THE FUTURE OF CORPORATE GOVERNANCE: INSIGHTS FROM THE UK

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FOREWORD

When the first phase of this research project was published in May 2000, few people would have imagined that by the time that this second phase was published, corporate governance would have the high public profile that it does today. However, the intervening period has seen a wave of corporate scandals across the globe which has forced corporate governance to the top of government and business agendas worldwide. In the US, the government responded quickly to the crisis of confidence with the Sarbanes-Oxley Act and in the UK, meanwhile, we have had the government appointed Higgs report review of the roles and responsibilities of non-executive directors as well as the Smith report into the role of audit committees. Both of these reports have now been incorporated into the Financial Reporting Council’s revised Combined Code guidance, which comes into force later this year.

The final phase of this research project has therefore been completed at a time when corporate governance is extremely topical. The research report addresses many of the themes that have been considered by the Higgs and Smith committees and provides some interesting insights into the views held by stakeholder groups. To get the information for the study, the researchers sent questionnaires and interviewed a selection of finance directors, non-executive directors (audit committee chairs), internal auditors, external auditors and sophisticated users of accounts.

The study itself was originally inspired by an earlier ICAS project on Auditing into the Twenty-first Century, published in 1993 which Fraser, Henry and Wallage then developed for a collaborative project with NIvRA in 2000 to consider corporate governance in the Netherlands. Fraser and Henry have now gone on to suggest some amendments to the proposals in the 2000 study, and have added a number of new
proposals of their own, for consideration and discussion by the various stakeholder group representatives.

The researchers found that existing corporate governance mechanisms in the UK were generally perceived to be adequate. However, they also found widespread recognition that there are limitations to any system and that this is totally dependent on the integrity and competence of individuals. Given the public concern about corporate governance over the last couple of years, and the volume of unfavourable media comment about the subject, there is a need for urgent consideration in the UK of where corporate governance could or should go from here. In this regard, the research study makes particularly interesting reading through its suggestions of amendments to existing UK corporate governance mechanisms and stakeholders’ views on them. As such the Research Committee of The Institute of Chartered Accountants of Scotland has been delighted to sponsor this project, and hopes that it will be of considerable help to those charged with developing corporate governance.

Nigel Macdonald
Convener
Research Committee

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Thanks are also due to the referees and the ICAS Research Committee for their helpful comments. We also appreciate the advice and encouragement that we received from Professor Vivien Beattie, the Director of Research at ICAS during the term of this project. We also acknowledge the help of Margaret Doak, who transcribed the interview tapes for us, and Isobel Webber, personal secretary to the Director of Research, for her work in typesetting the report.

The Research Committee and the researchers are particularly grateful to the Trustees of the Scottish Chartered Accountants Trust for Education, who gave financial support for this project.
EXECUTIVE SUMMARY

In view of the continuing and extensive debate on corporate governance issues in the UK since the publication of *Auditing into the Twenty-first Century* (ICAS, 1993) it was decided to revisit its proposals in the light of contemporary business and corporate governance developments. ICAS therefore decided to fund a major research project into the future of corporate governance and the external audit function. The research was centred on the proposals contained in ICAS, (1993). The first stage of the project was set up as a collaborative venture between ICAS and NivRA in the Netherlands and the results were published in *The Future of Corporate Governance: Insights from the Netherlands* (Fraser, Henry and Wallage, 2000).

Fraser, Henry and Wallage (2000) produced revised proposals based on those produced by ICAS (1993). The present and final stage of the research is concerned with audit and corporate governance in the UK and relates to the feasibility and desirability of implementing the revised proposals for external audit and corporate governance arrangements made by Fraser, Henry and Wallage (2000). In addition the research is concerned with the identification of views on recent developments in corporate governance and also seeks to draw insights from aspects of contemporary corporate governance practice. The report presents the results of a large-scale postal questionnaire survey of interested parties and of twenty case interviews. Recommendations are made on the feasibility and desirability of implementing the proposals made by Fraser, Henry and Wallage (2000) and on the improvement of corporate governance practice in the UK.
Objectives and research approach

The three specific objectives of the present research are:

1. To identify and explore the views of various stakeholder groups on several major contemporary issues and possible future developments in audit and corporate governance. These issues include organisations’ approaches to internal control and risk management and the roles of internal and external auditors and of audit committees in relation to risk management. In addition, the role and effectiveness of non-executive directors has become a matter of pressing contemporary concern in the wake of a new wave of corporate scandals in both the UK and the US. The subsequent UK government-appointed review into the role and responsibilities of non-executive directors under the chairmanship of Derek Higgs reported in January 2003. Its conclusions and recommendations reflect many of the themes addressed in this report.

2. To identify and explore the views of these same stakeholder groups on the proposals made by Fraser, Henry and Wallage (2000) and, where relevant, by ICAS (1993).

3. To form a view on the feasibility and desirability of implementing the Fraser, Henry and Wallage (2000) proposals and to formulate new or amended proposals where necessary.

There were two major stages to the research reported here. In the first stage, an extensive postal questionnaire was sent to 1000 individuals covering five constituencies with an interest in corporate governance and audit. These five constituencies were financial directors, non-executive directors (audit committee chairs), chief internal auditors, external auditors and sophisticated users. In the second stage of the research 20 semi-structured interviews were carried out exploring in
greater depth issues included in the questionnaire or highlighted by the questionnaire results.

**Main findings**

- The existing UK tradition of corporate governance is regarded positively both in terms of its relative lack of emphasis on detailed regulation and in terms of its grounding in the unitary corporate board. There is no enthusiasm for the alternative two-tier board system. The opportunity should be taken to build positively on the goodwill that exists towards the existing system.

- While existing mechanisms are perceived as adequate in broad terms, there is a perceived need to strengthen certain aspects of the existing corpus of corporate governance and in particular to enhance the calibre, effectiveness and available pool of non-executive directors.

- There is recognition that shareholders are playing an increasing role in corporate governance. While this is regarded as a positive development, there is a need for this trend to develop further through the establishment of shareholder committees or other means.

- There is broad support for the establishment of strong internal audit functions as proposed by ICAS (1993) and by Fraser, Henry and Wallage (2000). The ‘new’ internal audit functions tend to be smaller units than traditional internal audit departments, but with greater impact at boardroom level, particularly in the area of providing assurance on risk management within the organisation. The innovative and imaginative internal audit functions now being adopted by some organisations provide opportunities to strengthen corporate governance. The support for internal audit functions remains strongest in large organisations, and there is some
opposition to making internal audit functions mandatory for all listed companies.

- There is support for the proposition that internal control systems should cover a broad spectrum of risks and that the board should be responsible for the effectiveness of risk management and control systems.

- There is broad support for the proposition that reporting on internal controls and risk management should be the province of the directors rather than the external auditors, but there is no enthusiasm for ‘boilerplate’ reporting on control effectiveness, risk management and going concern. A number of participants expressed the view that companies should report the major risks they face, together with the procedures in place to manage these risks, but others believed that it is difficult to make meaningful statements of this type without unacceptable exposure to litigation.

- *The Turnbull Report* has been a catalyst for the formalisation and embedding of risk management within organisations. Companies are employing a variety of mechanisms to encourage staff to be aware of risk matters as a fundamental part of their daily activities.

- The proposals of the US Blue Ribbon Committee on audit committee effectiveness are broadly supported, but there is a lack of enthusiasm for detailed regulation on the constituency, relationships and functions of audit committees. There is broad agreement that audit committees have an increasingly important role to play, especially in the areas of monitoring the nature and volume of non-audit work given to auditors and of financial risk management.

- There is little support for the proposal (ICAS, 1993, Fraser, Henry and Wallage, 2000) that external auditors should be renamed external assessors and should exercise a function that is essentially
one of review with the bulk of audit work being carried out by internal audit.

- There is little support for the proposals (ICAS, 1993, Fraser, Henry and Wallage, 2000) that all listed companies should establish audit review panels and that there should be internal/external auditor co-operation of the kind envisaged in these reports.

**Modified proposals**

The research findings suggest various amendments to the proposals of Fraser, Henry and Wallage (2000) together with additional new proposals. These are as follows:

*Amended proposal 1:* Each company should establish monitoring procedures that are capable of providing the board of directors with sufficient information to fulfil its responsibilities in relation to control, risk management and other areas as appropriate. In the vast majority of cases this will involve the appointment of a strong internal audit team but in situations where the establishment of such a team is not thought to be appropriate, boards of directors should justify this decision by reference to the alternative processes in place to enable them to fulfil their duties.

*Amended proposal 2:* The findings of each investigation by the internal audit function should be reported to the chief executive, the audit committee and the external auditors.

*Amended proposal 3:* The recommendation in ICAS (1993) that the chief internal auditor should report on the establishment and effectiveness of management information and control systems and on the conformity of financial statements with the accounting records and legal and accounting standard requirements should be extended to cover: the identification of significant business risks, the effectiveness
of financial, operational and compliance controls and the quality of management information.

In the light of the lack of support for establishing audit review panels (ICAS, 1993, Fraser, Henry and Wallage, 2000) the following three proposals reflect the need to strengthen the existing structures of corporate governance and to explore other ways of improving corporate governance.

**New proposal 4:** In order to improve the effectiveness of non-executive directors and strengthen their independence, guidelines should be introduced on the maximum number of non-executive directorships that may be held by an individual and regulation should be introduced to control ‘cross-holdings’ of executive and non-executive directorships.

**New proposal 5:** An initiative should be established to address the shortage of suitably qualified non-executive directors and to strengthen their independence and reputation, by developing mechanisms aimed at facilitating young suitably-qualified executives to obtain non-executive directorships.

**New proposal 6:** In order to address the skills shortages among non-executive directors, an initiative should be established to train non-executive directors in general, industry-specific and company-specific issues in order to equip them to fulfil their responsibilities.

**New proposal 7:** In order to facilitate shareholder involvement in corporate governance, attention should be given to the development of fora, such as shareholder committees, that will encourage shareholders to assume a more formal role in the ways in which companies are run.
Further research

Further research is necessary in the following areas:

- Consideration of the most appropriate ways of encouraging younger executives to seek appointment as non-executive directors in other organisations, with the dual purpose of introducing fresh ideas to the organisations concerned and also assisting in the professional development of the individuals involved.

- The development of fora to enable shareholders to take on a more formal role in corporate governance and to make a greater contribution to the corporate governance of investee companies.

- The development of alternative control frameworks for use in organisations where dedicated internal audit functions are thought to be uneconomic or otherwise undesirable.

- Consideration as to whether public companies should separate their internal audit and risk management functions.

- Consideration of the most appropriate methods for the embedding of risk management within organisations.

- Consideration of the most appropriate models for internal/external auditor co-operation.

- In general, given the evident distaste for ‘boilerplate’ rules, attention needs to be given to ways of strengthening corporate governance while, at the same time, paying attention as much as possible to the dominant preference for a minimalist approach to regulation.
CHAPTER ONE

INTRODUCTION

Over the last decade corporate governance has continued to increase in importance as an area of business and societal concern, both within the UK and internationally. In the UK a continuing series of concerns, scandals and crises has set the scene for the publication of a stream of reports, from the Cadbury Report in 1992 to the Higgs and Smith Reports in 2003. In the US too, recent events, such as the Enron and Worldcom affairs and the alleged audit failures in relation to these companies, have prompted action, including legislation in the form of the Sarbanes-Oxley Act in late 2002.

It is therefore timely to explore the views of important stakeholder groups on major contemporary issues and possible future developments in audit and corporate governance in order to suggest ways by which the corporate governance process within the UK can continue to be improved and refined.

Background

This report presents the second and final stage of an investigation into the future of audit and corporate governance. The first part of the project involved drawing implications from corporate governance practices in the Netherlands for the future of UK audit and corporate governance and the results from that stage of the project were published under the title The Future of Corporate Governance: Insights from the Netherlands (Fraser, Henry and Wallage, 2000). This final stage of the
project is concerned specifically with audit and corporate governance in the UK.

The research project as a whole was conceived as a development of the radical proposals for the future of audit and corporate governance that were contained in *Auditing into the Twenty-First Century* (ICAS, 1993), a discussion document published in June 1993 under the aegis of the Research Committee of *The Institute of Chartered Accountants of Scotland* (ICAS). ICAS (1993) proposed changes to both audit and corporate governance. These proposed changes are summarised briefly here; ICAS (1993), and Fraser, Henry and Wallage (2000) give fuller descriptions.

**Changes to audit and corporate governance arrangements proposed by ICAS (1993)**

*Enhanced internal audit function.* It was proposed that each listed company should establish an internal audit function that would be responsible for much of the work carried out currently by the external auditors.

*Financial Reporting and Audit Committees* (FRACs) would be established for each company. These FRACs would be made up entirely of non-executive directors and would be similar to existing audit committees but would have additional functions and responsibilities, in particular relating to the supervision and monitoring of the internal audit function.

*Change in role of external auditors.* As much of the existing work of the external auditors would be carried out by the enhanced internal audit function it followed that the work of the external auditors would become more judgemental and less procedural. To reflect this, it was also proposed that the external auditors be renamed external assessors.
Establishment of Audit Review Panel (ARP). It was suggested that this new body be established to take responsibility for the appointment and remuneration of the external assessors and for generally supervising the assessment process. This new body would be independently constituted and its members\(^1\), who would have no other connection with the company, would be appointed from a list maintained by some competent authority such as the Stock Exchange.

There was no UK evidence to substantiate whether or not these radical proposals would be workable. However, key ICAS (1993) proposals were paralleled by contemporary practice in the areas of audit and corporate governance within the Netherlands. Internal audit had long enjoyed a much higher profile and status within the Netherlands than within the UK and had commonly been used by major companies to carry out many of the functions proposed for internal audit by ICAS (1993). Additionally the arrangements for the establishment of an additional monitoring body in the form of an ARP, and arguably the proposal for the establishment of FRACs, paralleled certain aspects of the continental-style supervisory boards that are a feature of Dutch corporate governance.

The first stage of the research, therefore, aimed to:

- Identify and understand present corporate governance practice in the Netherlands with particular reference to the audit function, through visits to three selected Dutch companies. For each company visited this involved:
  - identification of the functions, responsibilities and *modus operandi* of the audit committee, internal audit function and supervisory board.
  - assessment of how these bodies interacted with each other and with the executive board and external auditors.
  - identification of how the bodies’ effectiveness was measured and whether they were perceived to be effective.
• To either confirm the desirability and feasibility of the original ICAS proposals or to recommend amendment.

Findings from first stage of project: Dutch fieldwork

In this section the key findings of the first stage of the project regarding corporate governance practice in the Netherlands are briefly summarised. The modified proposals for the future of audit and corporate governance made by Fraser, Henry and Wallage (2000) are then detailed.

Supervisory boards and audit committees

These are considered here together as in the Netherlands the audit committee is usually a sub-committee of the supervisory board. The main functions of the supervisory board are to supervise management on behalf of all major stakeholders and to act as a sounding board for management ideas. Through the audit committee, the supervisory board attempts to obtain assurance on the effectiveness of control systems and financial reporting through liaison with internal and external auditors. The supervisory board system as it operates in the Netherlands is considered to create the potential for the existence of a group of independent specialists within the company that have an interest in preserving the independence of both external and internal auditors. However several weaknesses of the Dutch two-tier board system were identified. These include the commonality of audit committee and supervisory board personnel, the perceived lack of independence of the supervisory board from the management board and the lack of expertise of some audit committee members in financial matters. With widespread and evident concern in the UK over the quality and effectiveness of non-executive directors, alternative board structures remains an issue of pressing concern.
Internal audit

Fraser, Henry and Wallage (2000) identified several strengths of internal audit as it operated in the Netherlands. Internal audit typically covered a wide range of business activity embracing both financial and operational audit. There was evidence of the extension of internal audit work to operational control matters and risk assessment. Thus internal auditors were becoming senior management advisors. Other strengths included the quality of internal audit staff, the size of internal audit functions within the companies visited, the high regard in which internal audit was held by management and the high level of advice and support offered to management by internal audit. Internal audit functions tended to operate independently within organisations and to enjoy considerable authority and reputation. There appeared to be close co-operation between internal and external audit. However there was concern about the lack of independence of internal audit from management boards. There were suggestions to the effect that if internal audit operated independently it was because management allowed it to be so. This weakness was exacerbated by the apparent lack of positive mechanisms both to monitor internal audit activity and to ensure its independence within the organisation.

As a result of these findings Fraser, Henry and Wallage (2000) produced revised proposals, based on these produced by ICAS (1993), as follows:

1 (Retained from ICAS, 1993) Each company should appoint a strong internal audit team that is capable of providing the FRAC with sufficient information to fulfil its responsibilities on behalf of the board.

2 (Retained from ICAS, 1993) The findings of each investigation by the internal audit function should be reported to the chief executive, the FRAC and the external assessors.
3 (Extended proposal) The recommendation in ICAS (1993) that the chief internal auditor should report on the establishment and effectiveness of management information and control systems and on the conformity of financial statements with the accounting records and legal and accounting standard requirements should be extended to cover acting as risk management consultants to confirm that all significant business risks have been identified. He/she should also give assurance on the quality of data emerging from routine systems and the effectiveness of management, and liaise with external auditors on the allocation of audit work.

4 (Retained from ICAS, 1993) The external auditors should be renamed the external assessors and to a considerable extent the external assessors should carry out their work by assessing the work of a company’s internal auditors.

5 (Extended proposal) An independent ARP should be established to take responsibility for the supervision of the assessment process on behalf of the primary stakeholders, while being responsive to the needs of the secondary and tertiary stakeholders.

6a (Extended proposal) The role of the ARP proposed by ICAS (1993) should be broadened to a more proactive supervision of the planning, execution, completion and reporting of audit work undertaken by the external assessors. This would help to ensure that due rigour is applied to the assessment process.

6b (New proposal) The ARP should adopt a watching brief over the internal audit function, to confirm its effectiveness and independence within the organisation.

Structure of report

The remainder of the report is structured as follows:

Chapter two discusses the current literature on corporate governance and identifies key issues arising from this literature. These issues together with the proposals of Fraser, Henry and Wallage (2000)
and, where relevant, ICAS (1993), are then used to identify a number of research objectives for the empirical work.

Chapter three sets out the research method, comprising a postal questionnaire, followed up by interviews with members of key stakeholder groups to explore the research objectives further.

Chapters four to seven deal with the responses from questionnaires and interviews in relation to contemporary developments (chapter four), Fraser Henry and Wallage (2000) (chapter five), The Blue Ribbon Report (NYSE/NASD, 2002) (chapter six) and The Turnbull Report (ICAEW, 1999) (chapter seven).

Chapter eight sets out conclusions and recommendations, based on the results of the previous chapters.

Endnote:

1 It was proposed by ICAS (1993) that the number of members of each ARP should be small. Three was suggested as a possible number.
CHAPTER TWO

CONTEMPORARY DEVELOPMENTS
WITHIN AUDIT AND CORPORATE GOVERNANCE

This second stage of the project seeks to elicit the views of key UK stakeholders on the proposals of Fraser, Henry and Wallage (2000) and, where relevant, ICAS (1993). However the context in which these proposals require to be viewed is not a static one. Other proposals for the reform of corporate governance arrangements are now in the public arena, notably the proposals of The Blue Ribbon Committee that were made to improve the effectiveness of audit committees in the US.

In the UK, listed companies were required to comply in full with the Combined Code, including the Turnbull guidance for accounting periods ending on or after 23 December 2000, and, from a wider perspective, the corporate governance environment continues to evolve in response to pressures from regulatory bodies, from government and from other parties. This chapter, therefore, reviews recent developments in corporate governance and audit that are of relevance to the research.

The evolving audit and corporate governance background

The Turnbull Report (ICAEW, 1999, hereafter referred to as Turnbull) and, before it, the Hampel Report (Hampel, 1998) were published in a context of a growing demand for corporate reporting relating to matters of internal control and risk management. Turnbull was premised on the adoption by corporate boards of risk-based approaches to the establishment of sound systems of internal control and
on the subsequent monitoring of the effectiveness of these systems. The concept of risk adopted was a broad one with coverage of all significant business, operational, financial, compliance and other risks. *Turnbull* suggested that the review of internal control might be delegated to the audit committee or to other board members as appropriate, with the audit committee providing a focal point for the review of controls in general rather than merely financial controls.

*Turnbull* envisaged internal audit functions as playing an important role in assisting audit committees in their work in the internal control and risk management areas. Specifically, the main role of internal audit in this regard would consist of the evaluation of risk and the monitoring of the effectiveness of internal control in order to provide boards with much of the assurance required by them in these areas. These issues arising from *Turnbull* were important considerations that underpinned the extension of the original ICAS (1993) proposals by Fraser, Henry and Wallage (2000). Clearly then, matters relating to audit committees, internal audit and wider matters of corporate governance and risk management are interwoven and cannot be considered meaningfully as discrete issues. The research that is the subject of this report seeks to engage with all these issues. The last two years have seen continued debate on these developments in the literature. The following sub-sections consider some of this literature under the four headings of *Turnbull* and related issues, non-executive directors, audit committees and internal audit.

**Turnbull and related issues**

In the wake of *Turnbull* various authors emphasise the need for ‘enterprise-wide risk management’ (Viles, 2000). Viles argues that risk and uncertainty are endemic in the new economy and that this creates a compelling case for elevating risk management to a strategic level. Hill (2001) considers that there is a need for a ‘managed risk culture’.
Bolton (2000) states that *Turnbull* compliance gives organisations an opportunity to embed a risk management and control culture into their organisations. Baker (2001b) argues that *Turnbull* launched UK listed companies on a road towards a new era of business-driven risk management and other authors provide case studies of embedded risk management in the Post Office (Chown 2000), Diageo (Viles 2000) and Balfour Beatty (Boswell 2001), all citing *Turnbull* as a catalyst for these developments.

However the establishment of the focused risk management regimes advocated by these authors may not be a straightforward matter and recent literature highlights the complexities involved in implementing *Turnbull*. For example Younghusband (2000) argues that *Turnbull* requires companies to identify precisely their business objectives so as to ensure that the system of internal control covers all relevant risks. Companies will also require to examine the extent of their technological, environmental, legal and regulatory compliance as well as their management of ‘softer’ risks such as social (human rights) and reputational issues. Kemeny (2000) indicates that the initial compliance with *Turnbull* was exceedingly sketchy with only 13% of FTSE 100 companies opting for full compliance. Hodge (2001), however, indicates a significant increase from 1999 to 2001 as far as the number of companies complying with *Turnbull* is concerned.

There is considerable debate over the necessity to identify who has responsibility for the ownership of risks. Deloitte and Touche’s Martyn Jones argues that ownership of risk management must reside with management (Baker 2001b) and that, while it should be on the agenda of internal auditors, if they become so active in this area that they take over ownership of risk management they will run into objectivity issues and management will walk away from owning risk (Baker 2001b). A recent survey of ownership of responsibility for major business risks found that in eight out of ten organisations it was firmly placed with the executive board. In many businesses this was a joint responsibility with
the risk management department or, less commonly, with the internal audit department or audit committee (Baker 2001a). Hodge (2001) reports that the Deloitte and Touche 2001 survey indicates that Chief Executive Officers (CEOs) are increasingly taking on the ownership of risk management, with CEO ownership rising from 10% in 1999 to 35% in 2001. The research also noted an increasing trend of audit committees taking responsibility for the ownership of risks although this is only from 2% in 1999 to 11% in 2001.

At the same time there is some indication of a decrease in the number of companies where internal audit retains ownership of risks. Although there is increasingly perceived to be a role for internal audit in risk management there are potential pitfalls. Internal audit’s involvement in risk management does not guarantee that all risks will be assessed appropriately. Waring (2000) indicates that there is a danger of non-financial risks not being properly considered. Waring argues that in spite of much rhetoric about ‘holistic, integrated risk management’ only a minority of large organisations actually practice this and that there is a risk that the domination of internal audit departments in this area will lead to inadequate consideration of non-financial risks. On the basis of this literature, then, there appear to be two issues that remain unresolved. Firstly, the extent to which companies adequately manage all risks is not clear. Secondly, it remains unclear as to which internal monitoring bodies within companies are assuming ownership of risk management.

Other current literature continues to emphasise external auditors’ responsibilities in the areas of internal control and corporate governance. Cohen and Hanno (2000) point out that recent changes in auditing standards in the US increase significantly auditor responsibilities to consider management control philosophy and corporate governance as part of the audit process. The scope of internal control, and auditors’ responsibilities in relation to the area, remain matters of debate.
Non-executive directors

In the UK, 2001 and 2002 have seen an extensive amount of debate and media comment over the role and effectiveness of non-executive directors. Much of this has been a reaction to the latest wave of corporate scandals (Enron, Worldcom, Marconi, Equitable Life and others). Most notably Lord Young of Graffham, a one-time trade and industry secretary and chairman of Cable and Wireless took the unprecedented step of calling for the abolition of non-executives (Dickson, 2002). Lord Young argued that it is impossible for non-executives to carry out effective monitoring as they are insufficiently aware of what goes on in the companies of which they are directors.

Most other commentators have taken a less extreme stance and instead argue that more committed and ‘professional’ non-executives, who are prepared to shoulder greater responsibility and to put in more time (eg Hinks, 2002, Peaker, 2002), are required. This may lead to a shortage of non-executives who have both the necessary abilities and the required time commitment. Peaker (2002) argues that potential non-executives are becoming increasingly choosy about which companies they become involved with, often seeking ‘references’ for companies inviting them to join their boards in order to ensure sound corporate governance is in place. At the same time there is some evidence to support the view that the quality of non-executives in the UK is already increasing. Marx (2002) states that younger non-executives are more likely to have an early career background in accounting or finance.

In the US, the Sarbanes-Oxley Act of 2002 has aroused further controversy over director responsibilities, by stipulating inter alia that the audit committee of any company required to file reports with the Securities and Exchange Commission should be responsible for the appointment, compensation and oversight of the company’s independent auditor, who should report direct to the audit committee
(Hermsen et al, 2002). The UK government has responded to this debate and to recent failures in corporate governance by setting up the Higgs review of non-executives and also the Smith review of audit committees. The trade and industry secretary, Patricia Hewitt, stated in July 2002 that, like the US, the UK government was considering placing the formal appointment of auditors in the hands of non-executives (Wild, 2002).

The Higgs and Smith reports were published in January 2003 (Higgs, 2003, Smith, 2003), and the main proposals are summarised at Appendix A. However, in her speech of 29 January 2003, reacting to the report to the DTI by the Co-ordinating Group on Audit and Accounting Issues, Hewitt limited her comments on audit committees to endorsing the Smith proposals that audit committees should monitor auditor performance and develop and implement policy on the purchase of non-audit services from the auditor (Hewitt, 2003). The future role and responsibilities of non-executives directors, therefore, are open issues.

**Audit committees**

If audit committees are to assume responsibility for aspects of risk management then some revision of their traditional role is required. Fraser, Henry and Wallage (2000) made proposals (based on those of ICAS, 1993) for the reform of audit committees, and the audit function in general. In the US *The Blue Ribbon Committee* published recommendations on improving the effectiveness of corporate audit committees in 2000 (NYSE, 2000). In general, the proposals of *The Blue Ribbon Committee* are less radical than those of ICAS (1993) and of Fraser, Henry and Wallage (2000).

Some of *The Blue Ribbon* proposals are relatively non-contentious; for instance, the proposals that all large listed companies should have an audit committee consisting solely of independent directors\(^1\), that
all audit committees should contain at least one financially literate member and that each audit committee should be required to adopt a formal written charter. More radical are The Blue Ribbon proposals that audit committee charters should specify that the external auditors are ultimately responsible to the board of directors and the audit committee as representatives of the shareholders and that these representatives should propose appointment or removal of the external auditors to the shareholders.

The Blue Ribbon proposals that appear potentially the most contentious are those relating to audit committees’ responsibilities regarding the financial statements. These proposals suggest that audit committees should state in company annual reports whether or not management has reviewed the financial statements with the audit committee discussing the quality of accounting policies and significant judgements affecting the financial statements. Additionally, it is proposed that audit committees should state whether or not they believe that the financial statements are fairly presented in accordance with US GAAP.

The Blue Ribbon recommendations are supported by recent US literature. Raghunandan et al (2001) support the underlying assumptions of The Blue Ribbon Committee that audit committee composition is associated with the quality of audit committee oversight activities and that the independence and qualifications of audit committee members require to be strengthened. De Zoort and Salterio (2001) conclude that independent director membership on its own may not be sufficient to give audit committees sufficient expertise or motivation to challenge management. Factors such as knowledge of financial reporting and accounting may be important. De Zoort and Salterio (2001) believe that there is justification for auditor concerns that differences in audit committee member knowledge lead to systemic differences in audit committee member judgements about accounting disputes between auditors and management.
Although not as radical as the proposals of ICAS (1993) and of Fraser, Henry and Wallage (2000), *The Blue Ribbon* recommendations do have resource implications for companies that do not presently comply with the recommendations. Lightle (2000) suggests that internal audit functions can play a strategic role in the implementation of *The Blue Ribbon* recommendations. Additionally Lightle (2000) suggests that internal audit should report to the audit committee rather than to executive management. This thinking is consistent with the recommendations of Fraser, Henry and Wallage (2000) and with the original ICAS proposals, which suggested that the chief internal auditor should report to the FRAC as well as to the CEO, with a copy of the report going to the external assessors. In a similar fashion Bishop *et al* (2000) argue that *The Blue Ribbon* recommendations will lead to an enhanced role for internal audit. Internal audit functions are likely to be required to provide increasing levels of support to audit committees in their oversight of reporting and of risk management and control.

