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The relationship between the audit committee and decision-makers within an organization

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Abstract

Audit committees, governance type or otherwise, are a less common feature in EU Member States, where only few countries have extended audit committees or "governance"[1] or similar such committees[2].

Audit committees in the private sector focus on ensuring the reliability and the internal and external reporting, and therefore on the internal and external audit, the quality of internal control systems and risk management processes. For many countries applying this type of public sector audit committee may be too sophisticated, because there are no preconditions for its existence. The existence of audit committees does not automatically mean that organizations function properly and have no governance, internal control and external reporting problems.

Because of the importance of communication between the internal auditors and the audit committee, the paper addresses issues such as planning discussions with internal auditors, analysis and conclusions as a result of communication, questionnaire models for the addressed areas and planning the meetings with external auditors.

Keywords: *Management, internal auditors, internal control, external auditors, audit committee, board of directors*

JEL Classification: *M42, M48, M49*

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[1] UK, Netherlands, Ireland and recently France.

[2] Audit committees were created by the Belgian federal authorities. In seven other European countries, audit committees are mentioned in the relevant legislation.

Introduction

Audit committees constitute the key elements of corporate governance by providing management with an independent assessment of the degree of implementation of risk management processes and internal control, the quality of financial results, internal audit and its relationship with the external audit. By the result of the undertaken actions, the audit committee allow those charged with corporate governance to assess the quality of management and organization's development prospects.

Audit committees help to streamline the quality of information provided by the management based on the assessments, monitoring and surveillance activities carried out within the organization with regard to the results of financial activity undertaken, risk management, internal control and internal audit function.

Audit committees are set up within economic organizations as instruments of corporate governance, to oversee the internal audit function and strengthen the relationship between the management entity and this function, to track internal control functionality and effectiveness of risk management.

The main requirements so that audit committees can operate effectively and efficiently in achieving their overall purpose, namely of corporate governance tool, are: the availability of a suitable operational environment, independence, impartiality and integrity of the members of audit committees and high level of involvement in fulfilling that responsibility.

The audit committee shall ensure that the information provided by the functional structures of the organization are correct in all respects and there can be offered opinions on the quality of this information. It also provides support for the internal audit activity and raises the organization's management awareness of this function's role and importance.

1. Relationship with the organization's management

The audit committee oversees and monitors the financial reporting process conducted by the organization's management. There are direct collaboration relationships between the organization's management and the audit committee, that ensure the proper administration of the organization's activities.

Mainly, the audit committee is working and is based on the organizational management. It especially works together with financial directors, chief accountants, treasurers and chief financial controllers. In this regard, the audit committee communicates clearly its goals and expectations to the organization's management.

The audit committee's communication with the organization's management must be open and ensure discussing the risks associated with financial activities and the issues that currently affect the organization. The audit committee should meet at least once a year to debate the assessment of the management's effectiveness and how to communicate the results of these evaluations to the organization's management or the board of directors.

The audit committee may require internal auditors or external auditors to check the quality of management decisions, processes and procedures, as well as additional information concerning the judgment of management in the financial reporting process.

In the USA, *the ACC report regarding the audit committee's communication with the management* recommends that audit committees secure *written declarations* from the management on its responsibility for the integrity of financial reporting and control systems and processes, as well as their opinion on the quality of financial reporting and control. In in this regard, the management should provide a representation letter addressed to the audit committee.

2. Relationships with internal auditors

Internal auditors are perhaps the most valuable resource for audit committee. Apart from the fact that they provide the audit committee with assurance regarding the adequacy of the internal control system and participate in annual external audits, internal auditors can assist the audit committee regarding the evaluation of compliance with corporate policies, and by undertaking audits of the efficiency of processes' operability.

In some companies, internal auditors assist in project management for which the audit committee has assumed responsibility, such as the special investigations on suspected fraud or illegal payments.

