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BOARDS AND THE AUDIT FUNCTION

Presentation on by

Mr. Léo Goldschmidt,
Chairman of the Corporate Governance Committee
European Association of Securities Dealers (EASD)

[1]Company boards have traditionally had the responsibility for the existence of bookkeeping records and for the contents of the documents prescribed for the annual general meeting of shareholders (AGM).

But, at least in continental Europe until about twenty or thirty years ago, this did not in most instances give an indication of the actual degree of implication of boards in the determination and fair presentation of the accounts produced, nor of their involvement in monitoring the accounting and reporting process.

In many of even the most advanced industrialised countries, detailed accounting and auditing standards and regulation were scarce and of little substance.

Management usually prepared the accounts, without their being subjected to a meaningful audit.

Indeed, although the law generally foresaw that external auditors should be appointed, these were frequently designated from among one or the other shareholder's lesser qualified relatives, who hadn't made it to the board, but who could thus be offered some remuneration from the company. That remuneration was often expressed as a fraction of a director's annual profit-linked fee. Such practices obviously did not produce particularly competent auditors and in addition had an in-built conflict of interest.

No wonder that most management had a very free hand in the production of accounts and that transparency was not their major quality.

Looking back more than forty years, my first banking activities were in credit analysis – and I can assure you that to receive reliable and meaningful accounts from credit-seeking companies was then by no means a foregone conclusion.

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The context has since changed considerably, in particular in the following areas :

- generally accepted accounting and reporting standards and rules have been adopted
- auditing standards have been drawn up
- qualifications for external auditors have been laid down
- the internal audit function has been developed next to the older external audit
- corporate governance codes or recommendations have been issued

With all this, the board's role has changed too.

First of all, the scope of audits has expanded : it is no longer only the accounts themselves that are subject to scrutiny.

[1] The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries. This paper is subject to further revisions.

To be noted that with regard to accounts, the availability of accounting, reporting and auditing standards and regulations have set benchmarks which are as many guidelines to the board in the areas where its involvement has come to be required or expected. A case in point is the board's duty to define and publicise its own practical application rules of general regulatory valuation norms to the company's accounts – a clear indication that boards have to exercise judgement and not apply rules and fill out imposed grids purely mechanically.

But, in addition to the process of producing and monitoring financial - and now also *non-financial* - information destined to all concerned (management itself, the board, shareholders and also other constituencies like the representatives of the staff), it is the integrity of whole decision-making chain and the compliance with company policies and procedures, as well as to laws and regulations and even voluntary codes of practice, that is today concerned.

This in turn has triggered the need for the board to become conscious of the various elements that need to be subjected to audit: in the main, all areas where things can go wrong, first and foremost accounting, tax, social and ethical policies and practices, which can have serious economic and reputational repercussions that affect the standing and value of a company.

So the board must consider it as one of its responsibilities to ensure that these elements are indeed captured by the scope of the audit function within the company, that there exist comprehensive and prioritised audit programmes to scrutinise them and that shortcomings of substance encountered are communicated and acted upon.

Further, the notion of audit itself has been refined. The independent check on these elements carried out at intervals by the external auditor has been complemented by a more permanent internal audit function. To be noted that here a conceptual distinction has been introduced between audit proper – which is an assessment of the existence, quality, coherence and proper application of procedures and controls, and, on the other hand, the controls themselves, being the traditional concrete verification of the integrity and accuracy of the elements under examination.

It will be up to directors to understand the above principles – which is far from always being the case – and to see to it that the various aspects of external and internal audit and control are catered for and properly staffed. In addition, the board must ensure that those in charge of auditing have professional proficiency and are free to do their jobs without pressure from management or other conflicting interests.

Nomination procedures and criteria should therefore be developed. The auditors' reporting lines should be open, through to the board, without subordination to the CFO or screening by the CEO. Actually, significant facts will ultimately be brought to the shareholders' attention. This is by way of the external auditors' report to and their questioning by the AGM, or through the particular certification of certain documents which are also a responsibility of the board and are required in specific circumstances, such as prospectuses for the issue of new shares or valuations in case of public tender offers.