Thus while *The Blue Ribbon* recommendations may lack a radical edge, current literature both lends support to their general thrust and also emphasises the importance of internal audit and audit committee co-operation. *The Blue Ribbon* report, however, says little about the wider possible role of audit committees in risk management despite the exposure of this issue in other current literature.

In the UK the Smith Committee (2003), reporting in January 2003, made a number of recommendations on audit committees. These include proposals that audit committees should make recommendations to the board on the appointment and remuneration of auditors and report to shareholders in the annual report. In addition, the report recommends that a minimum of three independent non-executives, at least one of whom should ideally have a professional accountancy qualification, should serve on the audit committee and that all committee members should have a degree of financial literacy.
For companies to address their responsibilities under *Turnbull* properly, the contribution of audit committees as collaborators with internal audit is of obvious relevance. Younghusband (2000) points out that boards’ responsibilities in risk management may be delegated to audit committees. However, a recent survey of internal auditors indicated a degree of ambivalence regarding the amount of help that was being received from non-executive directors in the area of risk. Only 50% of responding internal auditors stated that non-executives were assisting them in these risk management matters (Anon, 2000). The same survey also indicated that about the same percentage of non-executives are either only helping a little or not at all with the improvement of risk management and control in their organisations. This is recognised as a difficult area for non-executives as they are not involved in the day-to-day running of the business and they may not have enough information to contribute meaningfully. Zaman (2001) and Bruce (2000) both present arguments that are consistent with this evidence. Zaman suggests that *Turnbull* expects too much of audit committees and according to Bruce, non-executives find that their roles are becoming more onerous and as a result are concerned about the extent of their potential personal liabilities.

Cunnington (2000a, b) describes how at the London International Financial Futures and Options Exchange (LIFFE) risk management is the responsibility of an Audit and Risk Committee. In addition to the normal functions of an audit committee, LIFFE’s Audit and Risk Committee approves the risk management strategy and is a forum for discussion on the Exchange’s ‘risk appetite’. Twice a year the committee undertakes reviews of the adequacy and effectiveness of internal control and risk management covering all activities of the Exchange, giving the Board appropriate assurance and monitoring action taken to mitigate residual risks. However, for audit committees to perform this function effectively, they would require both time and expertise. Zaman (2001) points out that *Turnbull* recognises that in reality the board is likely
to delegate the task of reviewing the effectiveness of internal control to its audit committee. Zaman argues that since non-executives lack day-to-day knowledge of the risks to which the company is exposed and they have limited time available to them, it may be unfair to expect them to perform more than a high level review of matters relating to the wider aspects of internal control. In summary, the effectiveness of the potential contribution of audit committees remains a matter for investigation.

**Internal audit**

There is no doubt that, overall, the internal audit function has become more visible because of the catalyst that *Turnbull* has been (Bruce 2000). Bolton (2000) traces the historic development of internal auditors from ‘policemen’ to business partners and argues that *Turnbull* gives internal auditors a clear opportunity to raise their heads above the parapet and to demonstrate their capabilities to their boards and audit committees. Likewise, Baker (2001b) highlights the view that the *Turnbull* report on risk management represents an opportunity for internal auditors to make an impact in the boardroom and to align their work more to real business issues. Certainly, internal auditors see *Turnbull* in a positive light and in a survey, a total of 92% of internal auditors thought that *Turnbull* was either good or moderately good for internal auditors (Anon 2000).

*Turnbull*'s prioritisation of embedded risk management has given internal auditors the opportunity to increase their influence greatly. *The Institute of Internal Auditors* considers that, given adequate resources and a wide enough scope, internal audit is well placed to provide the board with an objective opinion on risk management and internal control across all the activities of the company (IIA, 1999 quoted in Zaman 2001).
Younghusband (2000) also emphasises the role of internal audit in providing assurance on risk and control to management and in the US. Steinberg and Pojunis (2000) suggest an extensive role for internal audit in risk management and related areas. Cunnington (2000a, b) discusses the integration of internal audit and operational risk management under the umbrella of risk assurance services at LIFFE.

There are, however, potential pitfalls. Although Turnbull has given internal auditors great opportunities, it places them more in the spotlight (Cunnington 2000c) and internal audit departments must ensure that they are up to the task of meeting the expectations of the business and of delivering added value. According to a recent survey of finance directors of FTSE 200 companies, more than half the companies responding were lukewarm or negative about the internal audit function and its contribution to the business (Hodge 2002). If internal auditors are to meet the challenges facing them they will be required to develop new skills and become more business-oriented. Bou-Raad (2000) discusses the new range of skills to be developed by internal auditors. These include communication and facilitation skills, risk management principles and risk assessment applications. In addition, internal auditors need to learn to work as partners with management as distinct from working for management. There may be some doubt as to whether internal auditors will be resourced to the extent necessary to develop the requisite skills. If they do not, they could find themselves replaced by operational risk professionals or external consultants.

There is also a danger of loss of independence if internal auditors develop into risk management and control consultants. Cunnington (2000c) argues that while there are clear benefits to the integration of internal audit and risk management there is the potential for compromising internal audit independence. This is a particular hazard if internal audit is perceived as owning risk management. Baker (2001b) reports the view that while at present in many companies the head of
internal audit has a major role in risk management, this state of affairs will not continue. Eventually internal audit and risk management will increasingly be seen as separate activities. The role of internal audit will be to monitor risk management and the risk management role per se will be owned by others. Bolton (2000) describes how the head of internal audit may act as the ‘conduit’ within the organisation for pulling together the annual assurance that the board needs on risk management and control activities and thereby provide independent and objective assurance on these issues.

**Summary of key issues from recent literature**

In summary, the following issues emerge from the recent literature as unresolved:

- the extent to which companies adequately manage all risks;
- the roles of the monitoring bodies within companies in relation to risk management;
- the possible ways to enhance the effectiveness of audit committees, including *The Blue Ribbon* recommendations;
- the actual and potential contribution of non-executive directors to corporate governance;
- the actual and potential contribution of audit committees to risk management;
- the actual and potential contribution of internal audit to risk management; and
- the scope of internal control and auditors’ responsibilities in the risk management area.
Research objectives

Based then on the proposals of ICAS (1993), and of Fraser, Henry and Wallage (2000), and on the continuing debate on corporate governance and audit issues outlined above, the specific objectives of the research that is covered in this report are as follows:

1. To identify and explore the views of various stakeholder groups (covering key individuals in listed UK companies, external auditors and fund managers) on the major contemporary issues and possible future developments in audit and corporate governance. These developments include issues such as:
   - the scope of internal control (see, for example, Hampel 1998) and auditors’ corresponding responsibilities;
   - the extent to which risk management is embedded within companies;
   - the roles of internal auditors, external auditors and audit committees in relation to corporate governance and risk management (see, for example, Turnbull); and
   - the extent to which UK stakeholders support *The Blue Ribbon* recommendations on audit committees.

2. To identify and explore the views of the various stakeholder groups, listed under 1 above, on the proposals made by Fraser, Henry and Wallage (2000) and, where relevant, by ICAS (1993), in relation to:
   - external and internal audit, and the relationship between them;
   - the establishment and functions of Financial Reporting and Audit Committees (FRACs) and of Audit Review Panels (ARPs); and
• the functions and responsibilities of executive and non-executive directors in relation to corporate governance and risk management.

3. To form a view on the desirability and the feasibility of implementing the Fraser, Henry and Wallage (2000), and/or ICAS (1993), proposals and to amend where necessary.

Endnote:

1 In this context ‘independent’ directors are defined as individuals with no relationship to the company that may interfere with the exercise of their independence from management.
CHAPTER THREE

THE RESEARCH METHOD

Research approach

As explained in the previous chapter, the principal purposes of the research reported here are to investigate the views held by key individuals on the proposals (based on those of ICAS, 1993) made by Fraser, Henry and Wallage (2000), and on contemporary developments in audit and corporate governance that are relevant to these proposals. To this end, a large-scale postal questionnaire survey was first carried out and, subsequent to this, interviews were carried out with individuals representing various constituencies.

The postal questionnaire was sent to 1000 interested parties representing five different groups involved with corporate governance and auditing. These five groups were financial directors, non-executive directors (audit committee chairs), chief internal auditors, external auditors and sophisticated users. Two hundred questionnaires were sent to each of the five stakeholder groups. An extremely low response rate resulted for the sophisticated users and so a number of interviews substituted for the questionnaire study as a means of ascertaining the views of this group.

In order to explore more fully the views of the other responding groups, follow-up interviews were also conducted with representatives of each of the other groups that responded to the questionnaire.
The questionnaire

The questionnaire is reproduced as Appendix B to this report. The questionnaire was divided into four sections. The first section consisted of three questions dealing with contemporary developments. This was followed by a section of sixteen main questions concerned with the proposals made by Fraser, Henry and Wallage (2000). The third section was concerned with the issues arising from The Blue Ribbon Committee Report on audit committees in the US and consisted of eleven main questions. A further eleven main questions on issues arising from Turnbull formed the subject matter of the fourth and final section of the report. To aid participants in their responses a two-page background section summarised the key documents on corporate governance and audit that had been published over the last decade. Most questions required participants to scale their responses on a five-point Likert scale of 1 (strongly agree) to 5 (strongly disagree). In addition in all questions where a scalar response was required, a ‘don’t know’ response category was included. Two questions specifically asked for a narrative response and, in addition, respondents were given the opportunity to comment on the issues involved at eight points within the questionnaire.

Responses

The initial mailing of the questionnaire was followed by two follow-up mailings. The number of respondents and response rates are shown for each group surveyed in Table 3.1.
Table 3.1   Number and distribution of responses

<table>
<thead>
<tr>
<th>Respondent group</th>
<th>Number Surveyed</th>
<th>Number responding</th>
<th>Response rate</th>
<th>Code used in tables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Directors</td>
<td>200</td>
<td>34</td>
<td>17%</td>
<td>FD</td>
</tr>
<tr>
<td>Non-executive directors</td>
<td>200</td>
<td>36</td>
<td>18%</td>
<td>AC</td>
</tr>
<tr>
<td>Internal auditors</td>
<td>200</td>
<td>50</td>
<td>25%</td>
<td>IA</td>
</tr>
<tr>
<td>External auditors</td>
<td>200</td>
<td>49</td>
<td>24.5%</td>
<td>EA</td>
</tr>
<tr>
<td>Total¹</td>
<td>800</td>
<td>169</td>
<td>21.1%</td>
<td>TOTAL</td>
</tr>
</tbody>
</table>

Given the technical nature of the subject matter of the questionnaire, and the length of the research instrument (thirteen pages), these response rates are regarded as satisfactory. A significant majority of respondents provided narrative comments on the issues raised by the questionnaire where opportunity was allowed for this and in many cases these comments were extensive. These narrative comments add a significant degree of richness to the responses received and the researchers draw from them extensively.

The interviews

Interviews were carried out in five listed companies, of which two were members of the FTSE 100. These were both international conglomerate groups and each had a large number of subsidiary companies in a wide variety of international locations. These companies were selected, however, because each adopted distinctive policies towards risk management. One operated an internal audit function that also dealt with risk management. The other had separate functions for risk management and for internal audit although the head of internal audit reported to the head of risk management². The other
three listed companies were smaller and were concerned respectively with technology, oil exploration and intellectual property rights. Two of these had very small internal audit functions and the third had no internal audit department. In all listed companies the researchers interviewed the finance director, the chair of the audit committee and, where applicable, the head of internal audit. In addition, the director of risk management was interviewed in the company that had a separate function dealing with risk. Summarised details of the five listed companies are as follows:

**Table 3.2**  
*Details of listed companies*

<table>
<thead>
<tr>
<th>Company</th>
<th>Business</th>
<th>Turnover (£m)</th>
<th>No of Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Aerospace, Medical, Industrial</td>
<td>3,100</td>
<td>33,000</td>
</tr>
<tr>
<td>2</td>
<td>Gases, Supply Chain Management, Semi-</td>
<td>4,000</td>
<td>43,000</td>
</tr>
<tr>
<td></td>
<td>Conductors, Vacuums</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Digital home technology</td>
<td>400</td>
<td>750</td>
</tr>
<tr>
<td>4</td>
<td>Oil and gas exploration</td>
<td>100</td>
<td>400</td>
</tr>
<tr>
<td>5</td>
<td>Intellectual property rights</td>
<td>9.1</td>
<td>150</td>
</tr>
</tbody>
</table>

A partner from each of the ‘big four’ audit firms was interviewed. The research was restricted to these firms on the grounds that they accounted for the majority of listed company audits and that the ICAS (1993) and Fraser, Henry and Wallage (2000) proposals were restricted to listed companies. Finally, three fund managers were interviewed, two of whom specialised in UK equities and one of whom specialised in European equities. It was considered useful to interview a fund manager with a European specialisation on the grounds that this might
provide additional insight on the operation of the European two-tier board system.

Twenty interviews in total were carried out. Six of these were carried out at the interviewees’ place of work; the remainder were carried out by telephone. All interviews were recorded and the discussion of the issues in the following chapters includes quotations from the interview transcripts where appropriate. The interviews were semi-structured and were based on an agenda previously prepared by the researchers (Appendix C). Where requested, interview checklists were emailed to the interviewee prior to the interview. The interviews themselves were tailored to the function of the interviewee. Interviews normally lasted for around an hour. A summary of the persons interviewed is as follows:

**Table 3.3 Summary of Interviewees**

<table>
<thead>
<tr>
<th>Interviewee group</th>
<th>Listed Companies</th>
<th>‘Big Four’ Audit firms</th>
<th>Financial Institutions</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Directors</td>
<td>4</td>
<td>-</td>
<td>-</td>
<td>4</td>
</tr>
<tr>
<td>Audit committee chairs</td>
<td>4</td>
<td>-</td>
<td>-</td>
<td>4</td>
</tr>
<tr>
<td>Internal auditors</td>
<td>4</td>
<td>-</td>
<td>-</td>
<td>4</td>
</tr>
<tr>
<td>Risk directors</td>
<td>1</td>
<td>-</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Audit partners</td>
<td>-</td>
<td>4</td>
<td>-</td>
<td>4</td>
</tr>
<tr>
<td>Fund managers</td>
<td>-</td>
<td>-</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>13</strong></td>
<td><strong>4</strong></td>
<td><strong>3</strong></td>
<td><strong>20</strong></td>
</tr>
</tbody>
</table>

**Presentation and display of results**

The results of both the postal questionnaire survey and of the interviews are presented in chapters four to seven in the following order.
• Issues arising from contemporary business developments and other general corporate governance issues
• Issues arising from ICAS (1993) and from Fraser, Henry and Wallage (2000).
• Issues arising from The Blue Ribbon Report on improving the effectiveness of audit committees.
• Issues arising from Turnbull

All results relating to the postal survey, other than for open-ended questions, are presented in the appropriate tables. The tables show the average score (mean) and a measure of dispersion based on the standard deviation. Both means and measures of dispersion are shown for each respondent group and for the total of all respondents. The measure used classifies the dispersion into five groups as follows:

\[
\begin{align*}
SD & \leq 0.9 \text{ (very low)} \\
0.9 < SD & \leq 1.0 \text{ (low)} \\
1.0 < SD & \leq 1.1 \text{ (moderate)} \\
1.1 < SD & \leq 1.2 \text{ (high)} \\
SD & > 1.2 \text{ (very high)}
\end{align*}
\]

The labels attached to these groups indicate the relative dispersion; even the levels of dispersion described as low or very low may encompass considerable variation in the views of respondents. The level of dispersion within a group is indicative of the level of consensus; in general terms the lower the level of dispersion, the higher the level of consensus.

Overall ANOVA (analysis of variance) tests were undertaken to indicate the existence of inter-group differences. The researchers then tested for significant inter-group differences between the mean scores given by each respondent group using a standard t-test. The tables in
chapters four to seven indicate all significant inter-group differences at the 5%, or greater, level of significance.

The verbal anchors used in the questionnaire were, 1 = ‘strongly agree’, 2 = ‘agree’, 3 = ‘neutral’, 4 = ‘disagree’ and 5 = ‘strongly disagree’. In the discussion of the results descriptive labels are attached to the mean levels of agreement as follows:

<table>
<thead>
<tr>
<th>MEAN RESPONSE</th>
<th>DESCRIPTIVE LABEL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2.0</td>
<td>Strong agreement</td>
</tr>
<tr>
<td>2.0 to 2.5</td>
<td>Reasonably strong agreement</td>
</tr>
<tr>
<td>2.5 to 2.8</td>
<td>Mild agreement</td>
</tr>
<tr>
<td>2.8 to 3.2</td>
<td>Neutral</td>
</tr>
<tr>
<td>3.2 to 3.5</td>
<td>Mild disagreement</td>
</tr>
<tr>
<td>3.5 to 3.8</td>
<td>Reasonably strong disagreement</td>
</tr>
<tr>
<td>Greater than 3.8</td>
<td>Strong disagreement</td>
</tr>
</tbody>
</table>

The interviews were tape-recorded. In chapters four to seven quotations cited are from transcripts and are indicated in italics. The following code at the end of each quotation indicates the category of interviewee as follows:

<table>
<thead>
<tr>
<th>CODE</th>
<th>INTERVIEWEE CATEGORY</th>
</tr>
</thead>
<tbody>
<tr>
<td>FD</td>
<td>Finance director</td>
</tr>
<tr>
<td>AC</td>
<td>Audit committee chair</td>
</tr>
<tr>
<td>IA</td>
<td>Internal auditor</td>
</tr>
<tr>
<td>RD</td>
<td>Risk director</td>
</tr>
<tr>
<td>EA</td>
<td>External auditor</td>
</tr>
<tr>
<td>FM</td>
<td>Fund manager</td>
</tr>
</tbody>
</table>
Endnotes

1 Additionally two hundred expert users – fund managers and analysts – were also surveyed. However due to the very low response rate this group is excluded from the analysis of the questionnaire responses. Instead greater emphasis was placed on the interviews carried out with representatives of this group. We acknowledge the low response rate for fund managers and analysts to be a limitation of the study.

2 Child (2002) in a survey of FTSE 100 companies noted that, of 54 companies that replied, 40% operated a separate risk management department independent of internal audit.
CHAPTER FOUR

ISSUES ARISING FROM CONTEMPORARY DEVELOPMENTS IN CORPORATE GOVERNANCE AND BUSINESS REPORTING

In both the postal questionnaire and the interviews issues arising from contemporary business developments were explored. Views were also sought on the adequacy of the present UK arrangements for corporate governance. At the time during which interviews were conducted the role of non-executive directors had attracted much media comment, partly as a response to recent corporate failures both in the UK and the US, and so this was made a specific point of focus during the interviews.

Section 1 of the questionnaire sought to elicit the views of respondents regarding issues arising from contemporary business reporting developments. Three questions were asked in this section. Table 4.1 gives the mean responses and levels of dispersion for each of the four groups surveyed.
Table 4.1 Views on issues related to contemporary business developments

<table>
<thead>
<tr>
<th>Proposals: extent of agreement that:</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1.1) Existing corporate governance structures are able to cope with contemporary business reporting developments</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td>(1.2) Contemporary developments in auditing are likely to compromise the independence of the external auditor.</td>
<td>2.48 Low</td>
<td>2.21 Very low</td>
<td>2.66 Low</td>
<td>3.02 Low</td>
<td>2.59 Low</td>
</tr>
<tr>
<td>(1.3) External auditors increasingly work as partners with management</td>
<td>3.59 Very low</td>
<td>3.59 Very low</td>
<td>3.04 Mod</td>
<td>3.96 Very low</td>
<td>3.54 Very low</td>
</tr>
<tr>
<td></td>
<td>3.21 High</td>
<td>3.00 low</td>
<td>2.70 Very low</td>
<td>3.14 Mod</td>
<td>3.01 Mod</td>
</tr>
</tbody>
</table>

1 Significant differences between AC and EA, between AC and IA and between FD and EA.
2 Significant differences between EA and IA and between EA and FD.

Views on existing corporate governance structures

In general there was mild agreement that existing corporate governance structures are able to cope with contemporary developments in business reporting. All groups displayed high or very high degrees of consensus on this issue. External auditors were the least enthusiastic
about the adequacy of existing corporate governance arrangements and this group had a largely neutral view on the issue. The relative lack of enthusiasm of external auditors for existing corporate governance structures may reflect contemporary pressures on external auditors. Eighteen of the forty-nine external auditors who replied did not agree that existing corporate governance structures were adequate in the light of contemporary business reporting developments. One external auditor commented on the need for corporate governance to adapt to changing reporting requirements:

*Existing frameworks will need to continue to evolve to meet new demands for business measurement information/shareholder reporting.*

(EA)

Audit committee chairs were the most enthusiastic and this may reflect their key role and involvement in corporate governance.

At the interview stage of the project the views of interviewees were also discussed on contemporary corporate governance along with the other business reporting issues covered in the questionnaire study. In general interviewees reiterated the view that existing corporate governance structures were satisfactory but with the caveat that ultimately the people involved were more important than any formal structure. One audit partner stated that:

*… the big issue is that the system is only as robust as the way in which it is applied. And the way it is applied will depend on the people who are applying it.* (EA)

Another external auditor stated that while the essential matters came down to individuals it was necessary to have systems in place. A non-executive director made the point that in the UK the present success of the corporate governance system was dependent upon individual people, companies and circumstances. He went on to
contrast this with the US where in his view problems of corporate governance were systemic.

A general point that was repeatedly made by interviewees of all categories was that more regulation was not the answer to problems of corporate governance. This also applied to views about the role and competence of non-executive directors.

**Non-executive directors**

One audit committee chair made the point that there was a conflict between the general effectiveness of non-executive directors and their corporate governance contribution.

*The corporate governance contribution of non-executives can only be improved if you want to prioritise governance over effectiveness. There is a trade-off between the two. I think that the most important thing to stick to is clear separation of the non-executive chairman and executive chief executive roles. (AC)*

Higgs (2003) also recommended that a chief executive should not become chairman of his/her company.

Interviewees took the opportunity to comment extensively on the increasing demands that were being placed upon non-executive directors.

In general, while interviewees felt that there would be little benefit to be derived from regulators introducing additional rules on non-executives, one finance director stated forcibly that regulations on the maximum number of non-executive directorships that any one individual could hold might usefully be introduced. The point was made that there were instances in corporate Scotland of individuals continuing to hold an unacceptably large number of non-executive directorships.
I do not think that it is appropriate that you have a laundry list of non-executive positions. I don’t think you can do your organisations justice. I am in favour of a limitation on how many non-executive positions you can hold. (FD)

Similar comments were made by a non-executive director, although he was reluctant to fix arbitrary limits to the number of non-executive directorships an individual should take, a position also taken by Higgs (2003). The non-executive interviewed said that:

If the going gets tough, non-executives need to spend more time in the business. If you have a lot of non-exec directorships and things are going well, then you can probably cope with it. It is when three or four things start going wrong that you suddenly find that you have got much more demands on your time. You suddenly find that you are spending a lot more time and you are travelling, you are speaking to customers, you are speaking to overseas shareholders. I think that it is up to boards, when they are taking non-execs on, to look at individuals’ time commitments. But I think that to say that anyone can only have two or three or four, is not the right way to do it. (AC)

The same non-executive director made the point that time was required for productive relationships between executives and non-executives to develop, and that it was necessary for the non-executives to obtain a ‘feel’ for the business by, for instance, turning up unannounced and expressing a wish to look round the organisation:

In one company that I was involved with a few years ago, one of the directors knew the industry really well, and every time we had a board meeting he turned up an hour early and he walked round the factory. He would then come to the board meeting with interesting perspectives based on what he had seen. (AC)
While there was a view, then, that there was a limit to the number of non-executive directorships that any individual could deal with competently, opinions were expressed as to the limited availability of the people with the necessary skills. Another non-executive felt strongly that there was only a ‘very finite’ pool of resource in the non-executive sector:

*The actual skills and experience needed to play that role effectively in a vast number of publicly quoted companies is very great indeed, and the number of people that have both those abilities and an appetite to play that game, I think is very limited. A system that requires the non-execs to be the key to the corporate governance process will therefore be fundamentally flawed if there is not a sufficient quality and quantity of people available.* (AC)

The perception that there were relatively few people around with the appropriate quality was matched by a view that social acquaintances and previous business colleagues were no longer appropriate as non-executives. Several interviewees opined that the ‘old boy’ network had either died out or was no longer a credible source of non-executives. One chairman illustrated this point by stating that on the last occasion when his company had found it necessary to recruit additional non-executives it had gone straight to head-hunters. One external auditor stated that:

*There is no doubt that the days are gone of ‘John should be on the board because he has been in the sector and we know him well. He is a member of the golf club, and therefore he fits the profile’.* (EA)

One external auditor expressed the view that in order to avoid ‘old boy network syndrome’ executive directors should be excluded from the selection of non-executives:

*It is the execs that select the non-execs to be who they want them to be. If you have a very strong chief executive, effectively he appoints*
the non-execs. If you are going to take the non-executive role properly, you should probably distance the selection of the non-execs from the execs. (EA)

This comment indicates the concern at the influence exercised by executives over non-executive directors. One financial director opined that in the final analysis, the effectiveness of non-executives depended ultimately upon the attitude of the executive directors:

_It is almost impossible for outside parties to be at all effective in the face of executives who are not making proper disclosures. So I think logically what you have got is a system that depends upon people’s honesty. And if everyone is going to be honest then you do not need any of the controls. So my own view is that any controls, whether they are audit controls or non-executive directors, have really got very little chance of being effective in the face of persistent dishonesty._ (FD)

This financial director was pessimistic about the worth of any regulation that might be introduced in order to strengthen the effectiveness of non-executive directors:

_I think that it is a hopeless situation. I think that it is very largely the case that things are put in place largely for the sake of appearance. I cannot actually see a way by which these controls can truly be effective._ (FD)

One financial director observed that, as far as he could see, very few non-executives appeared ever to resign their positions on points of principle and indicated that this was a commentary on the quality of work of non-executives:

_One point that I always make in connection with non-executives is to ask how many non-executive directors have actually resigned from organisations across the UK in, say, the last five years? And the answer is, not many. And to me that is a sad indictment. I think it has been invariably a gravy train for too long for a lot of people._ (FD)
Other interviewees also commented unfavourably on the contribution made by many non-executives. One finance director held the view that it was difficult for non-executives to make a meaningful contribution because they had so much less knowledge of the company and also because the agenda for board discussions was closely controlled by the executive directors:

*Executives and non-executives, of course, have got exactly the same responsibilities in law. But it is so much more difficult if you are a non-executive, to have the depth of knowledge that the executives have got. Let me tell you what happens in practical terms. The executive directors of every company that I have been involved with, meet the day or the week before and get the party line sorted out. In my previous company the chief executive controlled all the questions. He even answered half the questions for the finance director. Fortunately in our company the chief executive is not going to contribute and the non-execs can ask anybody any questions.* (FD)

Part of the problem was perceived to be that for many individuals the risks and rewards involved in becoming a non-executive director were regarded as unfairly balanced:

*It does not take too many people to look at the newspapers and realise the implications of being a non-executive director with these onerous responsibilities. A lot of the really capable ones decide that there are easier ways to earn a living without jeopardising one’s reputation or even potentially exposing oneself to legal challenge.* (AC)

These views on the shortage of non-executives of the required stature and on the perceived lack of adequate reward for doing the job, together suggest a need to find ways of identifying and developing new non-executives of high quality. Two financial directors commented on the need to develop executives into non-executive roles and on a
desire on the part of young executives to take on non-executive roles in other organisations:

*My controller earns £200,000 a year and is very, very good. How many non-executive positions has he got? None! Nobody has asked him. And he is the sort of person, not on the main board of a FTSE 100 company, who would love to be a non-exec of other smaller plcs. Typically, these smaller plcs have retired guys on their boards, because they cannot attract working executives. And there is a pool of executives who are desperate. It fits their objectives within their own companies to have an outside interest. There is a whole pool of guys who are keen to find a non-executive role. (FD).*

*I personally think that there is a good argument for much more use of existing executives to be used in a non-executive capacity elsewhere. A cross-fertilisation if you like. I am very sure that I could sit on the board of a company and ask them pretty pertinent questions as a non-executive, because I know where all the holes are from my own organisation. (FD).*

Other interviewees expressed similar opinions although this was juxtaposed with the contrary view that there were significant problems involved in developing young executives into non-executive roles. One external auditor held the opinion that younger executives did not generally have the time to get involved as non-executives and that, in addition, there were often confidentiality issues. A non-executive also commented:

*I think that if you are a youngish director of an existing plc, you have a very, very full job in ninety-nine cases out of a hundred. I do not see many of them thinking that they have the capacity to take a couple of days or more out a month to adequately do the job at another business. And if it involved learning how other businesses*
operate in your own area, then clearly all sorts of competitive issues would arise. (AC)

Several interviewees commented on the skill-set required by non-executives. There was no general opinion that this should be regulated for, as proposed by, for instance, The Blue Ribbon Committee on audit committees in the US. However several interviewees commented on the need for non-executives to have financial knowledge and experience. Views here varied between those who considered it essential for all non-executives and those who considered it to be merely a useful attribute. One financial director suggested interestingly that non-executives from a non-financial background might actually be at an advantage as far as asking questions about the accounts is concerned:

I don’t think that accounting or finance experience is a prerequisite, merely helpful. In an odd sense, if non-executives do not have a financial background, they may ask more obvious questions. Whereas if they come from a financial background then there is a danger that they discuss with the auditors and with the company quite complicated accounting transactions and treatments, but they sort of nod their way through it on the basis that they understand it and everybody accepts it. Without an accounting background, they may ask more obvious questions, almost sort of Emperor’s new clothes type stuff. And they would then keep asking until they understood. (FD).