Within the communication relationship with internal auditors, information on issues to be considered with regard to the audit function can be obtained through a questionnaire such as the one presented in **Table 1.**

Table 1. Questionnaire regarding the communication relationship between the audit committee and internal auditors

CN	QUESTIONS	Yes	No	Comments
1.	Does the department use its time and resources efficiently and effectively?			
2.	Are the structure and size of the department adequate to meet the objectives set?			
3.	Is the level of experience of internal auditors appropriate?			
4.	Does the department appear to be objective and, if so, what procedures are followed to ensure objectivity?			
5.	Are the department members' technical knowledge sufficient to perform the duties properly?			
6.	Does the department have an ongoing program for the professional development of internal auditors?			
7.	Are there members of the department with sufficient expertise to audit information systems and address the technology used by the company?			
8.	Are the department tasks planned properly?			
9.	Does planning include written audit plans and programs?			
10.	What are the types of reports issued by the internal audit department and to whom are they sent?			
11.	Are audit reports issued regularly?			
12.	Do audit reports include sufficient detail to allow managers and/or the audit committee to take effective action?			
13.	Does the management respond in a timely and appropriate manner to the significant recommendations and comments made by internal auditors?			
14.	Do internal audit procedures include procedures in the areas of operational and financial areas?			
15.	Was it effective the involvement of the department in the annual audit?			
16.	What can be done in the future to ensure the maximum effectiveness and efficiency of the department?			
17.	To what extent is the outsourcing of the internal audit function used and what other areas are outsourced?			
18.	Is the internal audit function checked regularly and, if so, what were the results of the last checking?			
19.	What are the criteria used to establish and prioritize the annual plan and the long-term plans of the internal audit?			
20.	Are the tasks undertaken by the department focused on the high risk and sensitivity areas ?			
21.	What are the prospects of the internal auditor in terms of control, risk of fraud or compliance issues?			
22.	Was the internal audit department' plan evaluated to determine whether it is still appropriate?			

Source: Authors' compilation

The audit committee evaluates the internal audit annual work plan and compares it with its expectations and needs. Verification ensures that the internal audit plans and uses the available resources effectively, to get the best benefits in order to satisfy the audit committee's requirements.

Internal auditors must have direct access to the audit committee and meet for private talks with the audit committee, if necessary. Confidential exchanges between the audit committee and internal auditors are important because internal auditors must be "independent" from the management, although employed by it.

Internal auditors' activities and responsibilities may include:

- Internal control compliance tests to obtain suggestions regarding their improvement;

- Verification of compliance with company's policies and procedures;
- Recommendations on improving operational activities with the potential to reduce risks and increase profits;
- Special examinations performance related to conflicts of interest and compliance with the corporate code of conduct;
- Coordination with the external auditor within the annual audit.

In relation to internal audit, the audit committee generally considers the following aspects:

- The annual work plan, the tasks of internal auditors, the results of these tasks and any changes;
- Criteria used to determine and prioritize the internal audit annual plan and long-term plans;
- Management actions in response to recommendations of internal auditors;
- Any area with a high priority that has been postponed due to budget or other limitations;
- Significant findings of internal audit and whether the management's corrective actions are timely and effective.

3. Relationship with external auditors

By involving the audit committee in auditing financial statements, the external auditors are in a position to provide an objective assessment of the financial reporting process. For this reason, the audit committee should maintain opened, at all times, the lines of communication with the external auditors.

Most importantly, the audit committee should also question the purpose of the audit and its approach, any suggestions or recommendations that the management receives from external auditors regarding the financial reporting process and the associated issues, as well as the results of the annual audit, including any required communications.

Practice shows that only through open dialogue, regular, frank and confidential, the audit committee will be in a position to use the knowledge of external auditors in evaluating internal control, management, internal auditor and their respective impact on the quality and reliability of financial statements.

The audit committee should expect the external auditors to:

- Recognize that, ultimately, they are responsible to the board of directors and audit committee, as the board's representatives – their primary client;
- Maintain an open line of communication with the audit committee and the chairman of the audit committee, which ensures timely, open and frank discussions;
- Fully understand their expectations and design their communications to be direct responses to the audit committee's expectations;
- Meet privately and regularly, in the absence of management or internal auditors, to provide direct feedback regarding issues associated with the management or internal auditors;
- Discuss promptly any concerns with regard to financial reporting or financial performance;
- Communicate significant issues after these were transmitted to the management, but have not been addressed adequately;
- Advise in respect of matters which require the committee's special attention, in the auditors' opinion, in fulfilling its supervision responsibilities;
- Inform of any pressures regarding the duration of commitments from management, its level of cooperation during the audit and the potential impact on audit effectiveness;
- Assist the audit committee in evaluating the adequacy of the audit fees, in order to ensure a proper quality of audit services;
- Be available to assist the entire Board of Directors, on demand, in making recommendations to shareholders regarding the selection of audit firms;

Within the private meetings between external auditors and the audit committee, the committee has the opportunity to discuss the staff evaluations made by the auditors with regard to its size, experience and capabilities and their adequacy depending on the company's size and complexity.

