation, June 1997]

Does the committee have unrestricted access to documents and information from executive management, internal and external auditors?

The committee enjoyed unrestricted access to such information in almost all the respondent companies.

Does the committee receive pertinent information from executive management regularly?

Again, the answer was yes in almost all cases. Normally the committee would receive management information automatically – in other cases it would almost always receive information on request. A few companies noted that, since audit committee members also served on the main board of directors, (and would therefore be in receipt of management information), creating an additional formal information flow between management and audit committees would, in these circumstances, be inefficient.

“every Board should set up a committee to ensure that the accounting methods used in preparing the accounts are pertinent and consistent”

[Viénot Report recommendation, July 1995]

Our suggestions for audit committee administration

Frequency of meetings

We suggest there should be a minimum of three meetings per year:

- one prior to the announcement of the interim results;
- one during the year to discuss internal controls, the scope of the internal and external audit plans for the forthcoming year, and anticipated reporting issues (for example changes in accounting policies); and
- one prior to the announcement of the annual results, to discuss any further reporting issues, and to consider the annual accounts and matters arising from the external audit.

Meeting early enough

The proximity of a meeting to the announcement of results is important. A meeting only one day in advance of an announcement will add little to the process as there may be insufficient time to consider and reflect suggestions, or deal with issues arising. Ideally, the committee should meet to consider the major issues well in advance of a public announcement.

Attendance

As the survey demonstrates, there is a growing trend for external and internal auditors to attend all meetings. In the USA it is common for legal counsel to attend. Whether the Chief Executive attends audit committee meetings is a matter of choice, but there may be benefits from his or her attendance, particularly for certain items on the agenda.

Circulation of papers

Informal research shows that only 13% of audit committees receive papers a week or more in advance. We believe that three working days, together with a weekend, should be the minimum period for consideration of papers.

Private meetings with the auditors

To ensure that communication channels with external and internal auditors are open if a real need arises, there should be private meetings with the audit committee as a matter of course. Independent directors should have, as a separate agenda item at least once a year, a private discussion with the auditors. Even if there are no significant matters the auditor wishes to raise, such a meeting represents a useful "safety valve".

Audit Committee Charter or Terms of Reference

Realistic terms of reference, approved by the main board, define the audit committee's duties and provide it with sufficient membership, authority and resources to perform its role effectively.

The example below might take the form of a stand-alone policy statement or part of the company policy manual or directors' handbook. No one example necessarily encompasses all of the activities which might be appropriate to include in an audit committee charter. Furthermore, not all activities included in this sample Terms of Reference are appropriate for all companies.

Sample Audit Committee Terms of Reference

CONSTITUTION

The audit committee is a committee of the Board of directors. Its primary function is to assist the Board in fulfilling its oversight responsibilities by reviewing the financial information which will be provided to the shareholders and others, the systems of internal controls which management and the Board of directors have established, and the audit process.

MEMBERSHIP

The Committee will be appointed by the Board from amongst the independent/non-executive directors of the company and will consist of not less than [three] members. The quorum for meetings will be [two] members.

The chairman of the Committee will be appointed by the Board.

MEETINGS

Meetings will be held not less than [three] times a year. The external auditors may request a meeting if they consider one is necessary.

The Chief Financial Officer, head of internal audit and the external auditors will normally attend meetings. Other Board members will also have the right of attendance. However, at least once a year, the Committee will meet with the external auditors without executive Board members present.

Sample Audit Committee Terms of Reference (continued)**DUTIES**

In meeting its responsibilities, the audit committee is expected to:

- 1 Review and update the committee's charter or terms of reference annually.
- 2 Provide an open avenue of communications between the internal auditors, the external auditor and the Board of directors.
- 3 Consider the appointment of the external auditor and make recommendations to the Board of directors, review the fees or compensation of the external auditor, and consider any questions of auditor resignation or dismissal.
- 4 Review the appointment, replacement or dismissal of the head of internal audit.
- 5 Consider the independence of the internal auditor and the external auditor, including review of the non-audit services provided by the external auditor and related fees.
- 6 Consider the respective scopes of work and audit plans of the internal auditors and the external auditor.
- 7 Review with the head of internal audit and the external auditor the co-ordination of audit effort to ensure completeness of coverage, avoid duplication of effort, and promote the effective use of audit resources.
- 8 Consider and review with the external auditor and the head of internal audit:
 - the adequacy of the company's internal controls including computerised information system controls and security; and
 - management letters and any related significant findings and recommendations of the external auditor and internal audit together with management's responses thereto.
- 9 Inquire of management about significant risks or exposures and assess the steps management has taken to minimise such risk to the company.

Sample Audit Committee Terms of Reference (continued)

10 Review with management and the external auditor at the completion of the annual examination:

- the company's annual financial statements;
- any changes in accounting policies and practices, and compliance with accounting standards;
- major judgmental areas;
- significant adjustments arising from the audit;
- the findings of the external auditor's audit of the financial statements and his or her report thereon;
- any significant changes required to the external auditor's audit plan; and
- other matters related to the conduct of the audit which are to be communicated to the committee under generally accepted auditing standards.

11 Review other published documents and consider whether the information contained in them is consistent with the information contained in the annual financial statements.

12 Review with management and the external auditor the interim financial report before it is published.

13 Consider and review with management and the head of internal audit:

- significant internal audit findings during the year and management's responses thereto;
- any difficulties encountered in the course of the audits, including any restrictions on the scope of their work or access to required information;
- any changes required in the scope of their audit plan; and
- the internal audit department budget and staffing.

14 Review legal and regulatory matters that may have a material impact on the financial statements, related company compliance policies, and reports received from regulators.

Sample Audit Committee Terms of Reference (continued)

15 Meet separately with the head of internal audit, the external auditors, and executive management to discuss any matters that the committee or these groups believe should be discussed privately with the audit committee.

16 Report committee actions to the Board of directors with such recommendations as the committee may deem appropriate.

AUTHORITY

The audit committee shall have the power to conduct or authorise investigations into any matters within the committee's scope of responsibilities. It is authorised to seek any information it requires from any employee of the company. The committee shall be empowered to obtain independent legal or other professional advice to assist it in the conduct of any investigation.

What matters does the audit committee review?

- financial reporting systems;***
- internal control systems;***
- internal audit;***
- external audit;***
- financial information to be published?***

The survey showed that, in most cases, all areas were addressed by the committee. In Belgium, Switzerland and Sweden, the committees' responsibilities with respect to published financial information were less well defined.

Does the audit committee monitor the effectiveness of management information and internal control systems, and the safety of the related IT systems?

Again, these areas were looked at by the majority of committees, although the picture was not uniform in each country – British committees were the most likely to review all three areas. Some companies placed very strong emphasis on the integrity of information systems, the response of one Swiss company being typical: "When this doesn't work, the business collapses."

Does the audit committee deal with extraordinary business transactions and incidents, such as cases of fraud?

Respondents at almost all companies believed that unusual transactions should be reported to and considered by the audit committee.

Does the committee review risk exposure and consider risk management measures? Does it assess going concern risks?

These areas were commonly dealt with by audit committees in Belgium, Italy and the UK, reflecting a growing view that the audit committee should concern itself with all risks which may, ultimately, pose a threat to the financial health of the business. In Belgium it was common for finance directors and internal auditors to make presentations to the audit committee members on how different types of risk (for example credit risk, environmental risks, IT risks) are managed in the company.

In other countries such as France, Sweden and Switzerland this view was less predominant. A number of Swiss companies commented that risk management was the domain of financial and operational management, or that these issues were dealt with by separate risk management committees, distinct from the audit committee.

It is perhaps surprising that almost half the audit committees do not consider going concern risk, since this does have a direct impact on the financial statements.

What responsibilities do audit committees have in relation to published financial information?

In most countries the majority of audit committees believed they should review financial information prior to publication; although preliminary and interim results were less commonly looked at than annual reports. This was particularly the case in Belgium, France and Switzerland. British and German audit committees reviewed the annual report almost without exception.

