

Audit must stand alone

David Damant believes that the solution to recent problems of audit failure is to have audit committees that can act independently of management

The job of the auditor is to do the painful checking. It is to confirm that a company's financial statements are in accordance with the accounting framework, comprising accounting standards, company law and any additional rules imposed by regulators. That may sound narrow, dry and technical but it is of supreme importance for equity investors. If the requirements that are clearly set out in the framework were precisely followed, most of the problems of audit failure, now under discussion in the Brydon Review into UK audit standards, would vanish.

Ensuring that the accounting framework is perfectly implemented is only a matter for the audit committee. Having a regulator oversee audit committees could have disadvantages, such as adding a bureaucratic overlay. It would also distract from the fundamental question: what would make audit committees effective?

I believe the answer to this is independence. An audit committee is a committee of the company board and needs a structure that enables it to act independently of management. That would mean being mainly composed of members who are explicitly responsible only for the financial statements. Such a committee would have direct and continuous access to all financial information in whatever detail it required, quite separately from the board, which would also have access to what was found. The only aim would be to ensure that the financial statements were in line with the accounting framework – in other words, that they followed all the rules, in spirit as well as to the letter.

There would almost certainly be high-quality people willing to serve on this kind of audit committee, since they would have no responsibility for the company's actions overall. Arguably it would be an easier role than the current lot of most non-executive directors, and the focus would give committee members more time to address auditing questions. The membership should be wider than those trained as accountants and include those with backgrounds as investors and other users of accounts.

What about the company's input? The chairman plus one other member of the audit committee would be members of the company board. They would be the interface – an intense job but focused on the crux of the problems that arise, including those highlighted by recent scandals. The relevant aspects would be discussed by members of the board

and the independent audit committee. If their conclusions differ, they resolve matters, or publish the alternatives, if that is appropriate. In this way, any questionable management actions or calculations could be independently and authoritatively challenged. Responsibility for the financial statements would remain, as it should do, with the board. But the audit committee would report independently to shareholders. This would meet the requirement set out in the Competition and Markets Authority's (CMA) latest study of

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the audit market “to ensure that the audit committees remain fully accountable first and foremost to shareholders”. This requirement is structurally impossible with the present status of the audit committee as a committee of the board.

Also, as the CMA study points out, “auditors cannot deliver a quality audit without a robust governance structure being in place at the company”. In reality, robust governance will not always be in place – that is a function of human nature. But, when it comes to the financial statements, an independent structure for the audit committee can be robust in itself, ensuring a quality audit. This in-built independence would make the audit committee effective in carrying out its duties of appointing and monitoring the external auditors and in its relationship with the company's internal audit team.

None of the other solutions on offer fully addresses the matters of public concern about audit quality. They rest only on the hope that those concerned in the present or proposed governance structures will ensure that the accounting framework is relentlessly followed. And that, I fear, promises the defeat of hope by experience. ■



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