The same financial director however emphasised that experience in corporate governance generally was a prerequisite for non-executives:

We use our non-execs as an aide memoire on corporate governance. We very much tell them that is their role, to correct us when we go wrong. (FD)
An external auditor argued that there were limits in the degree to which non-executives could be expected to be financially literate. However the lack of financial knowledge of many non-executives gave one financial director cause for concern:

_As far as non-execs are concerned, the thing that appals me in many companies is the lack of real in-depth financial knowledge. You find boards of directors where nobody has a clue. Look at the Enrons and so on in the US. I can understand how these things happen because many people do not have the technical knowledge to challenge management._ (FD)

Many reservations, then, were expressed about the abilities of non-executives to do their job properly. A fund manager expressed the view that despite the well-publicised debate on the value of non-executives following the most recent wave of corporate scandals in 2002, there were limits to what could be expected from even the best of them.

_No matter how good the non-executives are, it can be difficult seeing through a fraudulent situation._ (FM)

There is therefore a range of opinions on the effectiveness of non-executive directors and on the specific skill-set that effective non-executives require. In general there is a feeling that the effectiveness of the present system is largely down to reliance on individual competence and integrity. The consensus view is that additional regulation is not the way to improve the contribution made by non-executive directors. This reflects a view that the qualities and skills needed for non-executives to be effective cannot be easily defined. These include independence of mind, the ability to see situations in perspective, the ability to probe and question executives while remaining supportive and the possession of integrity. These qualities and others such as the ability to stand up to a dominant chairman or CEO have been highlighted
by the Institute of Directors in their response to the Higgs Review Consultation Paper (IoD, 2002)

While there is little support for regulation as a way to improve the effectiveness of non-executives, the opinions expressed about the increasing demands on, and skills required by, non-executives, together with a shortage of suitable individuals and an unrealistic rewards structure, are all indications of a need for change. One way forward may be to recognise that a necessary cost of the non-executive system is for major companies to allow younger executives the time and opportunity to develop non-executive expertise in other organisations. This is because probably the most likely source of potential non-executives is executives operating in large listed companies at sub-main board level.

The literature (eg Marx, 2002), suggests that younger non-executives are more likely to have an early career background in accounting or finance. By recruiting younger executives with such a background to non-executive roles, organisations, especially smaller listed companies, would be able to tap into a rich vein of skill and contemporary experience. There may be a useful role here for a central agency that would help to match companies and potential non-executives. The establishment of such an agency might also bring an additional degree of objectivity to the appointment of non-executives. There may also be a need for a re-appraisal of non-executives’ risk-rewards packages.

**Shareholders’ role in corporate governance**

The role of shareholders in corporate governance was explored with some interviewees. One finance director argued that shareholders were now taking a greater interest in their investee companies than ever before.
Non-executives previously did not have to worry much about the shareholders. The shareholders are much, much more proactive than ever before. (FD).

This finance director went on to give an example of how shareholders were becoming proactive in their dealings with non-executive directors:

*I went into a meeting in my capacity as finance director of Company X and somebody said to me ‘Right, we would like to ask you a few questions on Company Y; it’s not often that we get the chance to talk to a non-executive of one of our other holdings’. … When I see banks now on a regular basis with my normal hat on, it is not unusual for them to say ‘We would like to talk to you about one of the other companies that you are on the board of’. (FD)*

These remarks indicate that a more proactive shareholder role in corporate governance may help to sharpen the focus of non-executive directors. However, it appears that this proactive approach tends to be adopted only by fund managers and analysts, rather than by shareholders in general. There do not appear to be mechanisms in place to permit the general body of shareholders to play an effective role in corporate governance.

Many comments from interviewees reinforced the impression of a shareholder community more actively engaged with the directors of investee companies than ever before. A finance director commented:

*I spend a third of my time now on investor relations seeing shareholders. Previously it was 10-15%, now it is twice that. And I would say that we do 200 meetings a year. (FD)*

Respondents indicated the shareholders were taking an interest in a wider range of information than ever before. One risk manager indicated that in his company assurances were given to shareholders
on risk management at the annual shareholders’ meeting with the presentation being posted on the company website. While there is evidence of much more shareholder involvement this may not be an indication of an active interest in corporate governance per se and a financial director spoke of the difficulty he had experienced in persuading shareholders to vote, even on matters that concerned their interests directly.

However, both non-executive directors and auditors argued that shareholders were taking a greater interest in how companies were run:

*I would have said two years ago, that shareholders did not have any interest at all in corporate governance. I think that clearly now they are taking a keener interest. I have heard analysts asking questions about the auditors. … I was speaking to a company that was challenged by their stockbroker to do something about their auditors recently and I have never heard that before. There is definitely a move in the direction of people taking an interest in the auditors and making comment where they believe that it is necessary. (EA)*

This external auditor was asked whether or not he believed that shareholders could judge the calibre of non-executive directors by looking at the type of people who were on the board, he replied:

*I am sure that they do. In the accounts there is a reasonably significant CV for all of the directors. That is there to allow shareholders, institutions and analysts to understand what the qualities of the people involved are. So when the executives recruit the non-executives, they cannot just appoint their mate - that will be quite clear from his CV. They do go through a significant trawl searching for somebody with the right credentials. (EA)*

One audit committee chair gave it as his opinion that while shareholders were taking greater interest than ever before in corporate
governance the problem was that it was difficult for them to take any effective action:

*The problem I think at the end of the day with shareholders is that they have probably got maybe 2% of a company and their ultimate sanction is to sell their shares. It is difficult for them to take action.*

(AC)

These comments may indicate that there is a role for fora such as shareholder committees that allow shareholders to express, and to take action on, their corporate governance concerns. Alternatively there may be a need for institutional investors to explore avenues for more active corporate governance intervention as argued by Goobey (1999). Goobey, who writes as a senior fund manager, states that as share ownership has become more and more concentrated, investors cannot pass on corporate governance problems by selling their shares to a third party. Investors are more likely to sell to another institution or to a hostile bidder. Goobey argues that early intervention by shareholders pressing for necessary change is likely to prove to be a cheaper and more effective corporate governance mechanism.

Goobey argues that because of institutional investors’ experiences of a wide spectrum of companies (he mentions that his own firm invests in around 900 UK companies) they are able to identify patterns that are likely to destroy shareholder value over the long term. Goobey’s own institution seeks to actualise needed change through individuals with commercial main board experience making appropriate overtures to investee management. Strictly speaking, Goobey’s focus is corporate strategy rather than corporate governance but he argues that poor corporate governance is often an early sign of shareholder value destruction. Hatherly (1995) suggests a different approach in order to enhance shareholder involvement in corporate governance and moots the ideas of shareholder panels or audit committees as surrogates for them.
Although peripheral to the main focus of the research, some of the interviews with financial directors, and with non-executives, explored the issues of one-to-one meetings and inside information. It was clear that private one-to-one or other informal meetings with investors were a reality for all the companies studied. Interviewees took pains to stress however either that these meetings only discussed matters that were in the public domain or that care was taken to avoid discussing issues that would make shareholders insiders. Suggestions were made however, consistent with the pattern identified by Holland (1998), that private meetings might be used to elaborate on information already in the public domain:

In private meetings with shareholders we only discuss things that are in the public domain, or are interpretations of things that are already in the public domain. (FD)

Another financial director emphasised the sensitivity attached to the discussion of certain issues:

What you would really like to say about your company cannot be verified so you cannot say it in the accounts or in public announcements. You can certainly discuss it in informal meetings with investors. But as a public company you have got to be aware of whether you are providing them with inside information and that they can recognise it if they become insiders and are then able to deal with it as they see fit. (FD)

One finance director, who stated that following the publication of his company’s interim results thirty-seven one-to-one meetings had been held with shareholders, emphasised the necessity of trying to ensure that the information disseminated at such meetings was not price sensitive:

You have to review the material that you are providing them with and ensure that there is nothing that you are putting in that, in your
view, is price sensitive. If they ask whether you are about to be bid for and you say ‘yes’ and if you haven’t announced that I would expect to get struck off the register of directors. (FD)

An external auditor painted an interesting picture of the relationship between corporate boards and analysts from his experience that suggested that in some cases persistence on the part of analysts might result in the capture of price-sensitive information:

*They will phone up the finance director (normally) or the CEO, and say, ‘Your results are coming out. We are doing our annual review, to go out to our investors and we have got you down for profits of X for the year’. You are the financial director, what do you say? ‘I am not prepared to tell you. It is confidential information. When I speak to all my shareholders, I will tell you’. And they respond: ‘Well in that case I am going to write that my best guess is that it will go up by twenty-five percent’. You tell the finance director know that the market is going to get information that is significantly wrong. What do you say? He might say, ‘Twenty-five percent is clearly not right’. OK then, so twelve percent? Cannot say. Well it is less than twenty-five percent. Is it twenty percent? Cannot say. End of story … The ones that are right at the edge, that really push to the limit, have the brass neck to say ‘Well if you do not tell me, I am just going to write this’ and you cannot tell them, but they wheedle it out of you. Otherwise what is written could be absolute garbage. The share price will fluctuate. So you cannot afford not to do it. (EA)*

The impression of growing interest in corporate governance matters on the part of shareholders was confirmed in the interviews with fund managers.
Fund managers

The fund managers spoken to confirmed that corporate governance was a matter of growing importance to them:

*Corporate governance is pretty important. I manage money or invest money in continental Europe and corporate governance varies massively from country to country. It is something that we consider in terms of investment criteria. Most of my time is spent valuing companies and projecting companies’ earnings, but an important consideration is the corporate governance of the company and what is involved in the board structure, the independence of the board and so on. In Europe we continually come up against cronism, for want of a better word.* (FM)

While this fund manager’s work was involved with European companies the importance of corporate governance was confirmed by a fund manager who dealt with UK companies:

*It’s important and something that has been thrown into the spotlight with what has gone on in some of the big US corporations. It is something that certainly forms an important part of our investment process. When we are assessing a company our view of management is important. The strength of their corporate governance, as well as the composition of the board and the non-executives are factors that we look at.* (FM)

The fund managers spoken to had a positive view of corporate governance as compared with that of other countries. Opinions were expressed on the relative superiority of UK corporate governance and on the bureaucratic nature of corporate governance in continental Europe. In this respect the opinions of fund managers echoed those of interviewees more generally.

Thus the overall impression was one of increasing interest in corporate governance by shareholder and fund managers although
an interest in corporate governance mechanisms as such remains a minor interest for fund managers in particular. There may be a need for additional fora by which shareholders could engage more actively with corporate governance matters. Research focused specifically on this issue may be appropriate.

The fund managers spoken to did indicate that while they tended to see the executives all the time more contact with non-executive directors would be useful.

A financial director also made the point that a potential role for the non-executives was as a communication channel with investors:

*As an example, we had an analyst presentation last week. A couple of non-executives sat through the entire analysts presentation. I don’t think that they have yet got to the point where they go and visit investors on their own, but I don’t have a problem with non-executives going to see investors.* (FD)

There were comments by interviewees that may indicate that on occasion inadvertent or unwilling release of price-sensitive information might result in the breach of good corporate governance practice. The comments of one fund manager suggested a growing interest in corporate governance might be juxtaposed with short-termism on the part of institutional shareholders:

*I have observed short-termism on the part of shareholders over many years. There are many examples. The dot-com boom and the tech boom were the result of institutional shareholders piling into companies with short-term prospects but long term hope. And similarly there are examples of investments in venture capital. However there are undoubtedly examples of shareholders forcing management to do some things that have been for the long term good.* (FM)
Other stakeholders and wider concepts of corporate governance

The researchers explored with interviewees their perceptions as to whether or not corporate boards are now being required to engage with a much wider range of stakeholders than previously. Most interviewees believed that to some extent this was the case.

An internal auditor commented that:

*There seems to be, in terms of corporate social responsibility and company sustainability, a move to satisfy a wider audience now. You have got non-government organisations, transparency in terms of environmental issues and so on. You have got a lot of people to try and placate and keep happy.* (IA)

Some interviewees believed that this process was merely a case of paying lip service to political rhetoric; others that the reality was much more substantive than this and that real attention was being paid to stakeholders other than shareholders. The dominant view was somewhere in between these points of view and is illustrated by the comments of one external auditor:

*I think it is a huge issue. I think it needs some clarity of thought. Very briefly, boards of directors, particularly in a UK context, are accountable to shareholders. You cannot have accountability to a vast array of stakeholders or you get nothing done. Often the demands of different stakeholder groups are completely different. For example an environmentalist not wanting to put a plant on a particular patch of land compared to a shareholder who knows he is going to make a lot of money from doing that. Or better still an employee wants a job in a village in the middle of the countryside, and an environmentalist does not want to destroy the countryside, so do you build a plant there or not? You would get nothing done. I have made it a bit simplistic, but that is the broad thrust of my view. Having said that, to provide*
long-term value to shareholders you have to take into account the views of that multitude of other stakeholders.

We have seen obvious examples in the past - if you are going to dispose of an oil platform, you cannot just dump it in the middle of the sea or wherever if it is going to cause huge risk to your reputation. You have got to manage those risks to your reputation, because your reputation will affect the share price, will affect the long-term value and will affect whether people want to work for your organisation. (EA)

This way of thinking appeared to be common among the interviewees. The primary responsibility of the directors is seen to be to shareholders, but, in seeking to meet that responsibility, they acknowledge that the needs of other stakeholders have to be considered because, if these groups were dissatisfied, there would be a negative impact on shareholder value. The key to success was seen to be a balancing and managing of the needs and aspirations of all stakeholders in the pursuit of the main aim of maximising shareholder value. One audit committee chair argued that some stakeholder ‘action’ groups were ‘wrong’ and that it was the job of corporate boards to stand up to them. There was little evidence on the part of interviewees of wider concepts of corporate governance involving, for instance, the implementation of mechanisms that would give stakeholder groups other than shareholders a meaningful voice in corporate governance (Humphrey and Owen, 2000).

Web-based reporting

One questionnaire respondent commented on the need for corporate governance to engage with internet-based reporting:

Web-based reporting is not covered by existing structures. (AC)
There was limited comment by interviewees on the use of the web for reporting. While it was recognised that it was an effective and increasingly important medium for disseminating information to a wide range of interested parties, there was a wide variation in the extent to which it was used. In two cases at least, a web-cam was used to show the annual general meeting ‘live’ on the web site, but in most interviewer companies the web-site was used to display information already in the public domain.

**Auditor independence and contemporary audit approaches**

The contemporary risk-based audit approaches of the international firms have been criticised on the grounds that they are likely to threaten external auditor independence. As an illustration of the approach of the large firms, it is interesting that Eilifsen et al (2001), in a field study of the new audit methodology in action, argue that one of the beneficial results of the new audit approaches is that external auditors will be offered ‘new service opportunities’.

The second question in this section of the postal survey sought to elicit perceptions about the effect that contemporary developments in auditing were likely to have on the independence issue. The internal auditors in the sample were largely neutral on this. However 20 (34%) of these internal auditors took the view that external auditor independence was likely to be compromised by contemporary developments. All groups other than internal auditors disagreed strongly or reasonably strongly with this proposition and throughout these groups there was a very high degree of consensus.

A number of respondents’ comments reflected this:

*External auditors do work with organisations but that does not affect their independence. In our experience it makes it easier for them to raise difficult issues.* (FD)
While I believe that external audit is increasingly becoming a business partner I also believe that as long as objectivity is maintained that independence will also remain intact. (AC)

Existing corporate governance can work providing the spirit as well as the letter are followed. The way that external audit review areas such as risk is key. (IA)

External auditors increasingly work to understand more of how the company works but in the end will remain independent with their opinions. (IA)

The final question in section one of the questionnaire asked respondents whether or not they agreed with the statement that external auditors increasingly work as partners with management rather than as independent experts operating at arms’ length. On balance, respondents were neutral about this; internal auditors were most in agreement (mild agreement) and displayed the highest degree of consensus on this issue (very low dispersion). Twenty-seven of the 50 internal auditors who responded agreed with the statement. On average, finance directors demonstrated mild disagreement with the proposal that external auditors increasingly work as partners with management. Thirteen out of the 34 finance directors who replied indicated agreement or strong agreement and the finance director group had the lowest degree of consensus on the issue. On average audit committee chairs and external auditors were neutral about the proposition though again a divergence of view was apparent, particularly in the case of external auditors.

Respondents made a variety of comments on the ‘partnership’ approach between management and external auditors. External auditors’ comments tended to be the most commendatory of this approach.
Auditors have always been ‘hands on’ with their clients, co-developing solutions to their business needs. However, this does not constrain the auditor’s ability to take a rational judgement of their client’s financial statements – if anything it enhances it. (EA)

One respondent expressed the view that the independence and partnership approaches were not necessarily conflictive:

Senior management want external assurance as well as the shareholders. Thus, often their interests are aligned resulting in partnering. The external auditor must maintain independence in his external reporting and will do so if he has his long-term interests at heart. Thus it is not either partners or independence. (EA)

A few comments were critical of the partnership approach:

External auditors’ approach of working more closely with management appears to be driven largely by their desire to sell on additional work at premium rates. The contemporary development in auditing needs to be balanced with a strict prohibition on auditors taking on any consultancy work for the same client. (IA)

There is, therefore, some evidence of unease regarding the close involvement of external auditors with management.

At the interview stage, some interviewees took the opportunity to comment further on contemporary issues relating to the role of auditors. As with the responses to the questionnaire study there was little evidence of widespread dissatisfaction with contemporary approaches to auditing. One finance director made the point that to some extent these were reflective of changes at the client:

We have got a whole huge risk management process. And our auditors are all over us on that basis. To be fair it is a natural progression. But we now require to be much, much more clued up on risk management. And because we have got a process in place, they are involved hugely with it. (FD)
An external auditor argued that new audit methodologies did not change the audit approach fundamentally given the need to maintain standards and to protect the audit firm’s reputation:

*We have always taken the view that the prime aim of what we are doing is sticking our name to someone’s accounts. This puts our reputation at stake. So it does not matter how the trends and fads go, we have certain minimum standards. You cannot cut corners beyond that. And recent events have just proved how dangerous it can be.* (EA)

This auditor was adamant that auditors were jealous about protecting their independence:

*Well I have never really been convinced by these arguments about dependence to be honest. In my experience, certainly in my firm, people have been prepared to resign from audits, to walk away. However big a client is, our reputation is worth more than the biggest of our clients. We had an issue on a big client last year, needing resolution. It ended up by us pulling six of our board members out of a meeting to discuss what we should do. And throughout that discussion at no point did anyone say, ‘What fees are we getting?’ That did not come into it. It was a matter of, ‘What is the correct answer?’* (EA)

However one of the fund managers interviewed stated that as part of the corporate governance exercise on new acquisitions the split of the external auditor’s fees between audit and consultancy would be examined. A finance director of a smaller listed company expressed serious disenchantment both with the current state of auditor independence and with the implications of contemporary approaches to the external audit:

*Possibly some external auditors have walked away from clients and they can point to them, but I think that there is huge pressure on*
audit fees internally, to do with recovery of time and fees. They still act as sort of tertiary education departments, so therefore they have got all these people who are learning the trade and they are learning on my time. And the auditors are aware of that. They do not want to be charging too much time. They want to go on to the next job. Plus there is this statutory obligation, or the obligation that they impose on themselves to do things correctly.

I would argue that the moves by auditors towards higher-level assessment of risk have gone too far. Fundamentally, the approach used to be statistical in that you went and you documented the controls that all invoices were signed. Now the auditors ask who is actually exercising the control. But I think if you are then never going to check that the control is actually carried out, or you do it on a minimal basis, then you have swung too far. It is one thing to see on paper a control mechanism and be comfortable that it is in place, that it is robust, but if it is never carried out then I think that you have just got another problem. (FD)

These comments were echoed by an internal auditor:

I think that the level of materiality has probably gone too high in companies. I would like to get back to a bit more basic auditing. You know how you can have desk audits and then you can have limited audits and you can have full scope. I think that there will be a move back to fuller scope. (IA)

One of the fund managers interviewed also expressed scepticism about the value of what he called ‘airy-fairy’ contemporary audit approaches and argued that these included only a small ‘nitty-gritty’element.

On balance however most interviewees were more sanguine about the prospects for auditor independence and the integrity of the audit. Several interviewees believed that audit committees could
play a key role in this area. One non-executive felt that working with audit committees could help to move auditors away from thinking of management as the client while another believed that good non-executive directors could help the auditors to take a step back from the company if they were getting too close to management:

*The auditors in answering the questions that come up from the non-execs may appreciate a sense of what the ‘distant view’ wants to know about. And in answering these questions, they have almost got to take a step back themselves.* (AC)

One audit committee chair discussed the interesting, but sometimes neglected, issue of companies employing staff who had previously worked for the external auditors:

*These days there is always the suspicion that a lot of people are being pushed into client firms to make sure that the audit relationship endures. Funnily enough, in that respect, I worked myself for two large firms of accountants. And when I deal with these two firms, I find myself not wanting to be sucked in to being an alumnus of these two firms. Because I know the firms, I do not want that relationship to be too cosy.* (AC)

Other interviewees felt that the intrinsic qualities of the way in which most auditors approached their work made further safeguards or regulation unnecessary. One auditor felt that even with contemporary business approaches to the audit independence was actually stronger than ever before:

*I think clearly auditors are close to their clients in that you have to understand the business or you cannot actually do an audit. I do not think that this means that you have to necessarily put yourself in their pocket. And I think the fundamental thing is that actually auditor independence is stronger now than it ever has been; having seen what happened to Andersen concentrates the mind … So I*
think that auditor independence has been reinforced recently and that nobody is going to make any decision or do anything that may lose them their livelihood. (EA)

An internal auditor made the point that in his experience the quality of external audit work had improved over the years:

It has been enlightening to watch the improvements over the years on how they actually do look at risks and controls. (IA)

Two of the three fund managers spoken to expressed fairly negative opinions about the state of audit reporting. While one merely expressed the view that audit opinions were unlikely to contain any surprises another was more forthright:

There is massive scepticism over the quality of audit opinions quite frankly. When an audit report comes out, it tends to be very ‘after the event’. In terms of the formal audit report, the issues will tend to have been flagged well in advance of the audit report. And you know if there is a qualification, the market tends to be pretty efficient (depending upon what the qualification is about) in terms of reflecting the issue in the share price prior to that point. (FM)

However overall views of respondents and interviewees on the state of external audit were not overly negative. On balance both respondents to the postal questionnaire and interviewees did not express serious concerns about the state of auditor independence although there were some concerns about the implication of contemporary audit approaches for the independence issue. Concerns were also expressed about moves away from substantive testing by the international auditing firms in recent years.
Summary of results relating to contemporary business developments

- In general, existing corporate governance mechanisms are perceived as adequate, although external auditors displayed less consensus on this issue than the other groups surveyed with a significant proportion of the external auditors who replied to the postal questionnaire disagreeing with this proposition. The view was generally expressed that additional regulation would not improve the situation.

- There were varying views on the effectiveness of non-executive directors. In general it was felt that the system worked reasonably well. However, this was perceived to be dependent on the integrity and competence of individuals. Concern was expressed about the risk/rewards package for non-executives and about the shortage of suitably qualified candidates.

- There is evidence that shareholders have a more active interest in corporate governance issues than ever before and that this may help to provide an additional focus for the work of non-executive directors. However, there appears to be little opportunity for non-institutional shareholders to interact with their investee companies.

- Interviewees recognised that, in their interactions with analysts and shareholder groups, care had to be taken only to disclose information that was already in the public domain, to avoid the creation of ‘insiders’.

- There was recognition of the need to engage with a much wider constituency of stakeholders than hitherto. It is very much the case, however, that shareholders continue to be recognised as the primary group to whom corporate boards are responsible and that
attempts to accommodate the requirements of other stakeholders were primarily driven by the desire to avoid damage to the share price.

- Respondents and interviewees in general did not feel that contemporary developments threatened auditor independence although some strong reservations were expressed about the contemporary ‘partnership’ approach. Some respondents specifically highlighted the dangers inherent in external auditors undertaking consultancy assignments for audit clients.

- Questionnaire respondents and interviewees, however, did not in general believe that the new risk-based approach of the major audit firms threatened their independence. External auditors in particular, were robust in defence of the approach and indicated that, irrespective of fads and ‘packaging’ of the audit product, in the final analysis they were putting their name and reputation on the line by endorsing their clients’ financial statements. They regarded their reputation as being more important than the need to retain individual clients and examples were cited of where they had ‘walked away’ from a problem situation rather than compromise integrity.

- Close auditor interaction with directors was regarded as having positive benefits in that it enabled a greater understanding of the client’s business and thereby offered opportunities to identify and assess a wider range of risks that could affect the financial statements.

- There is concern, however, (although not on the part of auditors themselves) that the new audit approach considered issues at too high a level and there were calls for a return to more ‘basic auditing’ in the form of substantive tests.
• Concern was also expressed about the possibility of auditors using their new approach to give them the opportunity of selling additional services to clients, and eroding independence as a result.

**Issues for consideration**

• While the UK principles-based approach is perceived as having an advantage, it is apparent that no system is regarded as invulnerable and the effectiveness of corporate governance systems depend on the calibre of the individuals involved. Any system on its own will be unable to ensure acceptable levels of competence and integrity on the part of non-executives.

• Given that there is no discernible opinion in favour of systems incorporating supervisory boards the contribution of non-executive directors (and of shareholders) are likely to remain crucial to the effectiveness of UK corporate governance.

• Non-executive directorships are no longer seen as sinecures and more is being demanded from non-executives than at any time in the past. Non-executives need to examine the number of such positions they hold to make sure that they are not overloaded and could cope with, for example, simultaneous crises in more than one of the companies of which they are directors.

• The quality of non-executives appears to be improving – interviewees from all groups acknowledged the effective work being done by good non-executives, and it is apparent that non-executives are increasingly being recruited for their skills in financial, corporate governance and business matters and for their ability to offer an outside perspective on the company’s activities. The ‘old boy’ approach to appointing non-executives is becoming a thing of
the past. At the same time there are factors that continue to inhibit non-executive director effectiveness such as limited understanding of the role on the part either of the individual non-executive or of the executive directors, lack of training or being too close to the chairman or chief executive. At the same time one view may be that too much emphasis may have been put on the monitoring role of non-executives and not enough on their participation in the direction of the company.

- The limited pool of sufficiently skilled individuals is a major problem, and this might be tackled by encouraging highly skilled and motivated young executives in public companies to seek non-executive directorships as a means of broadening their experience and contributing to the effective running of UK plc.

- The UK system operates on the basis of a unitary board and it is important that aims and objectives of executives and non-executives are consistent. Developments of the roles of both executives and non-executives must emphasise the fact that they work together for the benefit of the company.

- Shareholders and analysts are playing an increasing role in governance and are actively appraising the calibre of board members including non-executive directors. While much shareholder intervention is centred on the existing extensive nexus of informal meetings with management there may be scope for the development of additional fora to facilitate a more formal role for shareholders in corporate governance.

- Audit committees do appear to have a role to play in monitoring the independence of the external auditors. This would include issues such as the level and nature of non-audit work offered to auditors. This role was recognised by interviewees and examples were given of situations where the audit committee had refused to
allow external auditors to attempt to sell other services on the back of audit work. Audit committee interviewees also commented that they were alert to other possible threats to auditor independence, for example the situation where a number of former auditors were working for the company.
CHAPTER FIVE


The second section of the questionnaire dealt with issues arising from Fraser, Henry and Wallage (2000).

Changes to audit arrangements

Questions 2.1 to 2.4 dealt with proposed changes to audit arrangements for listed companies and in particular with the allocation of responsibilities between internal and external auditors. Results for these questions are shown in Table 5.1
Table 5.1: Views on proposed changes to audit requirements

<table>
<thead>
<tr>
<th>Proposals: Extent of agreement that</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2.1) strong IA function should be established</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>1.97 High</td>
<td>1.92 Mod</td>
<td>1.74 Mod</td>
<td>2.53 High</td>
<td>2.04 Mod</td>
</tr>
<tr>
<td>(2.2) IA reports to chief exec</td>
<td>1.85 Very low</td>
<td>1.56 Very low</td>
<td>1.64 Very low</td>
<td>1.84 Very low</td>
<td>1.72 Very low</td>
</tr>
<tr>
<td>(2.3) Work of IA should include:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) risk management</td>
<td>2.12 Mod</td>
<td>2.36 Mod</td>
<td>2.19 Mod</td>
<td>2.43 Low</td>
<td>2.28 Mod</td>
</tr>
<tr>
<td>(b) confirmation of control</td>
<td>1.50 Very low</td>
<td>2.00 Very low</td>
<td>1.73 Very low</td>
<td>1.73 Very low</td>
<td>1.74 Very low</td>
</tr>
<tr>
<td>(c) assurance on data quality</td>
<td>2.09 Very low</td>
<td>2.14 Very low</td>
<td>2.53 Mod</td>
<td>1.98 Very low</td>
<td>2.19 Very low</td>
</tr>
<tr>
<td>(d) review of information</td>
<td>2.62 Very low</td>
<td>2.53 Very low</td>
<td>2.35 Low</td>
<td>2.31 Low</td>
<td>2.45 Very Low</td>
</tr>
<tr>
<td>(e) review of management</td>
<td>2.88 Mod</td>
<td>3.57 Mod</td>
<td>2.65 Mod</td>
<td>2.84 Low</td>
<td>2.99 Mod</td>
</tr>
<tr>
<td>(f) liaison with EA</td>
<td>2.79 Very high</td>
<td>2.25 Very low</td>
<td>2.24 Very low</td>
<td>1.98 Very low</td>
<td>2.32 Very low</td>
</tr>
<tr>
<td>(2.4) EA renamed as assessor</td>
<td>3.62 Low</td>
<td>3.82 High</td>
<td>3.69 Very low</td>
<td>4.04 Very low</td>
<td>3.79 Low</td>
</tr>
<tr>
<td>(2.5) establishment of ARP</td>
<td>3.78 Very low</td>
<td>3.88 Low</td>
<td>3.19 Very low</td>
<td>3.64 Low</td>
<td>3.62 Very low</td>
</tr>
</tbody>
</table>

1 Significant differences between EA and AC, between EA and IA and between EA and FD.
2 Significant differences between FD and AC and between FD and EA.
3 Significant differences between IA and EA, between IA and FD and between IA and AC.
4 Significant differences between AC and EA between AC and IA and between FD and AC.
5 Significant difference between FD and EA.
6 Significant differences between EA and FD and between EA and IA.
The establishment of an internal audit function

All groups other than external auditors strongly agreed that each public limited company should appoint a strong internal audit team. External auditors were significantly less enthusiastic about this proposal than all other groups. Typical external auditor comments were:

*Internal audit should be established where necessary. Not all plc need it, especially smaller ones.* (EA)

*Members of an audit committee have responsibilities as directors to satisfy themselves as to these matters and should determine what they need in the context of their company.* (EA)

*It depends on the circumstances of the business. The responsibilities can be fulfilled in a number of different ways – close involvement of the main board (including audit committee members) in all key operational decisions, specific reporting by external auditors, close involvement of key executive directors in all aspects of the business, coupled with detailed board reporting and peer reviews by one part of the business on another.* (EA)

It is possible that external auditors’ relative lack of enthusiasm for this proposal may reflect their views as to the competence of internal auditors and/or the possible economic consequences to external auditors of strong in-house internal audit functions. Consensus was either low or moderate for all groups, however, and a minority of respondents over all groups disagreed with the proposal. Other alternatives to internal audit mentioned by respondents included a combination of existing normal controls and reporting procedures plus external audit *(FD)*, company outsourcing of the internal audit function *(FD)* and the appointment of a risk officer *(EA)*.