Although in Germany the Supervisory Board, or another board committee, normally discharges the role of reviewing the published financial statements, an audit committee may be able to dedicate more resource to this task. One German board member noted that, compared to the Supervisory Board, the audit committee could review and interpret the financial statements in more depth.

Is the audit committee involved in decision-making on the application of accounting standards?

British and Swiss committees seem to involve themselves more in discussions of accounting standards. This was the case only in a minority of the Belgian, German and Swedish companies who answered our survey.

Company managements are increasingly addressing the operating and financial risks which they face in a more structured way. Many have initiated risk self-assessment exercises at business segment level. Fundamental questions are being asked such as: "What would cause this business to cease operations?"

Audit committees are beginning to review these wider business risks. In some cases, companies have established separate risk strategy committees to perform this task.

One immediate issue which audit and risk committees will have to face is the Year 2000 or "Millennium Bug" problem (the risk that some older computer software will not be able to cope with the century date change from "99" to "00"). Those companies which have not yet put into place an action plan to examine whether their business-critical systems are Year 2000-compliant may find they have insufficient time or resource to tackle any problems before it is too late.

"finance directors are making presentations to the audit committee members on how different types of risks are managed in the company"

Many commentators see internal audit as the “eyes and ears” of the audit committee

The internal audit function can assist the audit committee in meeting its responsibilities, particularly in the areas of internal control, fraud and internal investigations. Audit committees should consider whether the internal audit function's role is appropriate, has suitable reporting lines, and whether it is adequately resourced.

Unlike external audit, internal audit does not have a statutory, clearly defined role. The more traditional roles have been the provision of financial control assurance to ensure the integrity of financial information and to safeguard assets, and the prevention and detection of fraud.

Recently, however, organisations have become much more concerned with improving business performance. In response, more internal audit departments now see themselves as providing a business advisory service, “adding value” where previously they may have been viewed as merely “checkers”.

Informal research shows that internal audit managers of large British companies expect to spend much less time in future on traditional controls assurance procedures. They anticipate that more of their work will be forward looking, with time devoted to “added-value” activities such as self-assessment of business risks and design of controls to mitigate those risks.

The trend towards outsourcing can enhance the changing role of internal audit

Outsourcing enables the company to access a wider range of skills (for example in relation to treasury operations) which the small, traditional internal audit department may lack. It can also provide a solution to the difficulties faced by companies of all sizes in retaining specialist IT and treasury personnel. Outsourcing may also enhance the independence of internal audit from operational management.

We see an expanded role for both internal audit departments and audit committees. A strong internal audit function, reporting to a committee which has an interest in enhancing all aspects of business performance, has much to contribute to the maintenance of effective control systems.

Does the company have an internal audit department, and does the audit committee review and approve the scope of work of internal audit?

Of the 43 companies which answered this question, 88% had an internal audit function and, in most of those cases, audit committees review and approve the scope of work and activities of the internal auditors.

Does the committee monitor the cost-effectiveness of internal audit?

In Britain, Sweden and Switzerland, the committee frequently reviewed the cost-effectiveness of the internal audit department, but in no cases did the committees in French or German companies do so. It appears that, in these countries, operational management play a more dominant role in matters of audit expenditure and cost control. There also appeared to be a correlation between the length of time of establishment of the audit committee, and the interest taken in such value-for-money questions.

Does the committee approve the appointment of the head of internal audit, and does he or she have direct access to the committee?

A similar pattern to that outlined above is experienced with regard to internal audit appointments – in Belgium, France and Germany this function is normally the preserve of operating management. However, in almost 80% of cases, the head of internal audit enjoyed direct access to the audit committee.

Does the audit committee monitor co-ordination between internal and external audit work?

Co-ordination between internal and external audit was monitored at the majority of surveyed companies in Britain, Sweden and Switzerland; less so in other countries.