The audit committee may also discuss the auditors' evaluation of how the management approaches their problems or concerns, which may have an adverse effect on the financial and operational stability of the company.

The external auditors are accountable to the board of directors and the audit committee which hold first authority in selecting, evaluating and, where appropriate, replacing external auditors.

4. Planning the audit proceedings

Audit planning discussions should be held to allow the external auditors to discuss the purpose and objectives of their audits. During these meetings, management and auditors can focus on issues such as: the responsibilities of auditors and their independence; the scope of services to be undertaken and the associated fees; the company's significant accounting policies and any other recent developments in accounting or reporting which might impact the company.

For the assessment of the purpose and other considerations on the overall planning of internal audit and/or external audits, several questions can be formulated with regard to the issues presented in the questionnaire from **Table 2**.

Table 2. Questionnaire regarding the overall planning of internal and external audits

NC	Questions	Answers	Comments
1.	How are determined the business locations you will visit?		
2.	Do you think that some of our businesses present more risks than others? Why?		
3.	What do you think are our areas that present the greatest risks?		
4.	What procedures are you planning to follow in these areas?		
5.	Are there locations or areas which were considered to present high risks in previous years and are no longer considered as such? Why has the evaluation changed? What other significant changes, as compared to the previous year, were made in the planning of procedures?		
6.	Are there plans for the members of the audit team to visit corporate headquarters or other key locations? If not, why?		
7.	Are there other auditors involved in the audit? If so, do you participate in the process of determining the purpose of the audit? How to determine whether they are adequate for the tasks performed?		
8.	What procedures do you plan to authorize for the verification of the quarterly financial information?		
9.	What changes have occurred or might occur in the accounting regulations that may affect the company's financial statements?		
10.	Should the company consider consulting with the authorized structures[1] in the field with regard to any accounting issue?		
11.	Were there received any significant comments on how to fill the financial reporting templates? How were they resolved?		
12.	Is there an effective and efficient coordination of audit procedures between internal audit and external audit functions?		

Source: Authors' compilation

[1] Chamber of Financial Auditors in Romania, Ministry of Public Finance.

Audit committees should have in mind the fact that *the objective of an external audit is to express an opinion on the correctness of the company's financial statements*, based on the auditors' procedures. Meanwhile, the external auditors' procedures should be designed to obtain reasonable assurance that the financial statements are correct. *The auditor's report is not a guarantee.* The management and the audit committee should be aware of these limitations when discussing the responsibilities of external auditors.

Discussions on the audit results with management and the external auditors are essential and should preferably be held before the end of the financial year and also before the amount of the company's revenues is disclosed, and also before issuing an audit report on the company's financial statements.

Conclusions

Audit committees include individuals who have appropriate skills and competences, fulfil the role of a supervisory board with regard to how the activities are managed and also have an evaluation function focused on the management and overall development of the organization. Also, the audit committees are responsible for implementing the international principles and standards of internal audit by internal auditors.

Issues to be considered in terms of results of the communication between auditors and clients refer to the exposure areas of the company, the changes that took place in previous years, the audit findings and planning of private meetings and sessions with the auditors.

The questions to which the audit committee must obtain answers refer to the aspects presented in **Table 3**.

Table 3. Questionnaire regarding auditors' communication with clients

NC	Questions	Answers
A.	***Questions regarding the organization's exposure areas***	
1.	What are the most critical accounting policies, most complex, subjective or ambiguous decisions or assessments that have the greatest effect on the company's financial position?	
2.	Is the accounting treatment aggressive or conservative? How is it, compared with the previous years?	
3.	Have there been any changes of the planned procedures performed in the interest of the company or due to changes in the risk assessment? If so, why did they happen?	
4.	Can litigations affect significantly the company's financial position? What did the lawyers report on the status of these litigations or other matters? Is there appropriate information in the financial statements on this subject?	
5.	Were there identified any problems regarding taxation? For what period did the fiscal authorities decide to verify tax information? Has the State required access to documents on the company's taxation policies?	
6.	Were there identified any deficiencies in the company's IT system?	
7.	Were there consulted external specialists or company experts on significant issues?	
8.	Are there other risks or uncertainties that have not been disclosed?	
B.	***Questions concerning the changes compared to previous years***	
1.	What is the overall assessment of this year's financial statements' comparability with those from previous years?	
2.	What caused the significant changes? What reclassification, if any, was made to the amounts reported in previous years?	
3.	Were there areas where the company made a change or adopted an accounting principle when an alternative treatment provided significantly different results?	
4.	Have there been any changes in the accounting policies with significant effects on the financial statements of the current year or that could have an effect in the coming years? Are there expected any changes in accounting policies? How do the company's accounting policies compare with other policies from companies in the same field?	