Question 2.7 asked respondents to comment on how they would ensure that audit committees received sufficient information to fulfil their responsibilities in the absence of internal audit departments. Here,
a number of respondents made the point that there was no ‘one fit’ solution. For example, size of company was a consideration that was mentioned by various respondents:

*Not all listed companies are large organisations. Management structures in smaller companies can be tailored to provide information and assurance.* (FD)

There was strong agreement and consensus within all groups that internal audit functions should report their findings to the chief executive, the audit committee and the external auditors.

**Scope of internal audit work**

Question 2.3 of the questionnaire was concerned with the extent of coverage of internal audit work. Participants were asked whether or not the work of internal audit should include six different areas (questions 2.3 a to f). Risk management and confirmation of control (questions 2.3 a and b) were the two areas where participants agreed most strongly that internal audit should be involved. All four groups strongly agreed that the work of internal audit should cover the confirmation of controls (including financial, operational and compliance controls) and consensus on this issue was very high for each group. The four different groups also agreed strongly or reasonably strongly that the work of internal audit should include assurance on risk management although there was a broad spread of opinion on this matter within each respondent group.

In general, therefore, respondents held broad views of the work of internal audit departments. One respondent made the point, however, that internal audit might be unable to provide all the skills that were necessary:
Internal audit is too narrow as usually perceived - companies need integrated risk management functions embracing a wide range of skills. (FD)

Internal auditors were the only group not to agree strongly or reasonably strongly (with very high consensus) that internal audit work should include assurance on the data output of routine systems. Internal auditors scored this proposal significantly lower than did all other groups perhaps indicating that they held a more dynamic conception of their role than did the other groups. There was less enthusiasm for internal audit to become involved in reviews of the quality of management information and of the effectiveness of management. Review of management was the area that produced the most negative response. One internal auditor stated that:

Internal audit should not performance appraise management but should assess its policies, plans and processes. (IA)

While internal auditors themselves on average were in mild agreement with the proposition that they should be involved in this area, the other respondent groups were less enthusiastic. It is interesting that internal auditors’ position on this proposal relative to the other respondent groups is the opposite of what it is on assurance on data quality and this reinforces the impression that internal auditors, not surprisingly, view internal audit as a higher-level function than do other respondents. As one internal auditor observed:

The move of internal auditors towards looking at higher-level issues requires more business-experienced personnel. Performing substantive tests generally uses lower more detail-orientated personnel more suited to external audit. (IA)

The proposition that internal auditors should liaise with external auditors on the allocation of audit work was agreed with strongly by external auditors and reasonably strongly by audit committee chairs
and internal auditors. Finance directors only agreed mildly with this proposition, probably reflecting a view that liaison with the external auditors is properly a finance director function.

At the interview stage of the project the changing role of internal audit was explored with participants in greater depth and, in particular, the contribution that internal audit could make to risk management. Interviewees were asked for their perceptions as to how the role of internal audit had changed in their experience over the past decade. One external auditor summed up what was a common view:

*It basically comes right down I think to the internal audit profession trying to reposition itself over the last six or seven years from being a relatively unfashionable function. You never got accountants qualifying and wanting to be in internal audit. It was perceived to be one of the duller arms of accountancy. I am not saying it is just about re-badging, taking on new skills and repositioning themselves more as risk advisory/management people. In some organisations the difference is very blurred, if indeed there is a difference at all. And that comes back to what I said a few moments ago about some internal auditors being what I would call real internal audit (tick and bash assurance providers) and others facilitating risk management and providing ad hoc consultancy services. (EA)*

A finance director depicted a similar scenario in the context of his own organisation:

*Four years ago the internal audit function used to do things like check the payroll and check invoice processing. And it was quite a big group. It is now a much, much smaller group. And it co-ordinates the work of line people. (FD)*

Thus there was a general feeling among interviewees, although expressed in different ways, that internal audit functions had developed in recent years to become much more business orientated and this
reflects much of the contemporary literature on internal audit. Interviewees regarded these developments positively for the most part. At the same time there were some negative comments that reflected the traditional unfashionable image of internal audit. These were consistent with the relatively low views of internal auditors on the part of external auditors that emerged from the questionnaire responses. An external auditor commented:

Often, the internal auditor is purely financially trained. And sometimes financially trained to only a relatively modest level. (EA)

The functions and role of internal audit varied in the listed companies in which interviews were conducted. In the smallest of the selected listed companies there was no internal audit function, management taking the view that not only was an internal audit function unnecessary given the size of the organisation, it was difficult to get internal auditors with the appropriate level of expertise. The financial director (and chief executive) of this organisation commented:

We don’t have internal audit partly because of the size of the company and partly because of my views on internal audit. I think that there is a danger that if you appoint someone to internal audit, by definition they will find things to tell you that are wrong. … like auditors saying that there are no supplier statement reconciliations. And they tell you that every year, because they are obliged to fill in a bit of paper that details some points for management to consider. I don’t yet have the feeling that our business is so disparate geographically that management cannot get round and physically see what is going on. Much of our risk is technical rather than financial. Financially our business is very straightforward. (FD)

One finance director observed:
Would I have an internal auditor if Turnbull had not come along? Probably, because the organisation has grown. I think there is a point where you get a critical mass, where you do need an internal auditor. And I think that the internal auditor forms part of the risk management process. But he is just a member of the risk management committee like everyone else. (FD)

Both the questionnaire survey and the interviews, therefore, demonstrate that the proposal (ICAS 1993, Fraser, Henry and Wallage, 2000) that all listed companies establish internal audit functions may be too sweeping and the need for an internal audit department may depend on the size of the company and its organisational structure.

The size of the internal audit department in the other listed companies varied; however there was a tendency for internal audit departments to have become smaller and even within the very largest companies there was evidence of a tendency towards lean internal audit functions employing a small number of technically well-qualified staff.

The role of the internal audit functions in the interviewee organisations differed. Most obviously there was a distinction between those companies where internal audit covered the risk management function and those where it did not. Of the four listed companies that had internal audit functions one very large group had distinct functions for internal audit and for risk management whereas in the other three companies internal audit carried varying degrees of responsibility in the risk area.

In the large group where there were separate functions there had been a combined function until about three years previously but combining the functions had been found to lead to a clouding of issues and a lack of focus on basic controls in particular. The head of internal audit in this group stated:
What seemed to be happening was that we were losing focus on some of the real internal control basics. So we reorganised the group and said, ‘business assurance audit is out there doing the compliance stuff, basic internal controls, looking at balance sheets, making sure that the financials are correct, making sure the controls are there to prevent anything from going wrong’. And we set up a separate group of risk specialists that go in and look at the strategies, look at any new ventures, look at existing businesses and say, ‘What are the risks here?’ (IA)

The previous combination of the two functions had also led to a degree of confusion in the minds of the management of the group’s operating companies. The head of risk management commented:

The previous head of internal audit developed some quite good techniques. He actually introduced the technique of risk workshops, but the problem was that we were confusing our businesses. We were there as the facilitator to help them, while we were also there to check up on them. This was a real problem. So when I took on this role I separated the two parts out completely. (RD)

While the two functions were quite distinct there was a significant interface between them and key individuals were keen to engender a culture of mutual support. The head of internal audit commented:

From the internal audit point of view there are probably three main areas of activity that we would consider our responsibility. One would be the basic internal control reviews. Second one would be acquisitions and divestitures. The third one would be if something were to come up in the fraud arena. The risk guys do a lot of the up front work. And previously what they did is that they would go on out there and do a lot of the risk and country type reviews. Today if we were going to go to a country we would all sit in the same office and we talk openly about what the risks are. Both from our side as much
as their side. If they are going out to do a risk workshop anywhere in the world, it is likely that we would have already been there and we will say, ‘well these are the perceived risks that we have, these are the issues that you should be aware of’. And similarly the outcome from those risk workshops would feed into our team. (IA)

The head of risk management described how his department facilitated the ‘embedding’ of risk within the organisation through the concept of risk workshops:

*We carried out 55 risk workshops around our organisation globally at every level - the business unit level, the global line of business level, our executive management board, leading functions – HR, finance, Information Management, legal. We got them to submit all their risks. And what you get at the end of it and what you aim for is a prioritised set of risks, which are high impact, high probability against the scope you are setting, which are mostly strategic. Then we make sure that they have got action plans in place for them to mitigate those risks. We also focus in on what are the upside risks. In other words what are the opportunities and have they got action plans in place for those? (RD)*

Clearly within this group a great deal of effort and resources were expended in embedding risk within the organisation and in facilitating operating management to take control of risks. The embedding of risk management was a major issue in *The Turnbull Report*, and this issue is dealt with in more detail in chapter seven.

The other three companies had internal audit functions that covered the risk management area. One of these was a very large conglomerate with over two hundred companies in a wide variety of industries. Internal audit performed a key role in this group in relation to risk management. In this group internal audit had moved away from operational audit in recent years with a correspondently greater emphasis on risk management. A key role was played by internal
audit in the embedding of risk and risks were defined by collaboration between the head of internal audit and the operating groups. The head of internal audit defined the risks initially; the operating group controllers and chairmen subsequently reviewed his assessments. The head of internal audit then reported on risk assessment to the audit committee and through it to the main board. There was no feeling in this company that these arrangements did not work well.

In the case of the two smaller companies that had internal audit functions, these also dealt with risk management. In one of these a small team looked after the internal audit, risk management and ethics areas. The head of internal audit reported into the audit committee and the separate risk management committee. While the identification of risks was a general responsibility that was shared throughout the company, the combined internal audit and risk function was responsible for the auditing and prioritisation of risks. It was suggested to the audit committee chair of this company that there could be a danger that an internal audit function largely composed of people with an accounting background might not identify certain risks. He replied to the effect that the membership of the risk committee ensured that risks were reviewed by a group of people possessing collectively a broad range of expertise:

*There may be companies that I am not involved with, where you have got a crowd of accountants trying to identify business risks, which they are just completely incapable of doing. In our company the risk management committee is vital. We have got the head of legal services on it so that he can deal with contractual risks. We have got one of the health and safety guys on it. We have got the finance director. We have got a non-exec, me. We have got the general manager, operations. We have quite a broad spectrum of expertise; we are all trying to make sure that risk, in its broadest and most detailed sense, is embedded in the business. (AC)*
The role of internal audit in the risk management process in this company was mainly in the area of ensuring that risk management was embedded in the business and operated under the direction of the risk management committee rather than the audit committee.

The finance director commented:

*I think the risk management committee is a better forum to direct your internal auditor. They have to have independence and they have to have access to any parts of the business that they want and they have to report – in our case through the risk management committee to the board.* (FD)

His internal auditor summed up his responsibilities as:

*My role is both business risk management and compliance on the financial and commercial activity side … I report to the finance director, the risk management committee and through them to the board.* (IA)

In the second of the smaller listed companies that had an internal audit function this also played an important role in the risk management area. In this company the executive team and ‘continuous improvement’ groups were responsible for the identification of risks and embedding of risk management. Internal audit was responsible, not for coming up with improvements to risk management, but for reviewing the process and making sure that it was being followed. Internal audit, however, was responsible for running the risk workshops that were held periodically to make sure that risks were being identified properly. The head of internal audit explained how he exercised what was essentially a facilitating role here:

*I ask people, for example, what their top three issues are. Issues, note, not risks. They may actually be risks or they may be opportunities for improvement. That is the other way to consider risk. There may be the risk of something bad happening or there may be a risk of us*
missing the boat if we do not do something. That is the way that
you want people to think about the business. (IA)

Thus in this company while internal audit was not responsible
itself for identifying risks it sought to ensure that line management
applied an attitude of commercial awareness to the task. The head
of internal audit did not feel that his accounting background was a
barrier to his effective performance of this role and he stressed that
his professional accounting qualification had provided him with a
good basis for understanding what a business actually did. However,
if internal audit is to be effective in risk management at board level,
knowledge of how the business operates is necessary in addition to
accounting skills. As one internal auditor remarked:

Industry-specific knowledge is needed to enable internal audit to be
effective, especially in risk management at board level. An internal
business manager advising the board requires a bit of credence.

(IA)

Each of the internal audit functions in the interviewee companies,
then, had an important remit in the risk management area. There
was no strong feeling that internal audit should not be involved in
this area.

Renaming of external auditors and the establishment of
audit review panels

Questions 2.4 and 2.5 of the questionnaire were concerned
respectively with proposals originating in ICAS (1993) that external
auditors should be renamed as external assessors and that companies
should establish an audit review panel to monitor the work of the
external assessors. For all groups, respondents indicated a reasonably
strong or strong disagreement with these proposals, with the exception
of internal auditors, who were neutral about the proposal to establish audit review panels.

Summary

- There was strong support on average for the establishment of robust internal audit functions except on the part of external auditors who, on average, were mildly in favour. Size of company was a reservation expressed by a number of respondents.

- Those respondents who did not believe that the establishment of an internal audit function was always necessary suggested several alternatives. These included the close involvement of audit committees in operational decisions, peer reviews across the business, self-assessment by senior managers, the appointment of a risk officer, and an extended remit for external auditors.

- There is a general perception that the future of the internal audit function is a positive and proactive one, particularly in connection with its role in relation to risk management. Internal auditors, in particular, regarded their own function as a high level one, especially in the area of risk management.

- There was a high level of support for the proposal that internal audit should report to the chief executive. There was broad support for the involvement of internal audit in the various areas suggested.

- The replies to the questionnaire and the interviews both indicated widespread support for the involvement of internal audit in the risk management area. Generally, however, the view was that the role of internal audit should be restricted to monitoring risk management and the facilitation of line management’s ownership of risk rather than being part of the risk management process. This was reflected in the practice of the interviewee companies.
• There was little support for the proposals that the external auditors should be renamed as external *assessors* and that an independent Audit Review Panel (ARP) be established to take responsibility for the assessment process.

**Functions of audit review panels**

Question 2.6 asked respondents for their views on whether or not the proposed ARPs should be responsible for various areas of work. The results are shown in Table 5.2.

**Table 5.2 Views on proposed functions of audit review panel**

<table>
<thead>
<tr>
<th>Proposals: Extent of agreement that ARPs should:</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2.6a) take a proactive approach to supervision of EA</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td>(2.6b) adopt a watching brief over EA</td>
<td>3.38 High</td>
<td>3.55 High</td>
<td>2.79 Mod</td>
<td>3.49 Mod</td>
<td>3.30 Mod</td>
</tr>
<tr>
<td>(2.6c) agree appointment of EA</td>
<td>3.13 Very high</td>
<td>3.25 Very high</td>
<td>2.54 Low</td>
<td>2.64 Low</td>
<td>2.89 High</td>
</tr>
<tr>
<td>(2.6d) authorise additional work by EA</td>
<td>3.06 Very high</td>
<td>3.50 High</td>
<td>2.75 Mod</td>
<td>2.84 Mod</td>
<td>3.04 High</td>
</tr>
<tr>
<td>(2.6e) report publicly in corporate report</td>
<td>3.31 Very high</td>
<td>3.74 Low</td>
<td>2.60 Low</td>
<td>3.16 Low</td>
<td>3.20 Mod</td>
</tr>
</tbody>
</table>

1 Significant difference between FD and IA.
2 Significant difference between AC and EA.
3 Significant differences between IA and FD and between IA and AC.
4 Significant differences between FD and IA and between FD and EA.
The results shown in Table 5.2 reflect an apparent lack of enthusiasm for the establishment of ARPs. The mean scores for internal auditors are higher than for the other groups in the case of each activity suggested, reflecting internal auditors’ slightly greater enthusiasm for the establishment of ARPs. Although external auditors disagreed reasonably strongly with the establishment of ARPs, Table 5.2 indicates that this group on average were favourably disposed towards the idea of ARPs adopting a watching brief over external auditors and were ambivalent on average in respect of most other functions suggested. However, too much should not be read into these results, given the lack of interest in the establishment of ARPs.

Negative comments about the proposal for the establishment of ARPs were numerous. Some examples are:

*The requirement for an ARP implies that the role of the audit committee is not working.* (FD)

*I believe that the over-emphasis on the ARP is taking away responsibility from the whole of the board – you are creating an elite committee structure that downplays executives’ responsibilities and creates tensions within the boardroom.* (AC)

Many respondents felt that ARPs simply replicated what audit committees were supposed to do. Three typical comments on this issue were:

*All these matters are currently in the brief of the audit committee so why is there a need to reiterate them in a renamed and frankly quite inappropriate body?* (IA)

*The whole premise of the audit review panel is misconceived. Audit committees already exist and are evolving in a proper manner. Audit committees are increasingly looking at wider, relevant issues such as fraud, ethics and Turnbull.* (EA)
The audit committee and the ARP are virtually the same provided the audit committee is independent and effective. (AC)

Few comments were made in favour of the establishment of ARPs. One internal auditor gave qualified approval to ARPs by commenting:

*I do believe ARPs are necessary but I also believe that independence is a state of mind – pressure can only be brought to bear on weak characters.* (IA)

Question 2.8 invited participants (if they did not consider the establishment of ARPs to be necessary) to comment on how they would ensure that external auditors were encouraged to act in the interests of shareholders and not to succumb to executive director pressure.

Respondents again mentioned the role of audit committees as important here and unsurprisingly this was most evident in the audit committee chair group.

*The audit committee and in particular its chairman are key to ensuring the correct relationship between the company and the external and internal auditors.* (AC)

*It is the responsibility of the non-executive directors on the audit committee to ensure external auditors are not unduly pressured.* (AC)

However respondents from all groups made the point that the existence of effective audit committees would make ARPs unnecessary. The comments of respondents from all groups emphasised the professionalism of external auditors as vital:

*If the accounting profession is incapable of instilling high standards and integrity into its leading practitioners it should no longer be considered a profession and should give up its charters.* (FD)
Try working with a major audit firm – they know where their responsibility lies. In 25 years I have never experienced an auditor jeopardising his independence on a material issue. (AC)

External auditors should be independent and work to very high standards, they should not be unduly pressurised by executive directors as they are professionals and supervised by independent supervisory bodies. (IA)

You need robust auditors. I do not see an audit review panel would help or hinder this. (EA)

Some suggestions made by respondents focused on other mechanisms to achieve appropriate auditor behaviour. These included:

A more effective system of disciplining auditors who do not maintain high standards. They have a statutory duty and should be held to do it well. (AC)

Auditors should have to change every 3-5 years and make a clear divide between consultancy and audit. (IA)

Some respondent comments made the point that no committee or panel could ensure appropriate auditor behaviour. Some external auditors, in particular, were clear on this point.

A panel, committee or whatever it is called does not ensure this anyway. There is already rotation of the audit partner on listed clients, and without simplifying matters too far professional training largely achieves independence. There is no way to legislate against the few instances which raise problems. (EA)

No matter how many checkers you have checking the checkers you can never eliminate the pressure from executive directors. You have to deal with that pressure. (EA)
Summary

- Each respondent group on average disagreed strongly with the proposal to establish audit review panels.

- It is not surprising, therefore, that respondents displayed largely indifferent attitudes towards the various functions proposed for these panels. Various alternative mechanisms to ensure that auditors act in the best interests of shareholders were suggested by respondents. The alternatives suggested tended to be those that have already been rehearsed in the academic and professional literatures and public fora, such as reliance on audit professionalism, more effective disciplinary systems for auditors, rotation of auditors and more effective audit committees.

- In general, however, the dominant theme emerging from the many comments made by respondents is that effective audit committees should make ARPs unnecessary and there is an evident distaste for the establishment of another monitoring body. Once again, there was little enthusiasm for ‘boilerplate’ solutions.

Collaboration between external and internal auditors

Questions 2.9 to 2.15 sought to elicit the opinion of respondents as to whether external and internal auditors should work jointly on various financial auditing matters. The results are shown in Table 5.3.
Table 5.3: Collaboration of external and internal auditors

<table>
<thead>
<tr>
<th>Extent of agreement that IA and EA should work jointly on:</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2.9) planning</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>2.06 Low</td>
<td>1.94 Very low</td>
<td>1.96 Very low</td>
<td>2.00 Low</td>
<td>1.99 Very low</td>
</tr>
<tr>
<td>(2.10) compliance testing</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>2.29 Low</td>
<td>2.36 Very low</td>
<td>2.56 Mod</td>
<td>2.27 Very low</td>
<td>2.37 Very low</td>
</tr>
<tr>
<td>(2.11) substantive testing</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>2.68 Mod</td>
<td>2.72 Low</td>
<td>2.96 Mod</td>
<td>2.74 Low</td>
<td>2.78 Mod</td>
</tr>
<tr>
<td>(2.12) opinion on business performance</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>2.94 Mod</td>
<td>3.11 Mod</td>
<td>3.08 Very low</td>
<td>3.39 Mod</td>
<td>3.13 Mod</td>
</tr>
<tr>
<td>(2.13) opinion on systems reliability</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>2.50 Mod</td>
<td>2.50 Very low</td>
<td>2.62 Low</td>
<td>2.98 Very high</td>
<td>2.65 High</td>
</tr>
<tr>
<td>(2.14) opinion on going concern status</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>3.62 Very high</td>
<td>3.19 High</td>
<td>3.20 Mod</td>
<td>3.89 Low</td>
<td>3.48 Mod</td>
</tr>
<tr>
<td>(2.15) reporting to management on 2.12 to 2.14</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>2.79 Mod</td>
<td>2.44 Low</td>
<td>2.65 Low</td>
<td>2.94 High</td>
<td>2.71 Mod</td>
</tr>
</tbody>
</table>

1 Significant differences between EA and FD, EA and AC and between EA and IA.
2 Significant differences between EA and AC and between EA and IA.

Table 5.3 shows that the areas of work where there was most agreement with the proposition that external and internal auditors should collaborate were audit planning and compliance testing. For each of these areas there was strong or reasonably strong agreement (and also high or very high consensus) for all groups except internal auditors who only agreed mildly with the proposition that collaboration was appropriate in the area of compliance testing. On balance respondents were mildly in favour of collaboration in the areas of substantive testing...
and of the formation of an opinion on systems reliability, although external auditors were significantly less favourably disposed to internal auditors opining on systems reliability than were other responding groups.

However some comments were made that emphasised the different roles of internal and external audit:

External auditors do not require to opine on system reliability. (EA)

Internal and external audit have different purposes - accordingly each should basically do its own work but there should be liaison to avoid duplication and arrangements to co-ordinate effort to best overall effect. (EA)

Respondents were neutral on the issue of collaboration on the formation of an opinion on business performance. The area where there was most disagreement with the notion of collaboration was that of the formation of an opinion on the going concern status of the entity although audit committee chairs and internal auditors were on average neutral on the issue. There were however some strongly negative comments:

Internal auditors are not independent and cannot therefore be relied upon in making judgements that are critical to the understanding of the financial statements. (AC)

I do not regard going concern as a matter on which the CEO and finance director should be assessed by internal audit – it will prejudice their independence. (AC)

Internal audit and external audit should form their own opinions based on work performed to reinforce independence and the different nature of the functions. (AC)
Finance directors disagreed reasonably strongly with the proposal for collaboration on the going concern opinion.

*It is the job of the external auditors to form their own opinions.*

*Management has a right to disagree but not to influence.* (FD)

External auditors were particularly negative. This group disagreed strongly with the proposal and their consensus on this issue was high. Thirty-six of the 49 responding external auditors disagreed or strongly disagreed with this proposal. Comments by external auditors include:

*Internal auditors’ jobs are at stake if the organisation is not a going concern. Thus they may not be objective.* (EA)

*I disagree on internal auditors giving an opinion on going concern since it is the external auditors who are usually solely ‘on the line’ for this aspect.* (EA)

Interviewees were also asked for their views as to how external and internal auditors should interact and on how this worked out in the organisations in which they worked. The view of most interviewees of whatever category tended to be that co-operation and interaction between external and internal auditors was limited because the two groups have distinct objectives. One external auditor suggested additionally that the expertise of internal audit might be questionable:

*Much internal audit work focuses on areas that do not necessarily fall into external audit risk areas. It’s partly because of the way they are directed, in terms of avoiding duplication of external audit work. Partly because external auditors can only take a limited amount of comfort from internal audit work. Do they have the qualifications, the experience and the understanding? My experience is that you rarely get big benefits.* (EA)
As far as the smaller listed companies in which interviews conducted were concerned, co-operation between external and internal auditors tended to be informal and/or *ad hoc*. The internal auditor of one smaller plc stated:

*If I need any extra support from the external auditors then I simply pick up the phone. Similarly from the external auditors’ side when they come out for the half year and full year, we more than often just sit down and have a quick catch up as to what both parties are doing. It is quite informal.* (IA)

If internal auditors are heavily involved in risk management, there is likely to be some interface between internal and external auditors in the area of corporate governance reporting. The finance director of a smaller plc commented:

*Our internal auditor tries to speak to them probably once a year, to make sure that everything he is doing is in accordance with what they would expect him to be doing for the purposes of signing off on Turnbull.* (FD)

His internal auditor explained that:

*(External auditors) have to get comfortable with the Turnbull requirements and what we are actually doing there … . I put together an audit trail of how we see business risk so that they can get comfortable with what we have been doing.* (IA)

However some internal auditors spoken to suggested a more focused relationship. The head of internal audit for a large international conglomerate indicated how the external auditors utilised the work of internal audit from the planning stage of the audit:

*We do a controls template, where we identify all the major risk areas in the larger businesses, what the control risks are and what the control objectives are, and then what the controls are against those objectives.*
And then who is actually responsible. And we actually hand that over to the external auditors. And it helps them to understand the business. You have new guys coming in on a pretty regular basis and it gives them a good start on understanding how the control mechanisms work. (IA)

This reflects the results shown in Table 5.3 indicating that the most common area of collaboration were planning and testing controls.

Summary

- There was broad agreement that collaboration between internal and external auditors was appropriate in the more routine aspects of audit work; however agreement was less evident in those areas where judgement was critical and, in particular, in the area of the going concern opinion.

- There was significant disagreement with the proposal that external and internal auditors should work together jointly in this area; this was especially so with finance directors and with external auditors themselves. Reasons for this disagreement included the legal responsibilities of external auditors in this area and the posited lack of independence of internal auditors.

- As far as the interviewee companies were concerned the larger the commercial organisation the greater and more systematic was the nature of the co-operation between external and internal auditors.

- External auditors, who need to confirm compliance with part of the Turnbull requirements, did, in some cases involve themselves in the work of internal audit, to confirm that they had an adequate basis for their opinion.
• External auditors had, in general, cautious attitudes to external/internal auditor co-operation.

• Finally, while the attitudes of none of the auditors (or other individuals) ruled out much more extensive co-operation the sort of collaboration envisaged by the ICAS (1993) and Fraser, Henry and Wallage (2000) proposals would involve in many cases in a major change in the way that external and internal auditors engage with one another, and there was little enthusiasm for it.

Supervisory boards

Question 2.16 asked respondents to what extent they believed that listed companies in the UK should establish supervisory boards with the same remit as their Dutch counterparts. The results are shown in Table 5.4.

Table 5.4 Views on establishment of supervisory boards

<table>
<thead>
<tr>
<th></th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td>Extent of agreement with supervisory board proposal</td>
<td>3.88 Mod</td>
<td>4.63 Very low</td>
<td>3.54 Low</td>
<td>3.67 Very low</td>
<td>3.93(^1) Very low</td>
</tr>
</tbody>
</table>

\(^1\) Significant differences between all groups except between IA and EA.