“companies without a strong internal audit function will be unable to provide an audit committee with sufficient information to fulfil its responsibilities”

[European Commission – 1996 Green Paper on Auditing]

We believe it is important to establish a direct link between the external auditors and the independent or non-executive directors.

The involvement of audit committees in matters of auditor selection and remuneration helps to reinforce the independence of auditors from operational management.

Does the audit committee play a key role in selecting the external auditors?

At over 65% of companies which responded (principally in the UK, Sweden and Switzerland) audit committees played a key role in selecting external auditors. In other countries auditor selection appears to rest with operational management.

Is the committee involved in agreeing the external auditors' scope of work?

In over 70% of respondent companies, audit committees reviewed the scope of the external audit work and the auditor's terms of engagement. Audit committees seemed least likely to perform this role in Belgium and Germany.

Does the committee monitor the external auditors' fees and the nature of non-audit services provided by the external auditor?

Monitoring of the auditor's fees was a task commonly performed by British, Swedish and Swiss committees. Again, matters relating to auditor remuneration were regarded by most Belgian, French and German companies as being the preserve of operational management. Only in Britain and in Switzerland did committees also monitor the nature of non-audit services provided by the external auditor.

Do audit committees enhance co-operation and communication between management, the board of directors and the auditors?

Yes, the great majority of companies believed that communication between management and auditors was improved. With some exceptions in Belgium, Germany and Sweden, most companies felt that the existence of the audit committee served to enhance the independence of the external auditor and raise the level of confidence in the audit process.

“it is appropriate to enhance the independence of the auditor by increasing the role of non-executive directors in his appointment”

[European Contact Group of large accounting networks – response to European Commission's 1996 Green Paper on Auditing]

Do audit committees assist in providing more objective and better information to the board of directors?

Most companies surveyed felt that the existence of the audit committee did help enhance the quality of financial and management information supplied to the board. Opinion was divided on whether this resulted in an actual enhancement of the quality of business management itself.

The representative of one Swiss bank noted that the establishment of the audit committee had led to clearer lines of responsibility (between management, the board of directors, and the auditors.) This was reinforced in the banking sector by the need to appoint a “compliance officer” to report formally to the audit committee each year that internal guidelines had been adhered to.

Does an audit committee add to the load on the management involved?

A significant minority of the companies surveyed did believe that the audit committee added to the demands placed on management resources, but this view was less commonly held in those companies which actually had an audit committee!

Does an audit committee add an unnecessary level of hierarchy?

Except in Sweden, few companies thought that audit committees added an unnecessary tier to the management structure, or that such committees created unwanted and additional bureaucracy. Even in Sweden, those companies which had audit committees viewed them positively; companies without audit committees perceived more problems.

Does the audit committee add an excessive cost factor?

Few companies (and none which actually had an audit committee) believed that establishing and running audit committees added significantly to their costs.

Will audit committee members need training to carry out their increasingly complex supervisory role?

A majority of companies in Britain, Italy, Sweden and Switzerland felt that audit committee members would require training to help them discharge their roles.

Executives of some multi-national companies, for example Aare-Tessin in Switzerland, linked the need for training to the increasingly complex environment in which business activities are carried out. Particular areas where it was identified that training would be valuable were business sector trends (for example for companies in the energy sector) and the “political” aspects of international investment.

There also appears to be some correlation between a recognition that training is valuable and the length of time that audit committees have been in existence. In the case of Italy however, which does not have a long history of committees, there appears to be an eagerness to learn perhaps driven by the acceptance of business leaders that improved governance structures are needed and will be demanded by the market.

Should audit committees pay increasing attention to individual aspects of risk management, such as: financial risks; information system risks; environmental risks; litigation risks?

Respondent companies almost unanimously believe that audit committees should in the future pay increasing attention to financial risks. However, many fewer believe audit committees should focus more on information systems, environmental and litigation risks, even though these can have significant financial implications.

The increasing importance of financial risk management was linked by some companies to the need for training. The director at one Swiss bank commented that all members of the board, not just audit committee members, needed to be trained in areas such as financial instruments. This need not amount to in-depth technical knowledge, but more to the ability to assess their effects on the company's development and controls.