NC	Questions	Answers
C.	***Questions regarding the audit findings and conclusions***	
1.	Will you issue an “unqualified opinion”? Were there considered other issues besides an unqualified opinion? If so, how have these concerns been resolved?	
2.	Were there identified any unusual transactions? Are you satisfied with the accounting treatment?	
3.	Has the management imposed any limitations regarding the scope of the audit? For example, have you been granted access to all employees, all records and company locations?	
4.	What were the audit findings for high-risk areas? Do you have some specific recommendations or comments for these areas?	
5.	What were the reasons for which the audit differences have not been registered (Were they immaterial for general operations)?	
6.	How is materiality determined in assessing these differences? What happens if immaterial elements become larger in the future?	
7.	Is there a plan for the recording in the next financial statements of the that adjustments which were not recognized in these financial statements?	
8.	Are there other financial reporting issues of which we should be aware?	

Source: Authors' compilation.

The main advantage of setting up an audit committee as a corporate governance tool consists in providing an independent evaluation of the operational and financial situation of the organization. This opinion is given as a result of the internal control assessment and financial management systems' functionality, and is also given based on the assessment of: risk management process effectiveness, monitoring the quality of reports provided by the internal audit, accounting policies and financial reporting.

Internal auditors are required, according to professional standards, *to communicate all the problems faced by the audit committee*. Also, the audit committee discusses with external auditors the results of the quarterly verifications.

Ernst & Young (2002) has developed a detailed list of topics that the audit committee can discuss during the quarterly meetings. The list was included in the document *Mechanisms of the Audit Committee* and can be presented in the form of a questionnaire such as the one in **Table 4**.

Table 4. Topics for the quarterly meeting with the audit committee

NC	Questions	Answers
1.	Was there cooperation from company staff? For example, did they answer the questions; or did you have to force them to answer? Were there other difficulties during the audit mission?	
2.	Have there been any pressures in relation to the time allocated to different tasks, including pressures about the time allocated to audit procedures? If so, what was their effect on the audit?	
3.	Are the internal auditors and financial managers qualified for the tasks they undertake – both at corporate and department levels? Is it necessary to hire specialists such as information technology auditors for the information system of the internal audit department?	
4.	Did you determine the existence of other concerns about the financial management?	
5.	Did the management respond adequately to the recommendations on improving operations and control mechanisms?	
6.	Does the financial management have the adequate resources, namely the experienced staff and IT resources?	
7.	Does the management have an adequate plan for recording in the following periods all the adjustments which were not recorded during the year?	
8.	Does the management have appropriate policies and practices for communicating with analysts?	
9.	What is your assessment of material risks of fraud in the financial statements and your understanding of the controls to mitigate these risks?	
10.	What are the areas that present the greatest risks? Were these areas covered by the audit committee in another context (meetings of the audit committee and/or written materials)?	

Source: Ernst&Young, 2002.

Audit committees have been developed mainly in countries with strong professional associations in accounting, who were a source of experience in the operation of committees and organizations that develop and apply economic principles of corporate governance. The role of the audit committee is crucial ensuring that the organization functions in accordance with the good governance accounting and auditing practices, and implements appropriate risk management processes.

Internal audit and external audit are the main functions within the entity, with which the audit committee performs its duties and responsibilities. In this context, there should exist an effective collaboration between the audit committee and the two functions. Audit committee members should support the independence of internal audit and ensure that the function has sufficient resources to provide an adequate level of quality of the information provided as a result of the developed activity.

From the overview of the communication process of the audit committee is resulting the complexity of this process and the need for the professional involvement of all the communication processes' "stakeholders", in coordinating the company's audit committee.

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