In many countries, it is not the board that approves the appointment and the fees of the external auditors, but the shareholders themselves. This stems from the fact that the external auditors also monitor the board's correct execution of its brief, in particular the actions, accounts and documents for which the board is responsible and accountable. Employees being stakeholders with a right to know what the company's situation is, some countries require that the designation of external auditors also be confirmed by the staff council or a similar organ.

Nevertheless, in actual fact, the board will in most instances have the upper hand in the selection process of external auditors and the negotiation of their fees, with firms or individuals belonging to a body of recognised certified professionals. They should of course be exempt from material conflicting

interests. This latter question is currently a hotly debated issue, since auditing firms have over the last twenty years also developed large consultancy practices (such as for strategy, management, tax and even legal advice). These activities generate fees that can be quite large in comparison with the remuneration for the audit alone – and being retained for such lucrative assignments by a company can on occasion affect the auditors' independence when auditing it or another company of the same group. Authorities are taking an increasingly stern stance on this issue.

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As has become clear, the board's responsibilities in the field of auditing have expanded considerably and are now better defined – and the question arises as to whether the board can indeed discharge its present broad array of relevant duties properly (and safely in terms of personal liability), given all its other equally important tasks and the fact that it only meets periodically.

It of course belongs to the full board to make ultimate decisions, to bear the corresponding responsibilities and to account for them, but the pragmatic solution is to delegate a part of the "eyes and ears" of the board on the matters at hand and their more detailed analysis and evaluation to a specific board sub-committee, generally known as the Audit Committee.

Initiated in the USA, this practice became obligatory for publicly quoted companies in the seventies, and thereafter successively spread to the United Kingdom and the rest of the world, although not necessarily as a compulsory feature.

For this committee system to work there are several pre-requisites, namely that :

- the audit committee's terms of reference and powers in relation to the above-mentioned duties of the board are clearly defined and regularly reviewed by the board itself

- the committee is capable of making objective judgements, i.e. independently of management or other conflicting interests

- the committee is therefore composed of *qualified* and *independent* directors, or at least that the latter are in the majority and provide the committee chairperson

- the committee makes no operational decisions (which remain the attributes of the full board and/or management), but only recommendations and has the ability to monitor their implementation or the reasons of their rejection

- the committee has access to the necessary information and company staff to perform its function, in particular that all internal or external audit reports of significance are brought to its attention

- external auditors have direct access to the committee, and that meetings may be organised with them if necessary without the presence of management

- the committee periodically reports to the board indicating the extent of its activities, its significant findings and the remedies brought (or not) to material malfunctions encountered.

Naturally, it is not for the audit committee to duplicate the external or internal audit process. It is much more to satisfy itself that that process is working satisfactorily, that the areas that need to be covered are so indeed and that deficiencies are spotted and acted upon in a timely fashion. It will also, for the benefit of the full board, make a first evaluation of and give comments on the adequacy of those financial and non-financial documents for which the board bears a particular responsibility.

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With a clear understanding of the underlying principles of the audit function, with qualified directors, with proper preparation of its decisions by a well defined and appointed audit sub- committee, the full board can thus practically exercise its duties to a large - but not exclusive - degree on the principle of management by exception. This is inasmuch as the audit committee works efficiently and competently, and can reasonably reassure the board on the execution of its mission in conformity with sufficiently comprehensive terms of reference.

Meeting these conditions will contribute to the board's adequate fulfilling of its own three main functions: directing, monitoring and rendering account.

All in all, the board's capacity to accomplish its brief in the field of audit will benefit the company in terms of greater credibility resulting from reliable reporting, enhanced coherence between standards set and their implementation, and decreased likelihood of deviation from the policy decisions of the company and from regulatory and ethical norms.

A recipe for long-term sustainability of the company and for positive effects on its shareholder value and cost of capital.