“audit committees will fall short of their potential if they lack the understanding to deal adequately with the auditing or accounting matters that they are likely to face”

[Cadbury Committee report]

Our suggestions for audit committee training

As the survey demonstrates, there is a need for companies to ensure that audit committee members are suitably equipped with the information and skills to discharge their responsibilities. We offer, below, some suggestions for ways these training needs could be met.

Induction

We recommend that new members of the audit committee should receive copies of the committee's terms of reference and a formal letter of appointment, setting out particular responsibilities, term in office, and remuneration.

New non-executive directors should:

- receive an information pack containing recent financial statements and other significant public reports, executive summaries of internal audit reports with commentary on how recommendations have been followed up, management letters from the external auditors, and company codes of conduct.
- attend induction sessions, where specific attention is given to the additional needs of non-executives who will serve on the audit committee. For example, the head of internal audit could explain the roles that the department plays in aspects of internal control; for example operations and business processes, IT systems, regulatory compliance and special investigations (including fraud).
- visit important business locations.

Continuing information needs

The committee should discuss the quality of the information it receives and make recommendations to the main board on its training needs. These might include attendance at external courses and seminars paid from the committee's budget.

Areas where training may be particularly valuable include:

- financial and risk management;
- treasury operations and controls;
- accounting and corporate reporting developments; and
- developments in wider business sector trends, business politics and corporate governance.

Unless such matters are already addressed by management, the external auditors should provide written guidance on developments in accounting and auditing in, or in addition to, their management letters.

Comments from executives interviewed as part of the survey reveal that the area of risk management, (and especially treasury operations and the potential impact on the business of complex financial instruments) is one area where information and training may be particularly valuable.

Should having an audit committee be a requirement for admission to the stock exchange?

Companies were divided on this issue. Those in countries where audit committees are more established, especially Britain, considered that they should be a mandatory requirement. In other countries, for example Germany, Sweden and Switzerland (where other management organs such as supervisory boards may fulfil the audit committee role) such a requirement was not seen as necessary.

Do you think that the stock market will call for audit committees to be introduced?

All respondent companies in Britain and France, and a majority in Belgium and Italy, thought that audit committees would become a requirement. In Italy, companies considered that pressure would be brought by the securities regulator, CONSOB, to make audit committees a requirement. German, Swedish and Swiss companies were more doubtful that the authorities would act to make such committees obligatory. In the absence of a stock market requirement, a majority of companies in the UK, Belgium and France thought that pressure exerted by shareholders would effectively make audit committees mandatory.

The importance of audit committees has not gone unnoticed by authorities and regulators in continental Europe – the Green Paper on Auditing provided a signpost that the European Commission sees audit committees as an essential part of the governance framework. The Commission's more recent consultation paper on Company Law asked for the views of interested parties on whether audit committees should be obligatory for large companies.

Investors increasingly expect independent directors to exercise a key role in monitoring the financial performance of companies. European business is beginning to react to these expectations. Governance codes sponsored by the business community and national stock exchanges, such as those already published in France and the Netherlands, and now planned for Belgium, are emerging. These codes make recommendations about audit committees.

The fact that market forces are leading to the establishment of national governance codes which respect local cultural and historical differences is perhaps one reason for resisting the imposition of supra-national or EU level legislation on corporate governance. Audit committees will evolve as investors increasingly demand and expect them.

“all markets should develop an appropriate Code of Best Practices, by which directors can regulate themselves... Such a code should be representative of the best governance practices in the market”

[Calpers Global Principles for Corporate Governance – December 1996]

On balance, do you believe audit committees are beneficial?

The overwhelming majority of companies who responded considered that, on balance, audit committees were beneficial. The exceptions were mostly Swedish companies. Significantly, even most of those Italian companies which did not have audit committees saw them as beneficial.

In interviews, several company representatives noted that their shareholders saw audit committees as a positive development, resulting in an improvement in the monitoring of operations.