The results indicate that each of the responding groups would view the establishment of continental style boards in the UK unfavourably. Finance directors and audit committee chairs strongly disagreed with the proposal and both internal and external auditors disagreed
reasonably strongly. In general there was a high degree of consensus on this issue although external and internal auditors were significantly more in favour of the proposal than were audit committee chairs and financial directors. This difference in view is interesting given the greater board experience of the latter groups. It is noteworthy that audit committee chairs, arguably the group with the most obvious corporate governance role, were the most opposed to this proposal. Of the 36 audit committee chairs who responded to the questionnaire, 23 disagreed strongly with the proposal and 11 disagreed. Of the 41 narrative comments made by respondents on this issue practically all were negative:

There is a need to simplify reporting and control, not the opposite-management actions need challenge from shareholders at regular contact meetings. (FD)

(Supervisory boards are) divisive, and per my German two-tier board experience, ineffective - usually just a formal charade with all real decision-making taking place elsewhere. (AC)

I believe the closer control which good NEDs exercise is preferable to the formalised legalistic role of a supervisory board. (AC)

Supervisory boards are ineffective and cause a misleading division of responsibilities between supervisory and board members. (AC)

Have concerns about conflict with management - where does it add value over and above existing non-executive role. (IA)

My experience is that supervisory boards are overly bureaucratic and used for rubber-stamping. This proposal is likely to reduce the healthy debate and challenge that comes from an active, well-run audit committee. (EA)
I tend not to favour ‘multi-layers’ of boards. The key issue, in any event, is the competence and objectivity of independent directors. (EA)

One of the least negative comments about supervisory boards came from an internal auditor who nevertheless appeared to indicate that he/she thought the establishment of such boards to be unnecessary:

The role/positioning of many boards of UK listed companies is not far short of being similar to a supervisory board – if anything the shortfall is the lack of representation of employees or stakeholders. (IA)

Another internal auditor highlighted the stakeholder theme and appeared to suggest that a supervisory board system that took cognisance of wider stakeholder interests might widen the scope of corporate governance:

‘Stakeholders’ are traditionally defined as those based on what management perceives is in their short-term interest (eg pleasing the existing shareholders as the priority). Anything to change this culture would be worthwhile. (IA)

Also explored was the issue of supervisory boards with interviewees. In general, views on the two-tier system were again heavily negative and reinforced the questionnaire results for this issue. One non-executive director gave an example from his own experience to illustrate how the supervisory board could be remote from the executives but at the same time lacking in any real independence:

I saw the supervisory board system working in Germany. It is a sort of non-executive board really, that sits remotely from the executives. At the same time in one company that I was involved with, the person who was the chair of the board of managing directors simply switched to becoming chairman of the supervisory board. (AC)

An internal auditor also gave an example from his experience:
I worked for one group where our German subsidiary had a supervisory board and we thought that it was a pretty wishy-washy outfit. We did not feel that it had any punch. It was just another layer, sitting there to try and give people comfort. (IA)

An external auditor held the view that the unitary board gave a greater opportunity to non-executives to make a contribution to strategy as well as to exercising their oversight role:

*The non-execs on a unitary board do have a huge contribution to make to strategy. It is a double-edged sword, governance. It embraces the efficiency of the board and the accountability of shareholders. And there is a lot of focus on accountability but not a lot of focus on creative value. And non-execs do have a role to play there too. That is an aspect of UK unitary boards, which is not apparent in US unitary boards or the two-tier boards we see in Holland.* (EA)

This external auditor also offered the interesting observation that, in the UK, to some extent a two-tier board system did operate *de facto* in that the non-executives almost always meet regularly independently of the main board.

A finance director held the view that supervisory boards were of limited use because their membership reflected a variety of political and vested interests and because meetings lacked openness:

*The top tier becomes very political. Not a lot of genuine board work, as I recognise it, gets done because you have people with a whole pile of vested interests. I found that these meetings were less productive than they would otherwise have been, particularly where you had labour representatives there.* (FD)

This finance director while arguing against the imposition of ‘non-executives’, which he believed occurred to some extent in Europe, at the same time acknowledged that this could provide benefits in terms of greater independence:
In the UK, a good chairman has a say in the selection of non-execs. To some extent they get people thrown at them in the continental system, where you do not have a choice. Admittedly these people will be more independent. (FD)

However interviewees in general felt that while supervisory boards were remote from business operations, they tended at the same time to lack real independence while being handicapped by vested and political interests.

Summary

- Respondents almost universally rejected the possibility of establishing supervisory boards on the continental pattern.

- This rejection was largely on the basis that this type of board is often ineffective, divisive and an unnecessary bureaucracy. In addition, such boards were often not sufficiently independent of management. In the UK, independent audit committees and non-executive directors could carry out the duties of supervisory boards effectively, and non-executives in addition were often able to make a contribution to the enhancement of creative value.

Summary of results relating to Fraser, Henry and Wallage (2000)

The main points arising from the responses to questions on the Fraser, Henry and Wallage (2000) issues were:

- There was wide support for the establishment of strong internal audit functions with wide-ranging remits. Both questionnaire responses and interviews revealed widespread support for internal auditor involvement in the risk management area.
• Companies are increasingly recognising the importance of strong internal audit functions, but the trend is to move away from large internal audit departments performing low level work to smaller groups of high calibre individuals able to address strategic and high level issues and reporting to the chief executive. This type of internal audit function is regarded positively.

• These internal audit functions tend to be involved in risk management, but usually in a monitoring, rather than an operational, role, in order to maintain their independence within the organisation.

• The principal areas of internal audit activity apart from risk management were the confirmation of financial, operational and compliance controls and respondents other than internal auditors believed that they should also provide assurance on the data output of routine systems.

• In smaller plcs, in cases where an internal audit function is not considered to be necessary, control is achieved by the close involvement of the audit committee in operational decisions, peer reviews across the business, self-assessment by senior managers and/or the establishment of a risk management committee or equivalent.

• There was little support for the proposal that external auditors should be re-designated as external assessors.

• The proposal to establish Audit Review Panels found little support, although internal auditors were less hostile towards this proposal than were the other respondent groups. Most participants in the research believed that an effective audit committee could fulfil the proposed review panel’s functions more effectively.
• There was broad support for collaboration between external and internal auditors in the more routine areas of audit work. However there was much less support for collaboration in the more judgemental audit areas and in particular as regards the going concern status of the company. It was clear that co-operation between external and internal auditors of the sort envisaged by the ICAS (1993) and Fraser, Henry and Wallage (2000) proposals was not regarded as feasible. This was largely because it was believed that internal and external auditors have different objectives. There is evidence of significant co-operation between the internal and external auditors especially in areas such as audit planning and control testing. This co-operation ranged from ad hoc consultations to extensive use by external auditors of internal audit control templates.

• There was almost no support for the establishment of supervisory boards in line with the continental model. The unitary board system within the UK was strongly endorsed. Such boards were perceived to be bureaucratic and ineffective. A unitary board consisting of competent executives, supported and monitored by non-executives, was seen by most participants in this research as the most appropriate way forward.

Issues for consideration

• It is clear that the recommendation (ICAS, 1993; Fraser, Henry & Wallage, 2000) that all listed companies establish internal audit departments does not meet with universal approval. Consideration needs to be given as to how this recommendation might be appropriately moderated and to what other alternative control strategies might be appropriate in certain cases.
• Given the very obvious lack of enthusiasm for the establishment of audit review panels attention needs to be paid to measures aimed at making existing audit committees more effective. Attention also needs to be given to identifying other measures that might strengthen external auditor independence.

• This research indicates a wide disparity in the expertise and emphasis of internal audit functions and the extent and nature of internal/external auditor co-operation therefore requires to be considered on its own merits in each case. The establishment of mandatory rules on the extent and nature of such co-operation would therefore appear to be inappropriate.


CHAPTER SIX

ISSUES ARISING FROM THE BLUE RIBBON COMMITTEE REPORT

The third section of the questionnaire asked respondents for their views regarding the proposals made by The Blue Ribbon Committee to improve the effectiveness of audit committees in the US.

The results for this section of the questionnaire are shown in Tables 6.1 to 6.3. In general the proposals in this section of the report received strong support from respondents. One respondent summed up the possible reasons for this by stating that:

In general in 3.1 to 3.11 (Blue Ribbon Committee questions) it feels as though these things happen already as agreeing isn't difficult.

(AC)

Audit committee membership

Four questions were asked on The Blue Ribbon proposals on audit committee membership. The results are shown in table 6.1.
These issues. To address these concerns, the Blue Ribbon Team proposed four sets of changes that were intended to strengthen audit committee composition:

<table>
<thead>
<tr>
<th>Extent of agreement on proposals relating to audit committee membership</th>
<th>FD Mean</th>
<th>AC Mean</th>
<th>IA Mean</th>
<th>EA Mean</th>
<th>TOTAL Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(3.1) Independent directors – large listed companies</strong></td>
<td>1.74 Very low</td>
<td>1.97 Mod</td>
<td>2.08 Very high</td>
<td>1.94 Low</td>
<td>1.93 Low</td>
</tr>
<tr>
<td><strong>(3.2) Independent directors – other listed companies</strong></td>
<td>1.97 Very low</td>
<td>2.08 Mod</td>
<td>2.00 Mod</td>
<td>2.06 Low</td>
<td>2.03 Low</td>
</tr>
<tr>
<td><strong>(3.3) Financial literacy – large listed companies</strong></td>
<td>2.06 Low</td>
<td>2.33 Low</td>
<td>2.02 Very low</td>
<td>1.96 Low</td>
<td>2.09 Very low</td>
</tr>
<tr>
<td><strong>(3.4) Financial literacy – other listed companies</strong></td>
<td>1.79 Very low</td>
<td>1.92 Very low</td>
<td>2.10 Very low</td>
<td>2.00 Very low</td>
<td>1.95 Very low</td>
</tr>
</tbody>
</table>

\[^1\text{There are no significant differences between any groups for each of the questions in this table.}\]

The results show that The Blue Ribbon proposals on the composition of audit committees enjoy strong support and are largely non-contentious. Each of the four proposals – concerned to ensure that all listed company audit committees are dominated by independent directors and include member(s) who are financially literate – received strong or reasonably strong support from all responding groups. Table 6.1 also shows that levels of consensus are generally high on these issues.

At the same time a few reservations were expressed on these proposals. A few negative comments were made about the proposed requirements for audit committee composition:
I disagree with 3.2 (requirement for a majority of audit committee members to be independent) because all audit committee members should be independent. (EA)

What is needed is common sense, not financial literacy. This would turn all audit committees into committees of accountants. (EA)

I have disagreed with 3.1 to 3.4 (proposals on audit committee membership) and have scored these at 5 (strongly disagree) not because these are bad suggestions but because I believe it is wrong to ‘mandate’ such policies. (EA)

Although strongly and thoughtfully expressed, however, these quotations represented very much a minority view among respondents.

**Audit committee duties and functions**

Questions 3.5 to 3.10 dealt with various areas of audit committee duties and functions. The results are shown in Table 6.2
Table 6.2 Audit committee duties and functions

<table>
<thead>
<tr>
<th>Extent of agreement on:</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Mean</td>
<td>Mean</td>
<td>Mean</td>
<td>Mean</td>
</tr>
<tr>
<td></td>
<td>Disp</td>
<td>Disp</td>
<td>Disp</td>
<td>Disp</td>
<td>Disp</td>
</tr>
<tr>
<td>(3.5) adoption of charter</td>
<td>1.68</td>
<td>1.92</td>
<td>1.58</td>
<td>1.98</td>
<td>1.79(^1)</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(3.6) report on adoption of charter</td>
<td>2.52</td>
<td>2.61</td>
<td>2.24</td>
<td>2.23</td>
<td>2.40</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Low</td>
<td>Mod</td>
<td>Very low</td>
<td>Low</td>
</tr>
<tr>
<td>(3.7) disclosure of charter</td>
<td>2.88</td>
<td>2.89</td>
<td>2.61</td>
<td>2.40</td>
<td>2.70(^2)</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Low</td>
<td>Mod</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(3.8) disclosure of ultimate audit responsibilities of AC and board</td>
<td>2.38</td>
<td>2.62</td>
<td>2.74</td>
<td>2.59</td>
<td>2.58</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Very low</td>
<td>Low</td>
<td>Very low</td>
<td>Low</td>
</tr>
<tr>
<td>(3.9) dialogue with EA on non-audit services</td>
<td>1.74</td>
<td>1.86</td>
<td>1.68</td>
<td>1.82</td>
<td>1.78</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(3.10) discussion with EA on auditors’ judgements</td>
<td>1.68</td>
<td>1.72</td>
<td>1.64</td>
<td>1.59</td>
<td>1.66</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
</tbody>
</table>

\(^1\) Significant differences between EA and FD, EA and IA and between AC and IA.

\(^2\) Significant differences between EA and FD and between EA and AC.

This group of Blue Ribbon proposals received strong support from respondents, reflecting their arguably non-contentious nature. The proposals concerned with the adoption of formal written charters by audit committees (question 3.5), dialogue with the external auditors on the provision of non-audit services (question 3.9) and discussions with the external auditors on judgements made by them on company financial policies (question 3.10) were particularly well supported. For each of these three proposals, all four responding groups indicated strong agreement and very high levels of consensus. For instance all
36 responding audit committee chairs agreed or strongly agreed with the proposal that audit committees should discuss with the external auditors the quality of their judgements on corporate accounting policies (question 3.10).

The other three proposals discussed here (questions 3.6 to 3.8) were less strongly supported; nevertheless, on average, participants agreed reasonably strongly or mildly agreed with the proposals and generally levels of consensus were high.

Some respondents expressed reservations as to the need for, or value of, additional reporting or disclosure requirements:

-I don’t believe any of these disclosure issues are necessary – just would create extra ‘boilerplate’. (FD)

A lot of these recommendations are form rather than substance. The key is that the committee operates effectively and holds the necessary discussions - not going through the motions so that they can publicly ‘tick the box’. (EA)

Audit committee reporting on financial statements

The final questions in this section (3.11(i)–(iv)) asked respondents for their views on whether or not the audit committee should report in the corporate annual report on several financial statement issues. The results are shown in Table 6.3
Table 6.3 Audit committee reporting on financial statements

<table>
<thead>
<tr>
<th>Extent of agreement on disclosure in annual report of:</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td>(3.11i) review of financial statements with management</td>
<td>2.50</td>
<td>2.78</td>
<td>2.20</td>
<td>2.43</td>
<td>2.48&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(3.11ii) discussion with auditors of issues in (i) above.</td>
<td>2.44</td>
<td>2.72</td>
<td>2.18</td>
<td>2.65</td>
<td>2.50&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Low</td>
<td>Very low</td>
<td>Low</td>
<td>Very low</td>
</tr>
<tr>
<td>(3.11iii) audit committee discussions on issues in (i) and (ii) above.</td>
<td>2.53</td>
<td>2.86</td>
<td>2.54</td>
<td>2.73</td>
<td>2.67</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Low</td>
<td>Mod</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>(3.11iv) Audit committee’s belief that financial statements are fairly presented in accordance with UK GAAP</td>
<td>2.71</td>
<td>2.94</td>
<td>2.44</td>
<td>2.89</td>
<td>2.75</td>
</tr>
<tr>
<td></td>
<td>High</td>
<td>Mod</td>
<td>Low</td>
<td>Very high</td>
<td>Mod</td>
</tr>
</tbody>
</table>

<sup>1</sup> Significant differences between AC and IA and between AC and EA.

<sup>2</sup> Significant differences between IA and AC and between IA and EA.

As far as these proposals are concerned, it is interesting that it was audit committee chairs themselves who were the least enthusiastic, significantly so in some cases. This may reflect perceptions of audit committee chairs as to the difficulties of ensuring that audit committees had the necessary financial expertise to carry out these functions; this was at least partially confirmed at the interview stage of the project. On balance, respondents’ views on these proposals might be summarised as mildly in agreement but unenthusiastic. Some comments by respondents reflected this:
Any audit committee should do all the things in 3.11 as a matter of course. Annual reports should not be covered with yards of ‘boilerplate’ formulae. (AC)

My neutral stance on 3.11 arises from my view that these issues are implicitly understood to be a requirement of a properly constituted audit committee and to disclose them each year in the annual report is unnecessary ‘boilerplate’. (AC)

Internal auditors were more favourably disposed to the proposals than were the other responding groups. Question 3.11(i) asked respondents for their views on the proposal that audit committees should state in the corporate annual report whether or not ‘management has reviewed the financial statements with the audit committee discussing the quality of accounting policies and significant judgements affecting the financial statements’. While internal auditors and external auditors were reasonably strongly in agreement (and displayed very high consensus) with this proposal, finance directors and audit committee chairs were only in mild agreement. Question 3.11(ii) dealt with the proposed disclosure by audit committees in annual reports as to whether or not the external auditors had discussed their judgements on the issues in question 3.11(i) with the audit committee. Question 3.11(iii) dealt similarly with confidential discussion of the issues in 3.11(i) and (ii) by the audit committee. On average, respondents to these proposals could be described as mildly favourable.

The final proposal (question 3.11(iv)) in this section received the least favourable response. This proposed that corporate annual reports should disclose whether or not ‘the audit committee believes that the financial statements are fairly presented in accordance with UK GAAP’. While internal auditors were in reasonably strong agreement with this proposal, finance directors were only in mild agreement and audit committee chairs and external auditors were neutral. Respondents made more negative comments specifically about this proposal than
they did about the other proposals concerned with disclosure in financial reports:

The responsibility for giving opinion on the financial statements should remain with external auditors. Many members of the audit committee will be directly or indirectly involved in preparing the financial statements. (AC)

Question 3.11(iv) (requiring audit committees to state that financial statements are fairly presented in accordance with UK GAAP) are appropriate only for large listed companies with a full quota of financially competent members – it may be unfair to ask this where the reliance is on one competent member. (IA)

Question 3.11(iv) represents unnecessary risk for audit committee members. External audit opinion should be sufficient. (EA)

Question 3.11(iv) is unrealistic and unfair to ask of non-accountants. (EA)

Respondents, then, did not tend to see anything specifically objectionable in The Blue Ribbon proposals apart from those relating to disclosure in the financial statements. However there appeared to be a clear feeling on the part of respondents that the implementation of these proposals would add little to audit committee effectiveness:

Many of the above proposals are well intentioned and are geared towards improving audit committees’ effectiveness. However a bland rules-based approach such as this would be likely to lead to standard, bland statements being made which would add little value to annual reports. It is important that the current UK ‘flexible’ approach is maintained. (EA)

Further audit committee effectiveness issues were explored at the interview stage of the project. Again while there were a variety of views the most common theme emerging was a consensus that an
overly prescriptive and rules-based approach was unhelpful. One audit committee chair made the point that to require all audit committees to have at least one member with financial expertise, could be unhelpful to smaller companies.

Small boards, with possibly only two or three non-execs, do not necessarily have one with financial expertise. Having said that, when structuring a board non-exec team, I would try very hard to get someone involved with financial expertise. But to define this as a requirement might cause problems. (AC)

However one financial director did stress the importance of a financial literacy requirement and opined that without this many audit committees might be fine at asking the ‘standard’ type of question but be lost if they got a ‘non-standard’ answer.

On the other hand, this somewhat limited view of audit committee capabilities was juxtaposed with examples of how valuable audit committees could be. An example given by an audit committee chair illustrated the less obvious issues that a perceptive audit committee member might ask:

We have a non-exec, who knows the industry very well and at our last audit committee meeting he said, ‘I have just got one final question. How many people in the company used to work for the auditors?’ I thought, ‘Well it is a very obvious question, but that is a new one on me’. So I said to the finance director, ‘How many?’ and he said, ‘Two’. I thought, ‘Well that is fine’. But if the answer had been ten, starting with myself or the finance director, I’d think, ‘Hold on here. We need to look at this’. (AC)

Comments by one external auditor reflected the overall views of many interviewees. He argued that while the quality of audit committees was undoubtedly variable with both some very good ones and some very bad ones, audit committees in the UK were more
effective than they were in the US. He went on to argue against the regulatory ‘boilerplate’ approach:

What does an audit committee member need? He needs to be independent in thought. He needs to be prepared to challenge the executive, the CEO, without fear he is going to get his head snapped off. He needs to have the time necessary to do the job properly. And these are perhaps things that you cannot regulate for. It’s not just about, ‘are you independent or not independent’, because those conversations ultimately are ‘boilerplate’ to a large degree. Throughout the year, the auditor has got to be going to them and saying, these are the issues both with your company and these are the issues in the accounting world. And I say two-way - the audit committee should be going and saying ‘We have read about Enron in the paper, their audit committee obviously got it wrong. Why did they get it wrong? What can we do to make sure that we do not get it wrong?’ (EA)

There is therefore a strong view that it is critical that there are transparent relationships between audit committees, executives and external auditors and that there is constant liaison between them, rather than limiting contact to one or two meetings per year.

Audit committees are not aware of individual issues unless they are brought to them either by the management or the auditors. Therefore the audit committee’s ability to influence things, the ability to oversee things is crucially dependent on the climate between the audit committee and the management and the audit committee and the auditors. (AC)

This need for ongoing liaison between audit committees and management was emphasised by a finance director in the context of earnings management:

You have an obligation to keep the market informed as to what you expect the financial position to be and to warn the market in terms
of profit warnings or otherwise. So there is expectation management in terms of the organisation and the investors and analysts. This process is very difficult to manage if you don’t keep in touch with your audit committee. (FD)

This finance director therefore suggested that audit committees should have the time to consider monthly management accounts and debate issues and concerns with the board as they arise. Recognition of this should encourage non-executive directors to take a realistic view of the number of such appointments that they can cope with at any given time.

Other interviewees reiterated these comments and stressed the importance of qualities such as integrity, trust and experience rather than those that could be reduced to matters of formal qualification. These comments by interviewees suggest a significant challenge for regulators. How can these intangible qualities be embedded in audit committees? There may be a role here for a greater emphasis on ethics in professional education, already recognised by the professional accounting bodies.

Some interviewees commented on the proposal made in 2002 in the UK by the Department of Trade and Industry that audit committees should assume the role of formally appointing the external auditors. Interviewees were generally unenthusiastic about this and, in fact, the government has not pursued this suggestion at the present time. Comments on this issue included the view that the external auditors’ appointment was a duty of the whole board, that the audit committee effectively carried out this duty already and that state appointment, as in France, was another alternative.

Similarly there was little enthusiasm for the idea mooted in the recommendations of the US Blue Ribbon Committee that audit committees report formally to shareholders in company annual reports.
Finally, the interviewees were asked for their views on the role of audit committees in relation to risk management and to the assessment of internal control. The view of respondents, in general, was that audit committees had only a limited role to play in this area. An external auditor opined that there were limitations to what could be expected of audit committees because of the complexities of risk management in large organisations:

*The typical public company is a very complicated business with a variety of businesses, locations, markets, geographic coverage, legislation etc. To ask audit committees to have a reasonable understanding of the risks and of how to mitigate them is a bit like asking them to be supermen.* (EA)

The finance director of one organisation was of the opinion that the audit committee could only be expected to contribute towards the management of financial risks. The main vehicle for risk management in his company was a risk management committee, comprising executive and non-executive directors.

*The risk management committee carries out part of the embedded risk philosophy of Turnbull through the organisation and it is responsible for monitoring the risks. A subset of these risks is financial and there the audit committee has a part to play. But only in that respect.* (FD)

This view was endorsed by a non-executive director in another company:

*The audit committee is responsible for the oversight of the financial controls in the business. It is not a role related to risk, which is a business objective. The role of reviewing business risk falls to the whole board . . . . Business heads report to the full board on their risk management profile, on their management of risk.* (AC)
The financial director of an international conglomerate did indicate that in his organisation, the audit committee was very much a major player in this area and drove the whole risk management process:

*The July meeting with the audit committee looks at risk management for the whole year. The head of internal audit reports on the issue to the audit committee. The audit committee then has to be in a position to say that there is a system of control that is effective.* (FD)

However, even in this company, risk management matters then went to the main board the members of which all accepted responsibility in this area. In summary then, the main board was generally seen as bearing the primary responsibility here with the audit committee playing a subsidiary but sometimes still significant role.

**Summary of results relating to Blue Ribbon Committee issues**

- The results of the questionnaire survey indicated that *The Blue Ribbon* proposals on audit committee membership were widely supported and largely non-contentious. *The Blue Ribbon* proposals relating to audit committee duties were also broadly supported by respondents to the questionnaire with the exception of those relating to disclosure in the financial statements. Respondents did, however, express reservations about a proliferation of ‘boilerplate’ reporting.

- When these issues were explored further at the interview stage of the project, however, it became evident that there was a general lack of enthusiasm for regulation as a way to improve audit committee effectiveness. While the majority of *The Blue Ribbon* proposals were again regarded as non-contentious, there was a strong view that a prescriptive approach to audit committee composition
and functions was inappropriate. There was little enthusiasm for ‘boilerplate’ regulation as this was seen as unhelpful, especially to smaller organisations where flexibility was required.

- The general view was that audit committees had only a limited role in the risk management area. Proposals to make audit committees responsible for risk management, for giving opinions on the financial statements and for the appointment of external auditors were not enthusiastically welcomed. Such issues were deemed to be matters for the entire board rather than a subset of it.

- There was little enthusiasm for the idea of audit committees giving an opinion on the financial statements or the going concern status of the company. Similarly there was little support for view that audit committees should formally appoint the external auditors. This was also regarded as a matter for the whole board.

- The results of the research indicate that the qualities sought in audit committee members tend to be intangibles such as integrity, trustworthiness, experience and the strength of character to ask difficult questions. Formal qualifications are regarded as relatively unimportant.

- Audit committees should have an open relationship with executive management and the external auditors, so that emerging issues can be discussed timeously in order to avoid undermining ongoing board interaction with investors and analysts. In order for this to be effective, audit committee members require the time to consider company developments on a continuing basis. Potential audit committee members require to make a realistic assessment of the time available to them in deciding whether to take on such appointments.
Issues for consideration

• There is a need for proposals that facilitate the appointment of individuals with personal qualities such as independence of thought, ability and willingness to ask perceptive questions and integrity, to audit committees.

• In view of the rejection of the idea that audit committees should appoint external auditors, there is a need to develop mechanisms through which shareholder influence in auditor appointments might be enhanced.

• The responsibilities and membership of audit committees require further consideration in the light of the recommendations of Smith (2003). The impact of Smith (2003) is considered in chapter eight.
CHAPTER SEVEN

ISSUES ARISING FROM TURNBULL REPORT

The fourth section of the questionnaire dealt with issues arising from the Turnbull Report.

Scope of internal control systems

Question 4.1 asked respondents the extent to which they agreed that the scope of a company’s system of internal control should embrace several risk areas. Results for this question are shown in Table 7.1.
Table 7.1 Views on scope of a company’s system of internal control

<table>
<thead>
<tr>
<th>Question</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>(4.1a) Accounting controls, including the maintenance of proper accounting records</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>1.41</td>
<td>1.50</td>
<td>1.30</td>
<td>1.20</td>
<td>1.35¹</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.1b) Evaluation of the financial risks to which the company is exposed</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>1.44</td>
<td>1.69</td>
<td>1.43</td>
<td>1.31</td>
<td>1.47²</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.1c) Evaluation of the business risks to which the company is exposed</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>1.59</td>
<td>1.81</td>
<td>1.57</td>
<td>1.53</td>
<td>1.63³</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.1d) Evaluation of the compliance risks to which the company is exposed</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>1.53</td>
<td>1.81</td>
<td>1.65</td>
<td>1.51</td>
<td>1.63</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.1e) Evaluation of the operational risks to which the company is exposed</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>1.61</td>
<td>1.89</td>
<td>1.55</td>
<td>1.71</td>
<td>1.69</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.1f) Evaluation of any other risks to which the company is exposed</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td></td>
<td>1.91</td>
<td>1.86</td>
<td>1.82</td>
<td>1.81</td>
<td>1.85</td>
</tr>
<tr>
<td></td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
</tbody>
</table>

¹ Significant differences between EA and between FD and between EA and AC.
² Significant differences between AC and FD, AC and IA and AC and EA.
³ Significant differences between AC and IA and between AC and EA.

All groups strongly endorsed the proposal that a company’s system of internal controls should embrace all of the areas identified and there was a high level of consensus among respondents. There was widespread recognition of the need for these issues to be addressed. This indicates that, for the most part, all groups embrace a broad concept of internal
control and there were no attempts to limit this to financial controls. The comments made by individual respondents indicated this.

(Commenting on the wide scope of internal control) It frankly cannot be otherwise or the system is deficient. Internal audit and any independent risk functions are also part of the system and their effectiveness must be reviewed too. (FD)

As you can see, I’m a firm believer in a comprehensive risk management system. (FD)

If a system of internal control excludes any of these areas it would be likely to be deficient in one or more aspects, which is inappropriate. (EA)

However, notwithstanding the scores given to the questions, some unease was expressed by a minority of respondents at the inclusion of all these aspects of risk management within the definition of ‘control’.

I regard (b)–(f) as being part of the normal management process. (AC)

Turnbull should have gone further on risk and downplayed control … Risk management is a management function and is dynamic – control is an operational function and is neither dynamic nor front line. (IA)

Getting the basics right first is important. Control functions which get too drawn into operational risk management often fail to deal with the basic accounting and financial controls. (EA)

Summary

- Respondents were in agreement that the system of internal control should embrace a broad spectrum of risks faced by a company.
On the other hand, concern was expressed that risk and control could be regarded as synonymous. There is a need to distinguish the two – risk management being a dynamic management function and control being an ongoing operational function.