The Director of Control and Administration at Iberia, the Spanish airline, noted that on the one hand, the Board's knowledge of financial, economic and information-related matters was enhanced, and on the other, this allowed a better exchange of information between management and shareholder representatives.

The fact that more European companies are seeking to raise capital on world markets means that, increasingly, their published financial information and governance arrangements will come under the scrutiny of foreign, particularly US, institutional investors and analysts.

Audit committees have an important role to play in ensuring that all financial data published by the company meets the standards, in terms of quality and level of disclosure, demanded by this sophisticated audience.

“every board should set up an accounts or audit committee, and should inform the AGM of its existence and the number of times it has met during the year”

[Viénot report recommendation – July 1995]

THE CEMS SURVEY IN ASSOCIATION WITH PRICE WATERHOUSE

The survey results presented in this booklet are based on the responses of some 65 companies to a detailed questionnaire about their experience of and attitudes to audit committees. In some cases, follow-up interviews were conducted with company representatives.

The survey sample of companies from eight countries was principally extracted from companies listed in the Financial Times Euro 500 Index, a ranking of European companies by market capitalisation. The eight countries were:

Belgium	Spain
France	Sweden
Germany	Switzerland
Italy	UK

Responses were analysed by researchers at academic institutions which are members of the CEMS network – The Community of European Management Schools. The CEMS institutions which participated in this study are as follows:

HEC School of Management, Paris	Professor Degeorge
ESADE, Barcelona	Professor Sulla
Universität zu Köln, Germany	Professor Sieben
London School of Economics	Mr McGuire
Université Catholique de Louvain, Belgium	Professor de Rongé
Università Bocconi, Milan	Professor Vigano
University of St Gallen, Switzerland	Professor Behr
Stockholm School of Economics	Professor Högfeldt

We are grateful to the following companies for their assistance with this survey:

Aare-Tessin AG
 Alcatel-Alsthom
 Allianz AG
 Almanij NV
 Alusuisse-Lonza Holding AG
 AssiDomän AB
 Astra AB
 Atlas Copco AB
 Banca Commerciale Italiana
 Banco Bilbao Vizcaya
 Banque Bruxelles Lambert
 Banque Paribas
 Barclays PLC
 Barilla S.p.a.
 BASF AG
 Bayerische Vereinsbank AG
 Belgacom
 BNP – Banque Nationale de Paris
 Bouygues SA
 British Gas PLC
 British Petroleum Company PLC
 British Telecommunications PLC
 Cariplo S.p.a.
 Credit Commercial de France (CCF)
 Daimler-Benz AG
 Delhaize Freres et Cie
 Electrolux AB
 ENDESA
 ENI S.p.a.
 Ericsson
 Hennes & Mauritz AB
 HSBC Holdings PLC
 Iberia
 IFIL S.p.a.
 Incentive AB
 Julius Bär Holding AG
 Leche Pascual SA
 Mannesmann AG
 Migros-Genossenschafts-Bund
 Mo och Domsjö AB
 Olivetti S.p.a.
 Parmalat
 Pedro Domecq SA
 Reed International PLC
 Repsol SA
 Rhone Poulenc SA
 Riunione Adriatica di Sicurtà
 Saint-Gobain
 Sandvik AB
 SCA (Svenska Cellulosa)
 Schneider Group
 Siemens AG
 Skandinaviska Enskilda Banken
 Skanska AB
 SmithKline Beecham PLC
 Société Générale de Belgique
 Société Générale
 Société Internationale Pirelli SA
 Sparbanken Sverige AB
 Stora AB
 Swiss Re
 Swissair
 Sydkraft AB
 Thyssen AG
 Union Bank of Switzerland
 Union Minière
 VIAG AG
 Volkswagen AG

"Audit Committees" is designed for the information of readers. While every effort has been made to ensure accuracy, the material is intended only to provide an overview of current trends and should not be viewed as comprehensive.

The following companion volume on corporate governance has been published by Price Waterhouse in Europe and is available from your nearest Price Waterhouse office:

"Converging Cultures – Trends in European Corporate Governance" (April 1997).