### Extent of director responsibilities

Questions 4.2 and 4.3 asked respondents to indicate the extent to which they agreed on a number of proposals for director responsibilities. The results are shown in Table 7.2.
Table 7.2: Views on proposals for director responsibilities

<table>
<thead>
<tr>
<th>Question</th>
<th>FD Mean Disp</th>
<th>AC Mean Disp</th>
<th>IA Mean Disp</th>
<th>EA Mean Disp</th>
<th>TOTAL Mean Disp</th>
</tr>
</thead>
<tbody>
<tr>
<td>The board of directors should be responsible for:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4.2a) Stating publicly their judgement on whether adequate financial resources are available to enable the company to remain a going concern for at least 12 months from the date of approval of the financial statements.</td>
<td>1.68 Very low</td>
<td>2.19 Very low</td>
<td>1.80 Very low</td>
<td>1.78 Very low</td>
<td>1.86 Very low</td>
</tr>
<tr>
<td>(4.2b) Setting up systems of internal control that inter alia minimise opportunity for fraud and other illegal acts and maximise the likelihood that such irregularities will be detected.</td>
<td>2.21 Very low</td>
<td>2.44 Mod</td>
<td>1.82 Very low</td>
<td>1.77 Very low</td>
<td>2.06 Low</td>
</tr>
<tr>
<td>The board of directors should report publicly on:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4.3a) The process that has been applied when reviewing the company’s system of internal control.</td>
<td>2.12 Low</td>
<td>1.86 Low</td>
<td>1.78 Very low</td>
<td>2.15 Low</td>
<td>2.17 Low</td>
</tr>
<tr>
<td>(4.3b) The effectiveness of internal control.</td>
<td>2.47 Low</td>
<td>2.28 Low</td>
<td>2.13 High</td>
<td>2.77 Mod</td>
<td></td>
</tr>
</tbody>
</table>

1 Significant differences between all groups except between FD and IA.
2 Significant differences between AC and FD, AC and EA and between AC and IA.
3 Significant differences between FD and AC, FD and IA and between FD and EA.
All groups expressed strong or reasonably strong agreement with these proposals and there were few dissenters within the groups. One external auditor commented

The directors are primarily responsible for these judgements/procedures and the more this is emphasised the better. (EA)

It is perhaps surprising that finance directors were so strongly in favour of a requirement to report publicly on going concern and most respondents who gave comments tended to be concerned at the dangers involved in making explicit statements on this.

I think there would be great problems in taking responsibility for the next twelve months. (AC)

The danger with going concern statements is that they become self-fulfilling prophecies. A company that believes there are risks but doesn’t vocalise them has a far greater chance of survival than one who highlights potential problems. (EA)

There was also strong or reasonably strong agreement that directors should have a duty to set up systems of internal control to minimise fraud and other illegal acts, but internal and external auditors were more strongly in favour of this than finance directors or audit committee chairpersons. Respondents who made comments, however, implied that such a requirement was somewhat simplistic, without considering risk and cost benefit issues. Examples of comments were:

The Combined Code and Turnbull have gone too far. I am not convinced that the benefits outweigh the costs of the process. (IA)

Systems of internal control must be commensurate with an assessment of the likelihood of the financial impact of fraud/illegal acts. (IA)

Use of controls to address opportunities for fraud should seek to optimise the cost of control not minimise fraud or maximise likelihood of detection. (IA)
In principle I would strongly agree that directors should set up strong controls, but I am confused by the terms ‘minimise’ and ‘maximise’. Risks should be managed in accordance with risk appetite. If these risks are ‘minimised’ then the organisation will not be in business. (EA)

It would appear, then, that some companies may seek to manage the risk of fraud as they do other risks and the levels of control specifically geared towards prevention/detection of fraud will depend on the philosophy of management as well as on the likelihood of fraud occurring and its potential impact.

All groups expressed mild to strong agreement with the proposal to report publicly on the process of reviewing control effectiveness and on control effectiveness itself, with the mean scores indicating less enthusiasm for the latter.

As with question 4.2, respondents who made comments tended to express reservations on the issue of reporting. Typical comments were:

I have no problems with the responsibilities, but reporting on the effectiveness of internal control is fraught with difficulties. (FD)

The board of directors are not independent of the internal controls and so should not (on their own) report on the effectiveness of control. Also, what standards should the directors apply when assessing effectiveness? (IA)

4.3b is too onerous on directors. (EA)

Interviewees also tended to be of the opinion that, if any statements on going concern or internal control effectiveness were to be made, they should be made by the directors rather than the external auditors and that auditors, at most, should comment on the directors’ statement. However, once again, there was a great deal of reluctance to introduce further ‘boilerplate’ reporting as this was not regarded as helpful to the
stakeholders who read the financial statements. Respondents were also doubtful whether directors or auditors could make meaningful statements without unacceptable exposure.

One external auditor commented:

You cannot issue a guarantee that a company will be a going concern. A lot of it comes down to judgement. There are a number of areas you can go through – the management themselves, have they got the ability to actually carry the business on? Have they got enough cash or funding to be able to run it properly and take on debt knowing that they can actually settle it in due course? But how do you cover the unexpected? … There are a lot of judgement calls. (EA)

Another external auditor compared the cultural differences between the UK and the US. In the US, financial statements tend to give a detailed analysis of what could go wrong and where the risks are in the business. In the UK it is different.

You don’t see anything like that in UK reporting. UK reporting is a chairman’s report that tries to give a clear understanding of how the business has developed and tries to put a positive spin on the numbers where possible. It is to a certain extent a sales document. As is the operating and financial review. You do not see the same level of critical assessment or clear statement of the risks. These are left unsaid … . In the States people are used to being frank and open about risks. In the UK, if you did not change the cultural mindset, anybody talking about risks in the same sort of language would be assumed to be telling the world that they had major problems … Any description of an actual risk would be read to mean that such a risk had actually crystallised. (EA)

Without a cultural shift, then, reporting on an ad hoc basis about going concern and risk management could create a negative reaction unnecessarily.
The US approach was not regarded as ideal, however. One non-executive, who foresaw a move towards more overt reporting of risks in the UK observed that:

_Typically you see more reporting of risks in the US, but in a very negative way . . . . In the average US announcement there are bucket loads of caveats at the bottom, which basically say ‘Well you had better disregard everything that we have said above’. (AC)_

However, bland and general descriptions of risk management processes were regarded as being of little real benefit to shareholders and some interviewees were of the opinion that there was a greater need for directors to be more specific about the risks faced by their companies and the management processes in place. What is really required in this context is a clear statement of the major risks faced by the company and what is being done to manage them.

_Shareholders put up share capital on a risk and reward basis. I think that the key risks at the macro level in the business should be put forward to shareholders. They should be aware of what those risks are and the company’s stance towards them. (AC)_

**Summary**

- Although the benefits to investors from going concern assurances from directors were recognised, doubt was expressed that meaningful statements could be made without exposing directors and auditors to unacceptable exposure.
- Similarly, reporting of high level risks and how they were being managed was regarded as helpful to accounts users, but, without a culture change, it was difficult to see how such statements could be made without causing unnecessary anxiety. There was a resistance to making bland, ‘boilerplate’ disclosures on risks and their management.
External and internal auditor responsibility for reporting on risk management

Questions 4.4 - 4.7 deal with proposals for external and internal auditors to report on risk management issues. The results are shown in Tables 7.3 and 7.4
Table 7.3: Views on external auditor responsibility for reporting on risk management issues

<table>
<thead>
<tr>
<th>Question</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td>The external auditors should report on their review of <em>systems in place</em> for risk identification and management of:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4.4a) Financial risks</td>
<td>2.91 Very low</td>
<td>2.72 Low</td>
<td>2.58 Low</td>
<td>3.48 Low</td>
<td>2.92&lt;sup&gt;1&lt;/sup&gt; Low</td>
</tr>
<tr>
<td>(4.4b) Business risks</td>
<td>2.65 Very low</td>
<td>2.64 High</td>
<td>2.52 Mod</td>
<td>3.33 Mod</td>
<td>2.79&lt;sup&gt;2&lt;/sup&gt; Mod</td>
</tr>
<tr>
<td>(4.4c) Compliance risks</td>
<td>3.00 Very low</td>
<td>2.92 High</td>
<td>2.67 Mod</td>
<td>3.65 Low</td>
<td>3.06&lt;sup&gt;3&lt;/sup&gt; Mod</td>
</tr>
<tr>
<td>(4.4d) Operational risks</td>
<td>3.03 Very low</td>
<td>2.94 High</td>
<td>2.71 Mod</td>
<td>3.66 Very low</td>
<td>3.09&lt;sup&gt;4&lt;/sup&gt; Low</td>
</tr>
<tr>
<td>(4.4e) Other risks</td>
<td>3.00 Very low</td>
<td>2.95 High</td>
<td>2.72 Mod</td>
<td>3.61 Low</td>
<td>3.07&lt;sup&gt;5&lt;/sup&gt; Mod</td>
</tr>
<tr>
<td>The external auditors should report on their review of the <em>effectiveness</em> of risk management of:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4.5a) Financial risks</td>
<td>2.79 Mod</td>
<td>2.42 Mod</td>
<td>2.48 Mod</td>
<td>3.33 Very high</td>
<td>2.76&lt;sup&gt;6&lt;/sup&gt; Mod</td>
</tr>
<tr>
<td>(4.5b) Business risks</td>
<td>3.21 Low</td>
<td>2.94 High</td>
<td>2.88 Mod</td>
<td>3.92 Low</td>
<td>3.24&lt;sup&gt;7&lt;/sup&gt; Mod</td>
</tr>
<tr>
<td>(4.5c) Compliance risks</td>
<td>3.09 Mod</td>
<td>2.81 High</td>
<td>2.90 Mod</td>
<td>3.78 Mod</td>
<td>3.15&lt;sup&gt;8&lt;/sup&gt; Mod</td>
</tr>
<tr>
<td>(4.5d) Operational risks</td>
<td>3.29 Low</td>
<td>3.11 Mod</td>
<td>3.02 Mod</td>
<td>3.94 Low</td>
<td>3.34&lt;sup&gt;9&lt;/sup&gt; Mod</td>
</tr>
<tr>
<td>(4.5e) Other risks</td>
<td>3.29 Very low</td>
<td>3.11 High</td>
<td>3.04 Mod</td>
<td>3.96 Very low</td>
<td>3.35&lt;sup&gt;10&lt;/sup&gt; Mod</td>
</tr>
</tbody>
</table>

<sup>1</sup> Significant differences between IA and FD, IA and AC and between IA and EA.
Significant differences between IA and FD, IA and EA, EA and FD and between EA and AC.

Significant differences between IA and AC, IA and EA, EA and FD and between EA and AC.

Significant differences between all groups except between FD and AC.

Significant differences between all groups except between IA and AC.

Significant differences between IA and EA, IA and FD, EA and FD and between EA and AC.

Significant differences between EA and FD, EA and AC and between EA and IA.

Significant differences between EA and FD, EA and AC, EA and IA and between IA and FD.

Significant differences between IA and FD, IA and EA, EA and FD and between EA and AC.

Questions 4.4 and 4.5 focused on whether external auditors should report on the review of the systems in place for risk management or report on the effectiveness of risk management itself. There was not a great deal of enthusiasm for these proposals. On the whole there was mild agreement that external auditors should report on effectiveness of financial risk management rather than systems, but for other risks, respondents tended to be neutral about the proposals, with reporting on systems being regarded as preferable to reporting on risk management itself. External auditors were not in favour of taking on these responsibilities and expressed mild to strong disagreement on all the proposals. In nearly all cases external auditors scored these proposals significantly lower than all other groups. This appears to indicate an understandable reluctance on the part of external auditors to assume additional responsibilities without additional remuneration and/or caveats.

At the interview stage, individual respondents confirmed this impression and expressed concern that external auditors would not be able to address these issues. It was pointed out that the auditor’s responsibility is to form an opinion on the truth and fairness of the
financial statements and systems are examined as a means to that end. Any further extension of external audit responsibilities would have liability implications. Typical comments were:

*I don’t think auditors in a three week period have any chance of evaluating what it takes ten times the number of employees to wrestle with on an everyday basis. You cannot put impossible responsibilities on external agents. The responsibilities you enumerate are those of the directors as a whole. (FD)*

*External auditors should only have to report on an exception basis where there is contradiction in management’s view and the evidence that supports management’s statement. (IA)*

*I do not believe segregating the risk sources and having different processes according to sources is necessary. Also, a number of the questions seem to imply an extension of auditor responsibility. This would need to be considered in the context of liability limitation and ensuring the current expectations gap does not widen further. (EA)*

*In practice the pressures on auditors include providing the most economical services at the correct price. The audit therefore concentrates on risk areas impacting the financial statements, taking into account materiality. Any wider comfort would increase the work/fees and be strongly caveated. (EA)*

*As part of their work in carrying out the audit, auditors should be reviewing systems only to the extent required in order for them to form an opinion on whether the financial statements give a true and fair view. An extension to the work should not form part of their audit. (EA)*

Interviewees’ views on the role of external auditors in relation to risk management were explored. Views again varied but, in general, external auditors themselves held wider conceptions of their role in this area than did interviewees from the selected plcs. However one
external auditor felt that external auditors should restrict themselves to whatever work in this area was necessary in order to form an opinion on the truth and fairness of the accounts. Another external auditor took the view that this was an area in which external auditors had always held an interest and the changes (as a result of Turnbull and other developments) had come from management’s side:

*Things have not really changed. We might assess risk management more explicitly now, but we have always formed a view on those sorts of things. I think we are probably being asked more by management for our opinion on their risk management processes.* (EA)

The comments of another external auditor suggested that if things had changed in terms of the auditors’ position this might partially be as a result of the auditors themselves redefining the nature of audit risk:

*The traditional approach to audit risk - when risk auditing was first introduced – was concerned with the risk that you signed a wrong audit report. We are now introducing the idea that audit risk is the risk that the company fails to meet its strategic objectives. So it involves taking a much wider view, where we sit down with management and say, ‘Right what are your main risks? How are you managing these risks?’* (EA)

The same external auditor emphasised that this involves going beyond considering the components of the financial statements:

*One of the primary issues is that you have to understand the business of the client. If you do not do that, then you really are at risk of getting the opinion wrong and exposing yourself as a professional adviser or whatever. So you have to look at all the risks.* (EA)

An alternative view is that all risks potentially have financial implications and that risks cannot therefore be easily compartmentalised into those that hold implications for the financial statements and those that do not. The same auditor, however, made the point that auditors
in his firm did not get specifically involved in assessing the risks and the effectiveness of risk management itself and that it was client staff themselves who were probably best placed to do this.

Another auditor took the same line on who should carry out the assessment of risk but disagreed with the argument that the auditor should be reviewing all categories of risk:

While we have become more involved in risk assessment we don’t do the risk management for the client. We help them to understand whether the assessment they have done is comprehensive and consistent with our own risk assessment, but the risks looked at by the auditor are not nearly as broad as those considered by the company. We only consider non-financial areas if the cause of the potential contingency has already taken place. (EA)

While then, views of external auditors differed as to their role in the risk management area all the external auditors interviewed held (perhaps unsurprisingly) positive views of external auditor involvement in this area. As far as the other categories of interviewee were concerned views were less consistently positive. The head of internal audit of an international conglomerate was complimentary, however, about the way in which, in his experience, auditors had improved their approach to this area in recent years:

They do look at the business. And the business risks. They do a report and we see it discussed at the audit committee. They will have discussed the issues with me and they will have seen each of the groups individually. I think it has been enlightening to watch the improvements over the years on how they actually do look at risks and controls. I do not know why this should be the case . . . . It must be better training within their teams. (IA)

One audit committee chair thought that, although initially external auditors had involved themselves in risk management with a view to
increasing their non-audit fee income, the approach was now more appropriate:

Auditors have been trying to (adopt a more strategic business approach), but it was partly because they are all busy trying to drum up consultancy work, but they cannot do that, especially post Enron. They are now extremely focused on financial issues. (AC)

A finance director of an international conglomerate also saw parallels between moves towards more active risk management within companies and external auditors’ own risk orientated audit approaches:

We now have a meeting with the external auditors where they lay out the whole scope of the audit. It is really their risk assessment of the company. It is based on what we do with our risk assessment reviews and so on. They build that all up and that is how they set the scope and the type of work they are going to do for their audit. (FD)

As one finance director observed:

I suppose if you are communicating your strategy appropriately to your shareholders … then I think it would be wrong to audit in isolation of the strategy. Therefore I think for the audit to actually be meaningful, it has got to be done within the context of the group’s strategy … I think they should be able to give advice as to whether the organisation is in a position to implement the strategy. But I do not think that they should set the strategy in any way. (FD)

The comments of these interviewees highlight an important theme that was touched upon by several interviewees – the interface between the risk assessment work carried out within a company and contemporary business risk centred audit approaches as currently practised by the ‘Big Four’ audit firms. The previous interviewees clearly saw this increasing interface as a positive development. However, another internal auditor working for a smaller plc and
who had trained in external audit with one of the ‘Big Four’, was less enamoured of current developments in external audit. This internal auditor, interestingly, commented that the international audit firms were getting confused as to whether they were managing the clients’ risks, or their own.

*I think it is certainly true in the light of recent events, that the international audit firms have got confused about whose risk they are actually managing. Risk management is a term that is bandied around and not necessarily fully understood. A risk-based audit approach should be looking at the client’s risk. I think that is an entirely valid way of doing internal audit. From an external audit perspective you have other stakeholders involved and you also have reputational issues. The external audit firms are trying to manage their clients’ risks by looking at the way their business works and forgetting the risk to themselves of getting something wrong. And I think that we are now seeing that, with more of them moving back to substantive audit approaches. But the main reason for the audit firms wanting to take a risk management approach was that it then gave them other opportunities to generate revenue from their clients. That may be a cynical approach and I will accept that, but I think that there is a grain of truth in it.* (IA)

Other interviewees suggested that external auditors could make little meaningful contribution to the risk management area. One financial director was particularly negative and held the view that the external auditors could not be expected to carry out anything other than the most superficial examination over the whole gamut of risk management and control. Another finance director argued that the external auditors were not sufficiently involved with the company to make a meaningful contribution. However one audit committee chair, while believing that risk management and assessment was best dealt with internally, argued that the external auditors could bring
an additional valuable perspective to bear because of their industry experience:

*I think that risk management is best dealt with internally. But I think that external auditors have got a wider perspective. For example, our auditors also audit one of the international oil companies. I am happy with that, because they are operating in the same sector as we are. So our auditors have got expertise which I think is helpful to us. Additionally it is helpful that our auditors have got a wide range of clients and a wide range of industries. What we are doing may well be quite narrowly focused. It is like having non-execs having a broader perspective than the execs in the company.* (AC)

**Summary**

- The consensus view was that external auditors have a limited but positive role to play in relation to risk management within auditee organisations. Auditors recognise that their primary aim is to express an opinion on the financial statements, but that an understanding of the principal risks faced by the business and how they are being managed is an important means towards that end. Although auditors are now focusing more explicitly on client risks, there was no fundamental change to auditor responsibilities.

- On the whole, there was recognition that there were real benefits deriving from the audit firms’ move towards business risk oriented audit approaches and that, post-Enron, auditors were well focused on their responsibilities.

- However, some respondents held the view that there was a danger that auditors concentrated on company risks rather than audit risks (the risk of giving a wrong audit opinion) and that the new ‘strategic business approach’ was, in part at least, a vehicle for obtaining consultancy work under the audit umbrella.
Table 7.4: Views on internal auditor responsibility for reporting on risk management issues

<table>
<thead>
<tr>
<th>Question</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
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<tr>
<td></td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td>Internal audit should provide the audit committee (on behalf of the board of directors) with assurances regarding the systems in place for risk identification and risk management of:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4.6a) Financial risks</td>
<td>2.00</td>
<td>1.83</td>
<td>1.72</td>
<td>2.06</td>
<td>1.90</td>
</tr>
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<td>Very low</td>
<td>Very low</td>
<td>Low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.6b) Business risks</td>
<td>2.12</td>
<td>2.08</td>
<td>1.84</td>
<td>2.08</td>
<td>2.03</td>
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<td>Very low</td>
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<td>Very low</td>
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<tr>
<td>(4.6c) Compliance risks</td>
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<td>Low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.6d) Operational risks</td>
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<td>1.84</td>
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<td>Very low</td>
<td>Low</td>
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<tr>
<td>(4.6e) Other risks</td>
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<td>2.27</td>
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<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Internal audit should provide the audit committee (on behalf of the board of directors) with assurances regarding the effectiveness of risk management of:</td>
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<td></td>
<td></td>
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<td>(4.7a) Financial risks</td>
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</tr>
<tr>
<td>(4.7b) Business risks</td>
<td>2.23</td>
<td>2.36</td>
<td>2.02</td>
<td>2.24</td>
<td>2.21</td>
</tr>
<tr>
<td></td>
<td>Mod</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>(4.7c) Compliance risks</td>
<td>2.03</td>
<td>2.25</td>
<td>1.98</td>
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<tr>
<td>(4.7d) Operational risks</td>
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<td>(4.7e) Other risks</td>
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</tr>
<tr>
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<td>Mod</td>
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<td>Low</td>
<td>Very low</td>
<td>Low</td>
</tr>
</tbody>
</table>

1. Significant differences between IA and AC and between IA and EA.
2. Significant differences between IA and AC and between IA and EA.
Questions 4.6 and 4.7 asked whether internal auditors should report to the audit committee on the systems in place to manage risk or on risk management itself. The mean scores tended to be lower than for questions 4.4 and 4.5, indicating that respondents regarded this as more the province of the internal than the external auditor. While all other groups expressed reasonably strong agreement for these proposals, internal auditors themselves expressed strong agreement on taking on these responsibilities. Differences between the mean scores given by internal auditors and by other responding groups were statistically significant in the case of ‘other risks’ and this reinforces the results of other questions indicating that internal auditors hold a wider conception of their role than do the other respondent groups. In virtually every case, the preference was for reporting on systems rather than on the effectiveness of risk management itself.

One respondent summed up the relationship between internal and external audit in this area by commenting:

*I believe that internal audit should review the systems and their effectiveness and report the findings of their review to the audit committee. The external auditors should report following compliance testing of the internal audit work.* (IA)

Respondents’ view on internal audit reporting on risk management complement opinions on the scope of internal audit work set out in chapter five.

**External and internal auditor co-operation on risk management**

Questions 4.8 and 4.9 considered whether internal and external audit should work together on reviewing systems in place to manage risk or on reviewing the effectiveness of risk management itself. The results are shown in Table 7.5
**Table 7.5  Views on external and internal auditor co-operation in reviewing risk management systems**

<table>
<thead>
<tr>
<th>Question</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
<th>TOTAL</th>
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<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
<tr>
<td>External and internal audit should work jointly on the review of systems in place for risk identification and management of:</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
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<td>(4.8a) Financial risks</td>
<td>2.74 Mod</td>
<td>2.58 Mod</td>
<td>2.44 Low</td>
<td>2.85 Very low</td>
<td>2.65 Low</td>
</tr>
<tr>
<td>(4.8b) Business risks</td>
<td>2.97 Mod</td>
<td>2.83 Mod</td>
<td>2.90 Low</td>
<td>3.08 Low</td>
<td>2.95 Low</td>
</tr>
<tr>
<td>(4.8c) Compliance risks</td>
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<td>2.74 High</td>
<td>2.88 Low</td>
<td>3.10 Very low</td>
<td>2.89 Mod</td>
</tr>
<tr>
<td>(4.8d) Operational risks</td>
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<td>2.91 High</td>
<td>3.04 Low</td>
<td>3.21 Very low</td>
<td>3.03 Mod</td>
</tr>
<tr>
<td>(4.8e) Other risks</td>
<td>2.94 Mod</td>
<td>2.91 High</td>
<td>3.02 Low</td>
<td>3.21 Very low</td>
<td>3.02 Mod</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
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<td>2.66 Mod</td>
<td>3.10 Low</td>
<td>2.83 Mod</td>
</tr>
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<td>2.92 Mod</td>
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<td>3.33 Very low</td>
<td>3.10 Low</td>
</tr>
<tr>
<td>(4.9c) Compliance risks</td>
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<td>2.83 High</td>
<td>3.04 Low</td>
<td>3.35 Very low</td>
<td>3.04 Mod</td>
</tr>
<tr>
<td>(4.9d) Operational risks</td>
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<td>3.00 Mod</td>
<td>3.18 Low</td>
<td>3.41 Very low</td>
<td>3.21 Low</td>
</tr>
<tr>
<td>(4.9e) Other risks</td>
<td>3.18 Mod</td>
<td>3.00 Mod</td>
<td>3.14 Low</td>
<td>3.39 Very low</td>
<td>3.18 Low</td>
</tr>
</tbody>
</table>

1 Significant differences between EA and FD, EA and AC and between EA and IA.
As with questions 4.4 and 4.5, there was little enthusiasm for these proposals. Internal auditors agreed reasonably strongly that they should work together with external auditors in reviewing financial risk management systems, whereas external auditors were neutral on this proposal. In all other cases respondents tended to be, at best, neutral concerning the proposals. It is again noteworthy that external auditors, while neutral on co-operation on reviewing systems in place, disagreed to a greater extent than the other groups on co-operation in reviewing the effectiveness of risk management itself. The very low dispersion among external auditor respondents indicated a high level of consensus on this issue.

Individual respondents making comments tended to think that external and internal auditors should co-operate, but not to the extent of joint working, mainly because of the differences in their responsibilities. Typical comments included:

_I agree with the partnership principle with internal audit doing much of the work._ (FD)

_In my view external auditors generally should be independent of, and work separately from, internal auditors etc, but should be cognisant of all internal audit work._ (FD)

_I see external audit as charged with an overview of all of the above but internal audit is a tool to assist, to look at specific areas, but not to be responsible for the overall review._ (AC)

_The goal is to avoid duplication but also to meet external audit independence requirements._ (IA)

_I see risk management as being an internal issue which should be reported by the board. External audit and internal audit should work together but external audit should not report publicly on the issue. Any weaknesses should be identified by internal audit and if they are truly objective should/would be corrected by management._
Issues may arise if management are not prepared to take heed of internal audit but that is another issue altogether. (IA)

**Audit committee responsibility for reviewing risk management**

Questions 4.10 and 4.11 considered whether the audit committee should have responsibility for reviewing systems in place to manage risk or for reviewing the effectiveness of risk management itself. The results are shown in Table 7.6


**Table 7.6: Views on audit committee responsibility for reviewing risk management systems**

<table>
<thead>
<tr>
<th>Question</th>
<th>FD</th>
<th>AC</th>
<th>IA</th>
<th>EA</th>
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<td></td>
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<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
<td>Mean Disp</td>
</tr>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
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<td>2.18</td>
<td>2.16</td>
<td>2.05</td>
</tr>
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<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.10b) Business risks</td>
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<td>Very low</td>
<td>Low</td>
<td>Very low</td>
</tr>
<tr>
<td>(4.10c) Compliance risks</td>
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</tr>
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<td>Very low</td>
<td>Very low</td>
<td>Low</td>
<td>Very low</td>
</tr>
<tr>
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</tr>
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<td>Very low</td>
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</tr>
<tr>
<td>(4.10e) Other risks</td>
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<td>2.34</td>
</tr>
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<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>The audit committee should have responsibility for reviewing the <em>effectiveness of risk management of</em>:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4.11a) Financial risks</td>
<td>2.09</td>
<td>2.14</td>
<td>2.26</td>
<td>2.22</td>
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</tr>
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<td>Very low</td>
<td>Low</td>
<td>Low</td>
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<td>(4.11b) Business risks</td>
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<td>2.36</td>
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<td>Mod</td>
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<tr>
<td>(4.11c) Compliance risks</td>
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<td>2.46</td>
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<td>2.30</td>
</tr>
<tr>
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<td>Mod</td>
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<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>(4.11d) Operational risks</td>
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<td>Mod</td>
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<td>Mod</td>
</tr>
<tr>
<td>(4.11e) Other risks</td>
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<td>2.42</td>
</tr>
<tr>
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<td>Mod</td>
<td>Low</td>
<td>Mod</td>
<td>Low</td>
<td>Mod</td>
</tr>
</tbody>
</table>

1 There are no significant differences between any group for all questions in this table.
Across all groups there was strong or reasonably strong agreement that audit committees should have a duty to review systems and to review risk management itself. As for the previous questions in this section, reviewing systems was more popular than reviewing the effectiveness of risk management, although external auditors in this case made little distinction between them. All groups placed the most emphasis on the review of financial risks, although there was reasonably strong agreement that all risks needed to be examined.

Comments by individual respondents illustrated the support for audit committee involvement, with some respondents pointing out that it would be likely that the audit committee would delegate the responsibility for the work to internal audit. However, companies should be flexible in their approach. Examples of comments included:

_The audit committee should have responsibility for ensuring that the system of internal control is effective and this is best done via a risk management process integrated within the management process and assessed regularly by internal audit._ (FD)

_Presumably the audit committee would not carry out the review themselves, but would make use of appropriate arrangements (eg internal audit)._ (EA)

_Generally the audit committee should have such responsibilities. But again, one size does not fit all. In some companies, risk committees may usefully carry out such a role._ (EA)

On the other hand, a number of reservations were expressed, particularly on whether the audit committee would be able to take on such responsibilities, given their level of expertise and the time available to them. There was therefore a danger of audit committee overload. The view was that business risk management is a duty of the board as a whole and the board cannot abdicate from this duty. Typical comments were:
In practice, audit committees may not have the ability to assess these risks — may need to create risk management committees with expertise to do this. (FD)

The audit committee should not supplant the board as the appropriate forum for a review of business strategy, which is the ultimate business risk. The NEDs should play a full part in business strategy formation, not merely review. Much turns on the size and complexity of the company. (AC)

The review of risk is more appropriately undertaken by a separate risk committee to avoid overloading the audit committee. (IA)

I disagree with this proposal. This is the responsibility of the board in the first place. It may delegate the review but usually to a sub committee — eg a risk management committee reporting back to the board. (EA)

Summary

- Audit committees should have a duty to review systems and risk management itself. However, it was recognised that audit committees may have time and/or expertise limitations and could delegate the responsibility for the work to internal audit.
- Alternatively, a risk management committee comprising both executives and non-executives, reporting to the board, may be a more appropriate vehicle to provide assurance on the effectiveness of the risk management processes embedded in the business.

*Turnbull* increased the emphasis on the need to embed risk management in the normal processes at every level of the business and, at the interview stage, the researchers explored the influence of *Turnbull* on perceptions of, and approaches to, risk management.
A higher profile for integrated risk management

There was virtual unanimity among interviewees that *Turnbull* had been beneficial, particularly in the way in which the report encouraged the formalisation of risk management. This approach enabled risks to be documented, reviewed and discussed openly all the time. One internal auditor confirmed that:

*If I was a non-executive director in any organisation, what has come out of Turnbull would give me a great deal more comfort.* (IA)

Non-executive directors interviewed also endorsed the higher profile given to integrated risk management following *Turnbull*. One audit committee chairman admitted:

*I started off being very cynical about risk management . . . but as I have become involved in it and seen it working, I have gone completely the other way . . . . Probably this is one of the most important aspects of corporate governance that has really come in over these last few years.* (AC)

It is arguable whether *Turnbull* itself was the catalyst for these changes or whether it has merely made formal risk management more explicit and functioned as a vehicle for the implementation of a process that was already under way. However, there is little doubt that companies are increasingly seeking to embed risk management in the normal business processes.

It is important that *Turnbull* is not regarded purely as a compliance exercise. One non-executive director commented:

*Turnbull is a kind of minimum level. It is not value added at all. It is a compliance-oriented programme. The issue is to manage risk proactively against the risk of business objectives, and to look at ways of making better decisions out of that, rather than purely doing a tick in the box exercise which Turnbull can very easily turn into.* (AC)
The internal auditor in another company agreed:

*Turnbull has forced risk management to be a sort of paper-filling exercise, which is perhaps where it falls down a bit. I think for it to work properly, it has to be seen as being an intrinsic part of the business, good business sense.* (IA)

**Embedding risk management**

A recurring theme among all groups of interviewees was the recognition of the increasing attempts to embed a risk management and control culture into their organisations, following *Turnbull’s* requirement. Risk management was perceived as part and parcel of doing business rather than a further process that was ‘bolted on’. Typical comments were:

*Risks should not be divorced from what you are doing.* (EA)

*Every time you make a business decision you are weighing up the risk factors involved in that decision … I don’t think that any business decision is made ignorant of the risks.* (EA)

Embedding risk management was defined by one interviewee as:

*Communicating throughout the organisation what the risk and control philosophy is. People need to know throughout the organisation what is and what is not acceptable … . People need to know what risks are appropriate for them to take and what are not. They need knowledge to be able to make these decisions, so you have to have training, you have to have any tools that are needed … . You have got to get people to take ownership, so you need to make risk management part of their every day life. You have got to make it part of their appraisal systems. You have got to create a culture where people do not get blamed if they do things wrong, because it is a culture of continuous learning rather than blame.* (EA)
Internal audit tends to play a major part in the embedding of risk management, but mainly in a facilitating role. Ownership of the risks and the operation of the processes to manage the risks was the duty of staff at business unit level. One internal auditor explained how his organisation sought to embed risk management.

*I came in and implemented a business risk management system, a sort of tool kit that people could actually use, and installed reporting and understanding throughout the group. And a lot of my time is still spent in ensuring that it is actually embedded throughout the business.*

*First of all, there was the drafting of the guidelines for business risk management . . . . Then aligning the divisions’ risk concepts to the business strategy and business plans. Then we presented this to the board to explain how we were going to do it throughout the group. Thereafter we took the presentation material to the group and explained what we were trying to achieve, and the process. And we also set up a means of reporting at business unit level, which is then fed into the group risk register. All the information on business risk is contained within this database and over the course of the last couple of years we have gone out and ensured that it is refreshed and understood throughout the group.*

*Some risks at business unit level may seem critical to them but when you actually take it up to a group level, perhaps it loses its high significance in the scheme of things. So we go out to the locations and run sessions there going through examples with the various departments there.*

*So that is the bottom up approach from business unit level. And then it is a case of summarising the information and taking it to a higher level, to the risk management committee and taking it to director level there and checking what we have in terms of business risks is actually as they see it as well. So there is a two-way process in there.*
This way we are fairly confident we are managing the key risks and we assess the controls that they have over these key risks and do a bi-annual report on the effectiveness of these controls . And that goes up through the risk management committee for review and then goes up to the board. (IA)

On the basis of the interview discussions, the embedding of risk management can be conceptualised as a process of:

(i) Communicating the risk and control philosophy throughout the business
(ii) Maintaining a comprehensive record of major risks facing the company
(iii) Training of staff to take ownership of risks and to think of risk as part of their daily lives

(i) Communicating the risk and control philosophy

The establishment of an acceptable level of risk is driven by both internal and external factors. The culture of the company and specific industry considerations are major influences on the establishment of an acceptable level of risk, but in addition, external parties (eg banks) may constrain the organisation’s risk appetite. The key to communication of culture is open discussion to arrive at a group consensus on the appropriate level of risk appetite.

The internal auditor of one large plc commented:

The setting of risk appetite comes back to the culture . . . . If you have got an open communication where the only failure is not to disclose and tell it as it is, which is how we do it, then I think that people down in the companies feel they can think of risk, talk about it and all we are interested in is managing it . . . Our FD holds meetings with the subsidiary FDs and he sits eyeball to eyeball with them. And he asks them ‘Has anything happened that you want to tell
me about?’ And it is amazing what comes out in this face-to-face communication. (IA)

The finance director of a small plc echoed the view that the absence of a blame culture was a key to effective risk management.

*Here there is no blame culture, in that it is not a problem if somebody makes a wrong decision … and again, in my opinion, that reduces risk if you have the right people who accept that culture … So actually your recruitment is your first point of control risk management.* (FD)

The risk philosophy of the company is also dictated by its culture and the market’s perception of that culture. One internal auditor stated that:

*We are a conservative company, recognising who our investors are, and what risk appetite they have.* (IA)

In evaluating any project, therefore, the finance team carry out their valuation modelling with this in mind.

*We look at country risks. With the banks and other financiers, there is only so much you can do in some countries before they will start imposing restrictions.* (IA)

(ii) *Maintaining a comprehensive record of major risks facing the company.*

A wide variety of methods were used to identify risks. The main approaches were:

- Facilitated workshops or conferences
- Interviews
- Control Risk Self Assessment
Facilitated workshops or conferences

Several interviewee companies used risk workshops run by, or facilitated by, internal audit. One internal auditor in a small plc commented:

*If a risk workshop is run on a periodic basis to identify those risks, who better than internal audit to run that? You know what output you require, because ultimately that will form the basis of your audit plan. You know the business inside out. You also know the individuals involved and you are also aware of the politics.* (IA)

However, as the risk management director in one large plc commented, there is a danger that company management will become confused as to whether internal audit is there to act as facilitators or to check up on the business. For that reason, his organisation chose to separate risk management and internal audit.

*I have risk specialists whose job it is to work with businesses, to facilitate discussions, to help them prioritise their risks and to help to put action plans in place. And then we had the internal audit, which we call ‘business assurance audit’. And they look at the baseline controls of the business. They go through all of those processes to review the control processes that work within them.* (RD)

Risk management workshops in this organisation are run globally at every level – including the business unit level, HR, finance, information management, and the participants are required to submit all their risks in advance. The workshops involve discussion using anonymous voting technology to develop a prioritised set of risks, which are perceived as high impact and high probability. This voting approach helps to safeguard against individuals being excluded from the decision-making process. Management are then required to set up action plans and controls to mitigate these risks and to report on
this to the appropriate board, together with a report on the controls over the high impact, low probability risks.

The role of the risk management specialists in this situation is very much to encourage participants to think widely and to prompt them on specific issues where appropriate. But responsibility for the identification and prioritisation of risks and the development of control procedures to track and manage these remains with line management.

A typical comment was:

*Line management must have the controlling hand. That is absolutely fundamental. And you have to have an independent group that can review that. We (risk management) help them do the assessment, and we then get managers to take ownership.* (RD)

This particular risk management director commented that the executive director in charge of a major geographical area told him:

*What I really like about this structure that you have got is that you send two of your risk specialists in to work with my team to help identify the risks so that we take ownership for them and we put our action plans in place. I much prefer that to the method you used to have, when you sent someone in for three weeks and then told me the things I do wrong.* (RD)

The internal auditor in another organisation described how, at an annual conference, senior managers of group companies in a given sector discuss the risks they face and the controls in place to manage these risks. In common with a number of interviewee organisations, a matrix of risks is produced to prioritise the risks by probability and impact, and controls matched against these risks. The results of this exercise are then cascaded up to the next level of the company, and a summary report is prepared by the operating groups. Internal audit is involved in reviewing all the major inputs to this document, which
are then discussed by the audit committee, and finally by the group parent board.

The finance director of this company summed up by saying that:

*Assessing risks and control effectiveness is not just a process where people fill in forms, send them in and we consolidate them. There is a whole review and debating process. You will have it at the lowest self-accounting unit. And then it goes up to a divisional level and to a major division level at which point the internal auditors get involved in the details. Then eventually we put it together for the whole plc. (FD)*

One audit committee chairman explained that:

*Most of the companies I am involved in, we try to persuade executive management that they should go away and have an away day. This is not a process within a company that should only involve board members, but really you should try to get it to work its way down through the company. Everybody has a contribution they can make on certain of these areas of risk. (AC)*

**Interviews**

As an alternative to, and sometimes in addition to formal workshops, a number of internal auditors/risk managers carried out interviews and discussions with line managers to identify, prioritise and manage risks. These interviews were also often conducted by internal audit. The internal auditor of one company explained that the way he approached these issues when he first started was to ask line managers:

‘OK, what are your top three issues?’ Not risks, but issues. They may actually be risks: they may also be opportunities for improvement. And that, of course, is the other way to consider risk. There is also
a risk of us missing the boat if we do not do something. That is the way you want people to think about the business and that’s how you take the business forward, and I think it’s an ongoing educational exercise. (IA)

In this kind of situation, internal audit is acting as a partner with line management, seeking to add value to the business by assisting in the risk management process, but avoiding too much intervention in case they impede the performance of the individuals who actually do the job. The success of internal audit in this regard can be measured by the extent to which the communication is two-way. The internal auditor explained:

If internal audit has got people thinking of risk, but also if these people have issues that they need addressing, but they do not have the resources or the skill set within their teams, and they are coming to internal audit without having to be prompted, then you have got a successful internal audit department. (IA)

The internal auditor in this company reports to the finance director, who described how the risk analysis is performed by the executive team, and then discussed with internal audit in order to identify the areas to investigate. The internal audit function, being extremely small, uses secondees from the operating groups to perform that type of work, because they are the people who really understand the issues. This work is supplemented by the establishment of continuous improvement groups.

These groups are responsible for monitoring risks and solving the issues as well. Coming up with solutions which ameliorate risk. So you are pushing the task down into the company as much as you can. (FD)
It was interesting to see an internal auditor function so integrated with the risk monitoring process. The issue of internal auditor independence was not perceived as a problem.

From an internal (audit) perspective, it is how you actually manage yourself within the business. If you show yourself as being objective, commercially aware, you are not going to be messed around by any individual regardless of who they are. You are therefore shown as having integrity. I think integrity is far more important than independence, although the two are inextricably linked. (IA)

One small plc which did not have an internal audit function, had established a risk review committee comprising both executives and non-executives.

We established, at group board level, risk management as a constant agenda item. And we set one of the non-executives with the task of pulling together under his chairmanship, a committee of the board to deal with risk management. The risk review committee reports to the main board on a two-monthly basis. (FD)

The audit committee chairman of another company explained how they had also set up a risk management committee following Turnbull, in addition to a small internal audit team. This committee also contained both executive and non-executive directors, drawn from a wide range of areas within the organisation.

We came from a standing start a few years ago when we knew we had to formalise a process, as a result of Turnbull and having to sign off on the company’s risk management procedures. We have regular meetings, probably every six weeks to two months. And we just talk about all the areas of risk in the business, and we prioritise them. We start with the big areas of risk and then we drill right down into the detail … . We have quite a broad spread of experience there,
all trying to make sure that risk, in its broadest and most detailed sense, is embedded in the business. (AC)

The internal audit team here addresses a wide variety of areas including risk management, compliance, ethics and internal audit. The head of internal audit is a member of the risk management committee and liaises regularly with it, as well as having a direct line to the audit committee.

We keep in touch with him. We know what he is doing and we talk about the risks, and their prioritisation. And there is a close relationship. (AC)

In this company the internal auditor makes a year end presentation to the board, reporting his findings, which helps the main board to sign off the financial statements.

Control risk self assessment

Some companies operated a formal system of control risk self assessment (CRSA). This approach usually involves line management at operating unit level supplying a statement to the board of directors covering compliance with codes and regulations and providing an overall assessment of the principal risks faced by the unit, prioritised by reference to a risk matrix. The statement would also typically outline the procedures in place to manage the risks. These documents would then be consolidated by the senior management, or a risk committee operating at parent board level. In one organisation, for example, this process took place annually, and the internal auditor confirmed that he used the completed forms as a basis for part of his audit work. The finance director explained that:

Every single unit has to certify to the chief executive every year. He has to write to the chief executive and say ‘I have gone through the
whole process and I have followed all the forms with the following exceptions’. And we get a whole list of exceptions and we have to follow them up. (FD)

Another organisation followed a similar approach, using a risk management committee.

The committee consists of the chairman of the board, the finance director and the general manager. In addition, we have company secretarial input, finance input, technical operations input, legal input. We have a risk register that goes down throughout the organisation. You have got to have a top down approach and the board has an obligation to manage the major risks to the business. And we issue letters to all the country managers and to the departmental managers saying ‘do you confirm that you are complying with Turnbull and that you are mitigating the major risks and that you have a review process and so on’? And this is passed up through the risk management committee and forms one of the bases for internal audit work. (FD)

However, some interviewees were unenthusiastic about a CRSA approach, on the grounds that it could degenerate into a paper pushing exercise. One internal auditor commented that:

We have two control risk documents. There is a self-assessment control risk document and then there is a separate control risk document, which is done nearer the end of the audit and which gives them a score based on a list of different criteria … If the score is over a certain amount then these become audited on a more regular basis than if it is less risky … But the difficulty with a lot of the self assessment is sometimes from a resource standpoint to get this stuff completed before we get out there. And then once we get out there it could become redundant to do it because we are actually doing the work ourselves. (IA)
A CRSA approach then could be effective if it was tackled properly, but if it was regarded as a form filling exercise required by head office or internal audit, local management may be tempted not to take it seriously.

These approaches are not mutually exclusive and organisations use a variety of methods to identify and monitor company risks. It was widely recognised, especially in larger organisations, that it was essential to draw on the experience of line managers and others at the individual business level for this, since these employees are involved in day-to-day operations. Considerable effort was being made, therefore, to tap into the knowledge and experience of staff at individual business level to make sure that, as far as possible, all significant issues are identified. It is also important to ensure that staff ‘buy into’ the risk management process.

(iii) Training staff to take ownership of risks

Interviewees were unanimous in the view that ownership of risk had to reside with line managers. This meant that there had to be a continuous education process to encourage staff at all levels to ‘think risk’ constantly when planning, monitoring and reviewing projects. One risk management director said that he had asked his CEO what success would look like in his department. The response was:

_When people come to me on any major project or performance contract and they actually include a discussion on risk in that, then I will know that you have succeeded._ (RD)

This approach means that local management, rather than internal audit, have to identify risks, prioritise them and develop their own tracking processes to monitor and manage them. In addition they need to operate their own control systems, both to prevent problems from arising and to ensure that business opportunities are identified.
The role of internal auditors and/or risk managers is to act as facilitators in the risk identification and management process and confirm that the established controls are operating effectively. In this way internal audit can keep their distance from the process itself.

Internal audit philosophy in relation to risk varied across the interviewee companies. In some cases internal auditors were risk managers focusing their attention on the company’s detailed risk identification and monitoring. In other organisations they were financial auditing experts monitoring control effectiveness, and in some companies, although they had a financial background, they spent most of their time investigating why projects were not being delivered on time. However, in all cases, internal audit acted as a check on processes rather than being part of these processes.

There is a danger that risk management is perceived as a ‘compliance issue’ – something that is done to meet Turnbull requirements, which will lead to additional bureaucracy. Risk management procedures need to be firmly identified with the strategic objectives of the organisation, with a view to improving performance and increasing shareholder value. This approach more readily focuses management’s attention on their accountability for risk management.

One audit committee chairman summed up by saying:

*Risk management is about managing risk proactively against the risk of business objectives and looking at ways of making better decisions out of that. (AC)*

The final key to successful embedding of risk management was the interest taken in the subject by the parent board. In the boards of all interviewee companies, risk management was regarded as a serious issue, following Turnbull’s requirement for directors to report thereon. This was evidenced by the establishment of high level risk management committees and the retaining of risk management as a standing board meeting agenda item. In addition, the board requirements for regular
reporting on risk assessment from lower levels of the organisation and the demand for risk considerations to be built into project documentation encouraged staff to approach their work from a risk management perspective.

**Summary of results relating to The Turnbull Report**

The main conclusions from responses on the issues arising from *The Turnbull Report* are:

- All groups endorsed the view that a company’s system of internal controls should embrace an evaluation of a comprehensive range of risks, but some concern was expressed that all aspects of risk management might not be included within the definition of ‘control’ and that there was a danger that concentration on operational risk management might result in a failure to deal with basic accounting issues.

- There was agreement across all groups that directors should have responsibility for setting up internal control systems and reporting publicly on the processes for reviewing control effectiveness and, to a lesser extent, on the effectiveness of internal control itself, although the difficulties of concluding on ‘effectiveness’ were noted. A number of internal and external auditor respondents also pointed out that the cost-effectiveness of controls to prevent or detect fraud had to be considered before they could be implemented.

- It was widely recognised that responsibility for control review and going concern assessment rested with the directors rather than the external auditors. Although auditors are increasingly investigating risk management as part of the new business risk approach it is not feasible for their investigations to be as comprehensive as those of management since auditors have less time and knowledge of the business.
There was a recognition that attempts should be made to disclose key risks at the macro level together with an explanation of the processes to manage these risks, and, while recognising the exposure dangers from making such statements, there was no enthusiasm for more ‘boilerplate’ comments in financial statements.

There was strong or reasonably strong agreement among all groups that the board of directors should be responsible for stating publicly their judgement on the adequacy of financial resources to enable the company to remain a going concern. Finance director respondents were particularly in favour of this proposal, but some respondents expressed concern at the dangers of making explicit statements on going concern.

There was little enthusiasm for the proposals that external auditors should report on risk management systems. External auditors themselves mildly or strongly disagreed with the proposals and a number of respondents across all groups pointed out that such work should not be part of the remit of the external auditor.

Reporting on risk management was regarded as the province of the internal rather than the external auditor and internal auditors expressed strong agreement to taking on this role. However, such reporting would only be done internally.

As with the proposals for external auditors to report on risk management systems, respondents tended to be, at best, neutral on proposals for internal and external auditors to work jointly on the review of risk management. Comments made suggested that internal and external auditors should co-operate, but not to the extent of working jointly.

There was strong or reasonably strong agreement that the audit committee should have a duty to review risk management systems and risk management itself and a number of respondents stated that this might well be delegated to internal audit. Concern was expressed that audit committees may not have the expertise or the time to do this work effectively and a risk committee
comprising executives and non-executives was suggested as a more appropriate alternative. It was recognised that risk management was a responsibility of the whole board rather than a subset of it (eg the audit committee).

- It is clear that Turnbull is regarded as having been beneficial, in that it encouraged the formalisation of risk management within organisations and facilitated the move towards embedding risk management within business processes. Organisations are working towards making consideration of risk a formal part of their everyday activities.

**Issues for consideration**

- In reviewing risk management and control effectiveness, it was widely recognised that a broad spectrum of control areas was required to be addressed and there were no suggestions the review should be limited in any way, for example to financial controls only. However, it is important that the establishment of control systems be subject to cost/benefit analysis and the precise nature of controls and risk management procedures will depend *inter alia* on the risk appetite of management. The laying down of detailed rules in this area may be unhelpful and a number of the respondents believed that Turnbull had gone too far in this respect.

- Statements reporting on the effectiveness of controls, risk management and the status of the organisation, should be made by management rather than by the external auditors. Auditors can usefully comment on statements by management. It is difficult, however, for meaningful statements to be made without risking exposure to litigation and respondents were not in favour of more ‘boilerplate’ comments. In addition, reporting on specific risks faced by a company may, without a culture change in the UK, result in financial statement users reading more into the directors’
statements than is warranted and drawing inappropriate negative conclusions.

- Notwithstanding this, boards should be encouraged to report more specifically on the principal risks faced by the company and the procedures in place to manage these risks. The Operating and Financial Review (OFR) might be an appropriate place for these matters to be reported and, since the process that produces the OFR is likely to be subject to audit, this may provide an opportunity for more meaningful reporting on the risk management process.

- The increasing interface between the external auditors and client management in reviewing risk management is regarded positively, and there is little concern that this has an impact on auditor independence. However, there is a danger that changes in the definition of audit risk may lead auditors to concentrate more on their clients’ risks (the risk of failing to achieve strategic objectives) rather than their own (i.e., the risk of giving an inappropriate audit report).

- A variety of methods are used for the embedding of risk management within the day-to-day operations of different organisations including the holding of workshops, interviews and the establishment of a control risk self-assessment system and there is scope for further research into good practice in this area.
CHAPTER EIGHT

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This chapter summarises the findings and conclusions on developments arising in the areas investigated together with recommendations for change. In addition, suitable areas for further research are also identified.

Corporate governance issues

Existing corporate governance mechanisms are perceived as adequate for the most part. In general, it is felt that the system works reasonably well. The UK approach to corporate governance is seen as superior to more rules-based approaches. At the same time, there is recognition of the limitations of any system of corporate governance. There is also widespread recognition that the existing system of UK corporate governance is dependent on the integrity and competence of individuals and that its effectiveness is particularly sensitive to these considerations. However, in the wake of much adverse media comment about the effectiveness of UK corporate governance in 2001 and 2002 there is a need for consideration as to how UK corporate governance can be strengthened in order to enhance stakeholder confidence while at the same time retaining its self-regulatory character. The Higgs (2003) and Smith (2003) reports aimed at improving the effectiveness of, respectively, non-executive directors and audit committees have an obvious relevance here and in this concluding chapter each of these reports is discussed in relation to the findings of the present research.
Non-executive directors

There is no discernible UK opinion in favour of corporate governance systems incorporating European-style supervisory boards. The unitary board system within the UK was strongly endorsed. Supervisory boards were perceived to be bureaucratic and ineffective. A unitary board consisting of competent executives, supported and monitored by capable and motivated non-executives, was seen by most participants in this research as the most appropriate way forward.

The contribution of non-executive directors is likely to remain pivotal to the effectiveness of UK corporate governance. The results of this research indicate that, on balance, the performance of non-executives is regarded as satisfactory. Extensive adverse media comment on non-executives in 2002 does not appear to strongly echo the opinions of either external auditors or key individuals in UK companies. Nevertheless, a significant minority of participants in the present research expressed negative opinions about the effectiveness of non-executive directors. The point made above about systems of corporate governance being dependent on the integrity and competence of individuals, applies particularly to non-executives.

Non-executive directorships are no longer seen as sinecures and more is being demanded from non-executives than at any time in the past. The quality of non-executives appears to be improving and non-executives are increasingly being recruited for their skills in financial, corporate governance and business matters and for their ability to offer an outside perspective on the company’s activities rather than for reasons of business or social connection. The ‘old boy’ approach to appointing non-executives is seen as largely a thing of the past. At the same time factors such as lack of training and lack of understanding of the role inhibit non-executive effectiveness. Doubts were expressed by participants in the research as to the influence that could be reasonably exercised by non-executives in the face of entrenched positions taken
by the executive directors, or where information was not supplied to non-executives.

Opinions as to the increasing demands on non-executives are matched by concern about the risk/rewards package for non-executives and about the shortage of suitably qualified candidates. Participants in this research acknowledged that the limited pool of non-executives with the requisite skills and experience is a major problem.

There is an urgent need to identify ways by which these problems may be alleviated. Non-executives require to examine their portfolio of directorships to ensure that they are able to meet their responsibilities as directors and to cope with any potential demands on their time and resources. However more active measures may be required and despite the reservations of many of the participants in this research about a regulatory approach to non-executive director requirements there may be a place for formal regulation regarding issues such as the maximum number of non-executive directorships that may be held by any one individual and ‘cross-holdings’ of executive and non-executive directorships. It may also be appropriate to consider the pivotal role of company chairmen and the separation of the roles of chairman and chief executive.

The limited pool of sufficiently skilled individuals might be tackled by initiatives aimed at encouraging suitable skilled and motivated young executives in public companies to seek non-executive directorships as a means of broadening their experience and contributing to the effective running of UK plc.

The research summarised above engages, then, with two major sets of issues concerning the effectiveness of non-executives:

- Firstly, the independence and influence of non-executives were highlighted. These were seen to be vital issues by research participants although there are strong and widespread views as to the limitations of an overly regulatory approach in this area and to the difficulty of defining ‘independence’ in a meaningful way. Because of this, the present report does not make specific proposals
in this area other than a proposal to control ‘cross-holdings’ of executive and non-executive directorships.

- Secondly, the research highlights the shortage of, and demands on, non-executives and measures to deal with these issues are proposed, including limits on the number of non-executive directorships that may be held by any one individual and an initiative to facilitate the development of suitably qualified younger executives into non-executive roles.

Each of these sets of issues is dealt with by Higgs. Higgs proposes various measures related to the first set of issues in order to secure the independence of non-executives. These include proposals for at least 50% of board memberships to be composed of non-executives. Potential problems with this proposal may include sourcing the required number of independent non-executives, the expense involved for smaller companies and the creation of unnecessarily large and unwieldy boards. As regards the second set of issues, Higgs does not suggest any limit to the number of non-executive directorships held, beyond stating that individuals should ensure that they have enough time to fulfil their duties and that full time executives should restrict themselves to one non-executive role. In addition, Higgs proposes that a potential list of non-executives from the non-commercial sector should be drawn up. These suggestions are consistent with, although not identical to, the suggested measures detailed below in the new proposals four and five. A third set of issues relating to the role of non-executives concerns their relationships with shareholders and this area is addressed below.

**Shareholders and other stakeholders**

There is evidence that shareholders are taking a more active interest in corporate governance issues than ever before. Shareholders and
analysts are playing an increasing role in governance and are actively appraising the calibre of board members including non-executive directors. While much shareholder intervention is centred on the existing extensive nexus of informal meetings between institutional shareholders and management, there may be scope for the development of additional fora, eg shareholder committees, to facilitate a more formal role for shareholders in corporate governance. The question as to whether institutional investors should meet routinely with non-executive directors should also be addressed. Higgs deals with this issue by proposing that a senior independent director should act as a conduit for shareholders to raise matters of concern. The researchers are cautious about this proposal believing that there is some danger that it could threaten the cohesion of boards. The importance of all directors working together in unity was a matter that was stressed by some participants in the present research. Additionally, it may well be the case that the senior independent director has only incomplete information on some matters. This would create the potential for misunderstanding. Several participants in the research stressed that non-executive directors cannot expect to have the same quality of information available to them as can the executives. It is therefore suggested instead, in new proposal seven detailed below, that attention is given to the development of various fora that will facilitate shareholders to assume a more active role in corporate governance.

At the same time there is recognition of the need to engage with a much wider constituency of stakeholders than hitherto. It is very much the case, however, that shareholders continue to be recognised as the primary group to whom corporate boards are responsible and it was the view of virtually all participants in this research that the enhancement of shareholder value remains the primary business objective.
**Scope of internal control**

There is general endorsement of the view that internal control systems should cover a comprehensive range of risks, but some concern was expressed that too great a concentration on operational risk management might result in a failure to deal with basic accounting issues. The nature and extent of control systems – eg on the detection and/or prevention of fraud – should be subject to cost/benefit analysis and the precise nature of controls and risk management procedures will depend on the risk appetite of management. The laying down of detailed rules in this area may be unhelpful and a number of the participants in this research believed that *Turnbull* had gone too far in this respect.

**Reporting on internal control**

Directors should have responsibility for setting up internal control and risk management systems and for reporting publicly on the processes for reviewing control effectiveness and/or the effectiveness of internal control itself. It is recognised that there are difficulties in concluding on control ‘effectiveness’. There is a high degree of consensus that boards of directors should be responsible for stating publicly their judgement on the adequacy of financial resources to enable companies to remain going concerns. While auditors may be able to provide useful comment on public statements made by management there is an opinion that it is difficult for auditors themselves to make meaningful statements of this type without increasing the exposure to litigation. Additional ‘boilerplate’ reporting by auditors or directors would not be regarded favourably. It is therefore proposed that statements reporting on the effectiveness of controls, risk management and the status of the organisation, should be made by management rather than by the external auditors. There is a significant opinion against reporting on the *specific* risks faced by companies.
Embedding of risk management

*Turnbull*, together with associated developments, has encouraged the formalisation of risk management within organisations and facilitated the move towards embedding risk management within business processes. Organisations are working towards making consideration of risk a formal part of their everyday activities. Further research is proposed into good practice in this area including consideration of the most appropriate methods for the embedding of risk management.

Establishment of audit review panels

The proposal to establish audit review panels (ICAS, 1993; Fraser, Henry and Wallage, 2000) has little support either within public companies or within the external auditor constituency itself. Most participants in the research believed that an effective audit committee could fulfil the proposed review panel’s functions more effectively. Given the very obvious lack of enthusiasm for the establishment of audit review panels, attention needs to be paid to measures aimed at making existing audit committees more effective. However such measures need to take cognisance of the strong sentiment of an antipathy towards ‘boilerplate’ rules-based approaches to enhancing the effectiveness of audit committees. Smith (2003) makes various recommendations and these are commented on below. Attention also needs to be given to identifying other measures that might strengthen external auditor independence.
External audit issues

Contemporary audit developments and external auditor independence

Close auditor interaction with directors is regarded as having positive benefits in that it enables a greater understanding of the client’s business and thereby offers opportunities to identify and assess a wider range of risks that could affect the financial statements.

There is no general opinion that contemporary developments threaten auditor independence although there are reservations about the contemporary ‘partnership’ approach. There is concern that contemporary audit approaches consider issues at too high a level and there are indications that a return to more ‘basic auditing’ in the form of substantive tests would be welcomed by some interested parties.

Audit committees do appear to have a role to play in monitoring external auditors’ independence. This may include issues such as the level and nature of non-audit work offered to auditors. There does not appear to be strong support for audit committees to assume responsibility for the formal appointment of external auditors.

External auditors themselves, however, are robust in defence of contemporary audit approaches and indicate that, irrespective of current fashions and ‘packaging’, in the final analysis they are putting their name and reputation on the line by endorsing their clients’ financial statements. They appear to regard their reputation as being more important than the need to retain individual clients.

External auditors and risk management

Although external auditors are increasingly investigating risk management as part of the business risk approaches that are now part of the audit methodologies of the international auditing firms it is not regarded as feasible for the scope of their work in this area to be as comprehensive as that carried out internally. The increasing interface between external auditors and client management in reviewing risk
management is regarded positively. However, there is some perception that changed audit methodologies may lead auditors to concentrate more on client risk rather than on audit risk.

There is little enthusiasm for external auditors to report on risk management systems. Reporting on risk management is regarded as the province of the internal rather than the external auditor.

**Redesignation of external auditors as external assessors**

It is clear that there is little discernible support for the ICAS (1993) and Fraser, Henry and Wallage (2000) proposal that external auditors should be re-designated as external assessors and this proposal, therefore, should be abandoned.

**Internal audit issues**

**Establishment of enhanced internal audit functions**

There is wide support for the establishment of strong internal audit functions with wide-ranging remits. In general, the trend is to move away from large internal audit departments performing low level work to a smaller group of high calibre individuals able to address strategic and high level issues, reporting to the chief executive.

It is clear, however, that the ICAS (1993) and Fraser, Henry and Wallage (2000) recommendation that all listed companies establish enhanced internal audit functions does not meet with universal approval. Consideration needs to be given to how this recommendation might be appropriately moderated and to what other alternative control strategies might be appropriate in certain cases. The requirement to establish internal audit functions might be moderated by a size exemption although care would be required in order to ensure that any such exemption would be framed appropriately and with sensitivity to the nuances, complexities and different risk characteristics of
different organisations. In cases where an internal audit function is not considered to be necessary, alternative control mechanisms might include any or all of the close involvement of the audit committee in operational decisions, peer reviews across the business, self-assessment by senior managers and the establishment of a risk management committee or equivalent. Attention needs to be given to the development of alternative control frameworks for application in cases (eg smaller public companies) where a dedicated internal audit function is considered to be uneconomic or otherwise undesirable.

**Scope of work of internal audit functions**

There is wide support for internal audit functions to be involved in a broad spectrum of audit work. Internal audit functions tend to be increasingly involved in risk management, but usually in a review, rather than an operational, role. One reason for this is that most organisations are conscious of the need to maintain internal audit independence within the organisation. In addition, a significant minority of larger public companies have established separate risk management functions and the available evidence suggests that this trend is likely to continue. Further research is necessary into the issue of the appropriateness of alternative organisational arrangements for internal audit and risk management. One issue is whether public companies of a certain size should establish separate internal audit and risk management functions.

**External/internal auditor co-operation**

There is broad support for collaboration between external and internal auditors in the more routine areas of audit work. However there is much less support for collaboration in the more judgemental audit areas and in particular as regards the going concern status of the
company. It is clear that co-operation between external and internal auditors of the sort envisaged by the ICAS (1993) and Fraser, Henry and Wallage (2000) proposals is not regarded as feasible. This is largely because it is believed that internal and external auditors have different objectives. There is, however, evidence of significant co-operation between the internal and external auditors especially in areas such as audit planning and control testing. This co-operation ranges from ad hoc consultations to extensive use by external auditors of internal audit control templates. There is also evidence of co-operation on the compliance work required to meet the _Turnbull_ requirements.

Given the variety in the size and scope of businesses, therefore, as well as in the type and expertise of internal audit functions, it is not considered that regulation and detailed recommendation on the nature and extent of internal–external auditor co-operation is likely to be useful.

**Audit committee issues**

**Audit committee membership, duties and effectiveness**

The results of the research indicate that _The Blue Ribbon_ proposals on audit committee membership and duties are widely supported and largely non-contentious.

However, the proposals relating to specific disclosures by audit committees in the financial statements are not favourably regarded. Public reporting by audit committees would generally not be welcomed by interested parties.

A general lack of enthusiasm for regulation as a way to improve audit committee effectiveness is evident and strong reservations were expressed about a proliferation of ‘boilerplate’ reporting. This was especially the case for smaller organisations where flexibility was regarded as essential.
There is little enthusiasm for the idea of audit committees giving an opinion on the financial statements. Similarly there is little support for the proposal that audit committees should formally appoint the external auditors.

The results of the research indicate that the qualities sought in audit committee members tend to be intangibles such as independence of mind, integrity, trustworthiness, experience and the strength of character to ask difficult questions. Formal qualifications are regarded as relatively unimportant. Smith (2003) has recommended, however, that at least one member of each audit committee should possess a professional accounting qualification together with recent and relevant financial expertise. Smith has recommended that the remaining members of audit committees should possess a degree of financial literacy. The researchers are sympathetic to these proposals; however there are reservations about Smith’s further proposal that at least three independent non-executives should serve on each audit committee because of potential recruitment problems particularly for smaller companies.

There is a need for proposals that facilitate the appointment of individuals with the requisite personal qualities to audit committees. Consideration might be given, for instance, to the establishment of mechanisms through which shareholders might have a formal role in the appointment of audit committee members.

Audit committees and risk management

The general view is that audit committees have only a limited role in the risk management area. Proposals to make audit committees responsible for risk management, for giving opinions on the financial statements and for the appointment of external auditors are not regarded with enthusiasm. Such issues are considered in general to be matters for the entire board rather than a subset of it although
some organisations are delegating this responsibility to dedicated risk committees, comprising both executives and non-executives. Some participants regarded risk committees to be a more appropriate vehicle for the direction of internal audit on the grounds that they were believed to be able to address a wider range of issues.

**Overall summary and recommendations**

In this concluding section the researchers comment on the feasibility and desirability of implementing the revised proposals on the future of audit and corporate governance made in Fraser, Henry and Wallage (2000). Additional proposals are made based on the views on contemporary corporate governance and audit issues of the various stakeholders groups that participated in this project.

The proposals made by Fraser, Henry and Wallage (2000) are indicated below in italics and the proposals retained or amended as a result of the present research in bold italics.

1 *(Retained from ICAS, 1993)* Each company should appoint a strong internal audit team that is capable of providing the audit committee with sufficient information to fulfil its responsibilities on behalf of the board.

It is clear that there is a widespread view that internal audit should have wider reporting responsibilities than merely to the audit committee. It is also evident that it may not be appropriate to require all listed companies to establish internal audit functions. It is suggested therefore that this proposal be amended as follows:

*Amended Proposal 1 – Each company should establish monitoring procedures that are capable of providing the board of directors with sufficient information to fulfil its responsibilities in relation to control, risk management and other areas as appropriate. In the vast majority
of cases this will involve the appointment of a strong internal audit team, but, in situations where the establishment of such a team is not thought to be appropriate, boards of directors should justify this decision by reference to the alternative processes in place to enable them to fulfil their duties.

2 (Retained from ICAS, 1993) The findings of each investigation by the internal audit function should be reported to the chief executive, the audit committee and the external assessors.

There was little support for the renaming of the external auditors as external assessors. It is proposed therefore that this proposal be amended as follows:

**Amended proposal 2 – The findings of each investigation by the internal audit function should be reported to the chief executive, the audit committee and the external auditors.**

3 (Extended proposal) The recommendation in ICAS (1993) that the chief internal auditor should report on the establishment and effectiveness of management information and control systems and on the conformity of financial statements with the accounting records and legal and accounting standard requirements should be extended to cover: the identification of significant business risks; the effectiveness of financial, operational and compliance controls; the quality of management information and the effectiveness of management.

There was little support for the proposal that internal audit should comment on the effectiveness of management. It is proposed therefore that this proposal be amended as follows:

**Amended proposal 3 – The recommendation in ICAS (1993) that the chief internal auditor should report on the establishment and effectiveness of management information and control systems and on the conformity of financial statements with the accounting records and legal and accounting**
standard requirements should be extended to cover: the identification of significant business risks; the effectiveness of financial, operational and compliance controls and the quality of management information.

4 (Retained from ICAS, 1993) The external auditors should be renamed the external assessors and that to a considerable extent the external assessors would carry out their work by assessing the work of a company’s internal auditors.

There appears to be little discernible support for this proposal or for the proposal that the external audit function would become one where the main focus was reviewing the work of the internal auditors. It is also apparent that there is little support for internal/external auditor co-operation of the sort envisaged by ICAS (1993) and Fraser, Henry and Wallage (2000). It is therefore proposed that the existing proposal 4 be abandoned.

5 (Extended proposal) An independent ARP should be established to take responsibility for the supervision of the assessment process on behalf of the primary stakeholders, while being responsive to the needs of the secondary and tertiary stakeholders.

6a (Extended proposal) The role of the ARP proposed by ICAS (1993) should be broadened to a more proactive supervision of the planning, execution, completion and reporting of audit work undertaken by the external assessors. This would help to ensure that due rigour is applied to the assessment process.

6b (New proposal) The ARP should adopt a watching brief over the internal audit function, to confirm its effectiveness and independence within the organisation.

It is apparent that there is little or no support for the establishment of audit review panels and that these would be seen in terms of the establishment of a further unnecessary level of bureaucracy. It
is therefore proposed that the existing proposals 5, 6a and 6b be abandoned.

This however highlights a need to strengthen existing audit committees and to explore other ways of strengthening corporate governance including shareholder involvement. The research reported here has also highlighted a need to address the shortage of suitably qualified non-executive directors and to strengthen their independence, competences and reputation. The following new proposals are made with these considerations in mind:

**New proposal 4 - In order to improve the effectiveness of non-executive directors and strengthen their independence, guidelines should be introduced on the maximum number of non-executive directorships that may be held by an individual and regulation should be introduced to control ‘cross-holdings’ of executive and non-executive directorships.**

**New proposal 5 - An initiative should be established to address the shortage of suitably qualified non-executive directors and to strengthen their independence and reputation, by developing mechanisms aimed at facilitating young suitably-qualified executives to obtain non-executive directorships.**

**New proposal 6 - In order to address the skills shortages among non-executive directors, an initiative should be established to train non-executive directors in general, industry-specific and company-specific issues to equip them to fulfil their responsibilities.**

**New proposal 7 - In order to facilitate shareholder involvement in corporate governance, attention should be given to the development of fora, such as shareholder committees, that will allow shareholders to assume a more formal role in corporate governance.**
Further research

Further research is necessary in the following areas:

- Consideration of the most appropriate ways of encouraging younger executives to seek appointment as non-executive directors in other organisations, with the dual purpose of introducing fresh ideas to the organisations concerned and also of facilitating the professional development of the individuals involved. Consideration also needs to be given to the issue of whether or not it is appropriate for retiring chief executives to later become chairpersons of their own companies.

- The development of fora to enable shareholders to exercise a more formal role in corporate governance and to make a greater contribution to the corporate governance of investee companies. Included within this is the issue of whether or not there should be regular and routine meetings between investors and non-executive directors.

- The development of alternative control frameworks for use in organisations where dedicated internal audit functions are thought to be uneconomic or otherwise undesirable.

- Consideration as to whether public companies should establish separate internal audit and risk management functions.

- Consideration of the most appropriate methods for the embedding of risk management within organisations.

- Consideration of the most appropriate models for internal/external auditor co-operation.

- Consideration as to the most appropriate means of enhancing audit committee effectiveness.
• Consideration as to the perception held by some participants in this research that changed audit methodologies may lead external auditors to concentrate more on client risk than on audit risk.

• In general, given the evident distaste for ‘boilerplate’ rules, attention needs to be given to ways of strengthening corporate governance while, at the same time, paying attention as much as possible to the dominant preference for a minimalist approach to regulation.
APPENDIX A

SUMMARY OF KEY RECOMMENDATIONS FROM THE HIGGS AND SMITH REPORTS

Higgs

- Independent non-executives should provide at least half the membership of listed company boards.
- A chief executive should not become chairman of the same company. No individual should chair more than one major company.
- Full-time executives should restrict themselves to one non-executive role. No limit is set otherwise on the number of non-executive directorships held but individuals should ensure that they have enough time available to fulfil their duties.
- A senior independent director should act as a conduit for shareholders to raise matters of concern.
- Non-executive directors should meet by themselves at least once a year.
- Non-executives should normally serve two three-year terms. Annual re-election should be required after nine years. Non-executives would not be considered to be independent after ten years.
- A list of potential non-executives from the non-commercial sector should be drawn up.
Smith

- Audit committees should include at least three non-executive directors.

- Audit committees should take an adversarial approach to management if they discover poor or misleading financial reporting.

- Audit committees should ensure that external auditors are independent, objective and do a thorough job.

- Audit committees should include at least one member with a professional accounting qualification and all members should be financially literate.
APPENDIX B

POSTAL QUESTIONNAIRE RESEARCH FUNDED BY THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND

SURVEY ON THE FUTURE OF AUDIT AND CORPORATE GOVERNANCE

We are conducting research into the future of audit and corporate governance in the United Kingdom. As part of our research, we are ascertaining the opinions of senior officials of listed companies on issues arising from recent reports on, and current developments in, corporate governance and we should be grateful if you would assist us with this work by completing this questionnaire.

Please post your completed questionnaires in the enclosed stamped addressed envelope.

The information you provide will be confidential to us as researchers and will be used only in summary form. It will not be identifiable with you in any way.

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THANK YOU FOR ASSISTING US WITH OUR RESEARCH
This questionnaire study seeks to elicit your opinions on the issues outlined in the background section on pages 2 to 4. The questionnaire itself is divided into four sections as follows:

**SECTION 1** Issues arising from contemporary business reporting developments page 5

**SECTION 2** Issues arising from Fraser, Henry and Wallage (2000) pages 5 to 7

**SECTION 3** Issues arising from *The Blue Ribbon Report* (NYSE/NASD, 1999) pages 7 to 8

**SECTION 4** Issues arising from the *Turnbull Report* (ICAEW, 1999) pages 9 to 11
BACKGROUND (Important – Please read before answering questionnaire)

Recently there has been an extensive debate on corporate governance within the UK. The following table summarises some key documents on corporate governance issued during the 1990s:

<table>
<thead>
<tr>
<th>Title</th>
<th>Country of Origin</th>
<th>Key Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Cadbury Report (Cadbury 1992)</td>
<td>UK</td>
<td>Aimed to improve information to shareholders, re-inforce self-regulation and strengthen auditor independence. Key proposals:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Boards of directors should report on the effectiveness of companies’ systems of internal control.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Listed companies should establish audit committees composed of at least three non-executive directors.</td>
</tr>
</tbody>
</table>
**Auditing into the Twenty-first Century** (ICAS, 1993)

### UK

**Major proposals to strengthen the UK system of corporate governance for listed companies. Key proposals:**

- Listed companies should establish enhanced internal audit functions with responsibility for much of the detailed work carried out by external auditors under existing arrangements.

- Listed companies should establish Financial Reporting and Audit Committees similar to existing audit committees but with additional responsibilities including the supervision of internal audit.

- External auditors should be renamed as external assessors with a corresponding change to their remit making this more judgemental and less procedural.

- Listed companies should establish an Audit Review Panel with responsibility for supervising the external assessment process on behalf of the primary stakeholders.
<table>
<thead>
<tr>
<th><strong>The Future of Corporate Governance: Insights from the Netherlands</strong> (Fraser, Henry and Wallage, 2000)</th>
<th>UK</th>
<th>Extended the recommendations of ICAS (1993). <strong>Key proposals:</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>• The role of internal audit should be extended to embrace operational matters such as risk management and control matters.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The role of the Audit Review Panel should be extended to encompass a watching brief over the internal audit function.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>The Hampel Report</strong> (Hampel, 1998)</th>
<th>UK</th>
<th>Introduced the Combined Code consolidating the recommendations of extant corporate governance reports. <strong>Key proposals:</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>• External auditors should report on internal control privately to the directors.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Directors should maintain and review controls in general and not merely financial controls.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Companies that do not already have an internal audit function should review the need for one.</td>
</tr>
</tbody>
</table>
| **The Turnbull Report**  
| (ICAEW, 1999) | **UK** | **Provided guidance to assist companies in implementing the requirements of the Combined Code. Key proposals:**  
|  |  | - Boards of directors should confirm the existence of procedures for evaluating and managing key risks.  
|  |  | - Companies that do not have an internal audit function should review the need for one annually.  

| **The Blue Ribbon Committee Report**  
| (NYSE/NASD, 1999) | **USA** | **Provided recommendations for the more effective and independent operation of audit committees. Key proposals:**  
|  |  | - All large listed companies should have an audit committee comprising at least three independent, financially literate directors.  
|  |  | - All audit committees should have a written charter and this fact should be stated in the annual report to shareholders.  
|  |  | - Each audit committee should actively engage in discussion with the external auditors on the quality of the company’s accounting policies and on any relationships that may exist between the external auditors and the company that may impact on the independence of the external auditors.  

In parallel with the debate on corporate governance, there is a contemporary awareness that the nature of financial reporting, and hence audit, is changing.

**Contemporary developments in business reporting**

It is argued that traditional financial reporting no longer satisfies users. Business reporting is likely to become increasingly user driven rather than producer driven leading to the increased provision of real-time information on a continuous basis and increased non-financial information.

**Contemporary developments in auditing**

This is likely to result in changes to the audit process. The extent of auditors’ involvement with clients’ business processes is likely to increase in conjunction with moves towards more risk-based approaches that emphasise understanding the client’s business. At the same time some degree of fusion of the external and internal audit functions may occur given the increasing incidence of the outsourcing of internal audit to professional accounting firms. This may raise questions about the adequacy of auditor independence.
SECTION 1 ISSUES ARISING FROM CONTEMPORARY BUSINESS REPORTING DEVELOPMENTS

To what extent do you agree with the following comments on contemporary business reporting developments? Please circle one number for each of the options below:\(^1\).

<table>
<thead>
<tr>
<th></th>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Don’t Know</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1</td>
<td>Existing corporate governance structures are able to cope with these developments.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>1.2</td>
<td>The contemporary developments in auditing described in the background section are likely to compromise the independence of the external auditor.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.3</td>
<td>External auditors increasingly work as partners with management rather than as independent experts operating at arms’ length.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Comments, if any
SECTION 2 ISSUES ARISING FROM FRASER, HENRY AND WALLAGE (2000)

To what extent do you agree that the following proposals for corporate governance in the UK are both feasible and desirable?

2.1 Each plc should appoint a strong internal audit team, capable of providing the audit committee with sufficient information to fulfil its responsibilities on behalf of the board.

2.2 Internal audit should report its findings to the chief executive, the audit committee and the external auditors.

2.3 The work of internal audit should include the following areas:
   (a) Acting as risk management consultants to confirm to the parent board and the audit committee that all significant business risks have been identified.
   (b) Confirming to the parent board and the audit committee that financial, operational and compliance controls are effective in practice.
   (c) Giving assurance on the quality of data emerging from routine systems.
   (d) Systems producing soft information and reporting thereon.
   (e) Reviewing the quality of management information, including forecasts and effectiveness of management at all levels of the organisation.
   (f) Liaising with external auditors on the allocation of audit work.
2.4 The external auditors should be renamed the external assessors and the external assessors should carry out their work to a considerable extent by assessing the work of a company’s internal auditors.

2.5 An independent Audit Review Panel should be established to take responsibility for the supervision of the assessment process on behalf of the primary stakeholders, while being responsive to the needs of the secondary and tertiary stakeholders.

2.6 The Audit Review Panel should:
(a) take a proactive approach to supervision of the planning, execution, completion and reporting of external auditors’ work.

(b) adopt a watching brief over internal audit, to confirm its effectiveness and independence within the organisation.

(c) agree the appointment of the external auditors with the directors and agree their remuneration.

(d) authorise any additional investigative or consultancy work to be performed by the external auditors.

(e) Report publicly in the company’s annual report on its work during the year.

Comments, if any

2.7 If you believe it is not necessary for a listed company to have an internal audit department, how would you ensure that the audit committee received sufficient information to fulfil its responsibilities?
2.8 If you believe it is not necessary for a listed company to appoint an Audit Review Panel, how would you ensure that external auditors are encouraged to act in the best interests of shareholders at all times and not be unduly pressurised by executive directors?

To what extent do you agree that external and internal auditors should work jointly on the following financial auditing matters?

2.9 The planning of audit work.

2.10 The execution of compliance tests.

2.11 The execution of substantive tests.

2.12 The formation of an opinion on business performance measurement.

2.13 The formation of an opinion on systems reliability.

2.14 The formation of an opinion on the company’s going concern status.

2.15 Reporting to management on the matters in 2.12 to 2.14 above.

Comments, if any
Large corporations in the Netherlands and some other European countries are required to establish supervisory boards, with the responsibility of supervising the policy of management and the general course of corporate affairs, including intervening and taking corrective action if that is in the stakeholders’ best interests. Audit committees tend to be sub-committees of, and to report to, supervisory boards, primarily on the audit process, the effectiveness of controls and the qualitative background to the periodic financial statements.

To what extent do you believe that listed companies in the UK should establish supervisory boards with the same remit as their Dutch counterparts?

Comments, if any

SECTION 3 ISSUES ARISING FROM BLUE RIBBON COMMITTEE REPORT

The following proposals inter alia were made to improve the effectiveness of audit committees in the US. To what extent do you agree that their implementation is feasible and desirable in the UK in order to improve audit committee effectiveness?
3.1 All large listed companies should have an audit committee consisting solely of independent directors (individuals with no relationship to the company that may interfere with the exercise of their independence from management).

3.2 All other listed companies should have an audit committee with a majority of independent directors.

3.3 All large listed companies should have an audit committee comprising at least three directors, each of whom is financially literate, and at least one of whom has accounting or related financial management experience.

3.4 All other listed companies should have an audit committee with at least one financially literate member.

3.5 Each audit committee should be required to adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee’s responsibilities and how it carries them out. The committee should review the charter annually.

3.6 Each audit committee should report in the company’s proxy statement for the annual general meeting of shareholders as to whether it has adopted a formal written charter and, if so, whether it has satisfied its duties during the prior year in accordance with its charter.

3.7 The audit committee charter should be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next report to shareholders or proxy statement after any significant amendment to that charter.
3.8 The audit committee charter for every listed company should specify that the external auditors are ultimately responsible to the board of directors and the audit committee as representatives of the shareholders and that these representatives should propose appointment or removal of the external auditors to the shareholders.

3.9 The audit committee should actively engage in dialogue with the external auditors with respect to any relationships or services that may impact the objectivity and independence of the external auditors and take appropriate action to ensure the independence of the external auditors.

3.10 The external auditors should discuss with the audit committee the auditors’ judgement about the quality of the company’s accounting policies, including issues such as the clarity and aggressiveness of policies selected and the underlying estimates or significant decisions made by management in relation to financial disclosure.

3.11 Each audit committee should state, in the company’s annual report whether or not:

(i) management has reviewed the financial statements with the audit committee discussing the quality of accounting policies and significant judgements affecting the financial statements.

(ii) the external auditors have discussed their judgements on the issues in (i) above with the audit committee.

(iii) the members of the audit committee have discussed the issues in (i) and (ii) above, without management or external auditors present.

(iv) the audit committee believes that the financial statements are fairly presented in accordance with UK GAAP.

Comments, if any
SECTION 4  ISSUES ARISING FROM TURNBULL REPORT

The classification of risks used in this and subsequent questions is taken from Implementing Turnbull - A Boardroom Briefing, published by ICAEW in 1999. The categories are:

(i)  *Financial risks*, including liquidity risk, going concern problems, high cost of capital and vulnerability of IT systems to attack.

(ii)  *Business risks* including inappropriate business strategy, general economic problems, political risks, obsolescence of technology, adverse government policy and industry sector in decline.

(iii)  *Compliance risks*, including litigation risk, breach of competition laws, health and safety risks and environmental problems.

(iv)  *Operational risks*, including skills shortages, loss of key contracts, poor brand management, stock-outs, loss of physical assets and business processes not aligned to strategic goals.

(v)  *Any other risks* not covered by any of the above headings, including an inability to implement change, business probity issues, other issues giving rise to reputational problems and missed business opportunities.

4.1 To what extent do you agree that the scope of a company’s system of internal control should embrace the following?
(a) Accounting controls, including the maintenance of proper accounting records.

(b) Evaluation of the financial risks to which the company is exposed.

(c) Evaluation of the business risks to which the company is exposed.

(d) Evaluation of the compliance risks to which the company is exposed.

(e) Evaluation of the operational risks to which the company is exposed.

(f) Evaluation of any other risks to which the company is exposed.

Comments, if any

To what extent do you agree with the following proposals for the board of directors?

4.2 The board of directors should be responsible for:
   (a) stating publicly their judgement on whether adequate financial resources are available to enable the company to remain a going concern for at least 12 months from the date of approval of the financial statements.

   (b) Setting up systems of internal control that inter alia minimise the opportunities for fraud and other illegal acts and maximise the likelihood that such irregularities will be detected.

4.3 The board of directors should report publicly on:
   (a) the process that has been applied when reviewing the effectiveness of the company’s system of internal control.

   (b) the effectiveness of internal control.
To what extent do you agree with the following proposals for corporate governance in the UK?

4.4 The external auditors should report on their review of *systems in place* for risk identification and management of:
(a) financial risks.
(b) business risks.
(c) compliance risks.
(d) operational risks.
(e) other risks.

4.5 The external auditors should report on their review of the *effectiveness* of risk management of:
(a) financial risks.
(b) business risks.
(c) compliance risks.
(d) operational risks.
(e) other risks.

4.6 Internal audit should provide the audit committee (on behalf of the board of directors) with assurances regarding the *systems in place* for risk identification and risk management of:
(a) financial risks.
(b) business risks.
(c) compliance risks.
(d) operational risks.
(e) other risks.
4.7 Internal audit should provide the audit committee (on behalf of the board of directors) with assurances regarding the *effectiveness* of risk management of:
(a) financial risks.
(b) business risks.
(c) compliance risks.
(d) operational risks.
(e) other risks.

4.8 External and internal audit should work jointly on the review of *systems in place* for risk identification and management of:
(a) financial risks.
(b) business risks.
(c) compliance risks.
(d) operational risks.
(e) other risks.

4.9 External and internal audit should work jointly on the review of the *effectiveness* of risk management of:
(a) financial risks
(b) business risks
(c) compliance risks
(d) operational risks
(e) other risks

4.10 The audit committee should have responsibility for reviewing the *systems in place* for risk identification and management of:
(a) financial risks
(b) business risks
(c) compliance risks
(d) operational risks
(e) other risks
4.11 The audit committee should have responsibility for reviewing the effectiveness of risk management of:
(a) financial risks
(b) business risks
(c) compliance risks
(d) operational risks
(e) other risks

Comments, if any

Thank you for taking the time to complete this questionnaire. We would like to discuss in more detail the issues covered with a number of interested parties. If you are prepared to be involved in this, please indicate your willingness in the space provided below.

I would be prepared to participate in an interview to discuss the issues covered in this questionnaire

Name ............................................................................
Position ...........................................................................
Company/Firm ...............................................................

Endnote:

1 In order to conserve space, scalar details have not been reproduced other than for question 1.1. All questions, with the exception of 2.7 and 2.8, each of which required purely a narrative response, employed the same scale as question 1.1.
APPENDIX C

ICAS RESEARCH PROJECT

Issues for interviews

1. Issues arising from contemporary business reporting developments

1.1 How robust are present corporate governance arrangements in the light of current developments?

1.2 How should directors work towards meeting the needs of different stakeholders?

1.3 How do your audit committee, internal auditors and external auditors interact?

2. Issues arising from Fraser, Henry and Wallage (2000)

2.1 What contribution can internal audit reasonably make to risk management?

2.2 What should be the role of external auditors in relation to risk management and control?

2.3 What should be the relationship between external and internal audit? (See Q1.3 above)
3. **Issues arising from Blue Ribbon Committee Report**

3.1 How effective can audit committees be in reality?

3.2 How can stakeholders be assured of audit committee effectiveness?

3.3 What contribution can the audit committee reasonably make to risk management and in assessing the effectiveness of internal control?

4. **Issues arising from the Turnbull Report**

4.1 How does a company embed risk management in its routine procedures, as *Turnbull* requires?

4.2 Do you manage fraud risk just like any other or are there other considerations here?

4.3 How does the board satisfy itself as to the effectiveness of the system of internal control following *Turnbull*?

4.4 To what extent should there be reporting on risk management and/or internal control?

4.5 What assurance can be given on going concern?
REFERENCES

*Internal Auditing*, August, p.25.
*Internal Auditing and Business Risk*, October, pp.32-33.
Hampel Committee, Committee on Corporate Governance (1998), Final report: Committee on corporate governance, Committee on Corporate Governance and Gee Publishing, London.


