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# AUDIT COMMITTEE FUNCTIONING IN PUBLIC INTEREST ENTITIES – CURRENT STATUS AND FUTURE PERSPECTIVES

**Abstract:** The statutory obligation for an audit committee establishment in public interest entities is set forth in the Act on Statutory Auditors of May 7, 2009. It constitutes the crucial component of corporate governance system as the guarantor of financial statements accuracy, appropriate relations with statutory auditors and internal audit. The functions of audit committee, resulting from legal regulations, include: accounting system monitoring with main emphasis on financial reporting, internal control system and risk management system, as well as the supervision and coordination of internal and external audits. The objective of the hereby paper is to present the essence, role, tasks and rules of audit committee functioning, as well as identify problems referring to its functioning efficiency assessment and its evolution directions.

**Keywords:** audit committee, public interest entity, financial audit, financial reporting.

## 1. Introduction

Global financial crisis experienced in recent years and its negative consequences for the large listed companies and economic organizations have exerted strong impact on changes occurring in financial reporting and auditing. This leads to certain observations regarding the current status of statutory audit and its future perspectives.

Financial audit is conducted in order to confirm financial information credibility and plays the role of a strengthening factor, or even determining trust and reliability in economic and social life. In order to meet these goals certain steps have already been and still are being taken regarding changes in financial audit effective in the European Union Member States. Particular attention should be paid to the introduced, for the first time in Polish legislation, regulations set forth in the Directive 2006/43/EC of the European Parliament and of the Council of 17$^{th}$ May 2006 on statutory audits of annual accounts and consolidated accounts [Dyrektywa 2006/43/WE] referring to appointing and functioning of audit committees, as well as their quality assurance, following adequate statutory requirements.

The recommendation to appoint audit committees appeared for the first time in Poland eight years ago in Best Practices in Public Companies 2005. However, the obligation to establish them has not appeared in legal regulations until 2009 and was set forth in the Act of 7th May 2009 on auditors and their government, entities authorized to audit financial statements and public oversight[1] [Ustawa z dnia 7 maja 2009…], and refers to public interest entities.

The objective of the paper is to present the essence, role, tasks and rules of audit committee functioning, as well as identify problems referring to its functioning efficiency assessment and its evolution directions.

In order to meet the presented paper objective the method based on analytical and critical approach to the existing legislation was applied, as well as comparative analysis of legal regulations with non-mandatory solutions, supported by a deductive method.

## 2. The essence and role of audit committee

The problem of financial audit is referred to in the aforementioned Directive 2006/43/EC which, to a great extent, is based on American solutions. It takes into account several years of American experience owing to the fact that the first reactions to fraud, resulting in many enterprises' bankruptcy and liquidation, occurred in the United States. In response to such cases the Sarbanes-Oxley Act of 30th June 2002 was enacted, the Public Company Accounting Oversight Board was appointed and new, special solutions with reference to accounting and auditing procedures were introduced.

Audit committee, referred to for the first time in the latest Act, represents one of the new bodies in the current structure of the financial audit activities oversight and control. In accordance with the regulations in force (American, European and Polish) an audit committee plays two basic functions. Firstly, it functions as a monitoring authority with regard to three systems functioning in an enterprise, i.e. accounting system covering financial reporting in particular, internal control system and risk management system. Secondly, its task is the oversight and coordination of work performed by both internal and external auditors.

In line with the first group of listed functions an audit committee, as one of corporate governance mechanisms, plays the role of financial information credibility guarantor with reference to financial information generated by an entity, ensures proper functioning of internal control system implemented by an entity management and provides assessment of the applied methods efficiency in risk identification, measurement and management. The second function performed by an audit committee is also important and consists in both, supervision and coordination of

[1] For the purposes of the paper an abbreviated name of the aforementioned Act is used, i.e. "Act on financial Audit."

work carried out by internal and external auditors. In this perspective an audit committee functions as the platform for cooperation and information exchange between external auditors and the audited entity bodies, including its internal auditors and the supervisory board, as well as between an audit committee and internal auditors.

In accordance with Art. 86 of the Act on financial audit [Ustawa z dnia 7 maja 2009…] an audit committee should faction in public interest entities, the members of which are appointed by the supervisory board or the control commission from among its members. An audit committee should be composed of at least three members. If, however, the supervisory board is made up of five or fewer members, the committee duties may be assigned to the board itself.

Attention should be paid to the fact that the solution set forth in the Act [Ustawa z dnia 7 maja 2009…] limits possibilities for audit committee establishment in other large economic entities in which supervisory board has no more than five members. This restriction is not included in the Directive 2006/43/EC [Dyrektywa 2006/43/WE…] in accordance with which a supervisory board without an audit committee should function only in small and medium-sized entities.

The Act lists public interest entities, obliged for audit committee appointing, enumeratively and also specifies entities exempt from such obligation. Table 1 illustrates the division into these two groups.

**Table 1.** Public interest entities obliged to and exempt from an audit committee establishment

| Public interest entities obliged to establish an audit committee | Public interest entities exempt from an audit committee establishment |
|---|---|
| 1. Issuers of securities, having an official seat on the territory of the Republic of Poland, admitted to trading on a regulated market of the European Union Member State excluding local government units.<br>2. Domestic banks, branches of credit institutions and branches of foreign banks.<br>3. Credit unions.<br>4. Insurance institutions and main branches of insurance institutions, as well as reinsurance undertakings.<br>5. Electronic money institutions.<br>6. Open-end pension funds and pension societies.<br>7. Open-end investment funds, specialized open-end investment funds, closed-end investment funds which investment certificates have not been admitted to trading on a regulated market.<br>8. Entities conducting brokerage activities excluding entities engaged exclusively in taking and transferring orders to buy or sell financial instruments or in investment advisory. | 1. Open-end pension funds, pension societies and investment funds.<br>2. Branches of credit institutions and branches of foreign banks.<br>3. Main branches of insurance institutions.<br>4. Cooperative banks.<br>5. Public interest entities in which neither supervisory board nor audit committee were appointed.<br>6. Credit unions. |

Source: author's compilation based on [Ustawa z dnia 7 maja 2009…].

In line with Art. 86, par. 4, an audit committee should be composed of minimum three members of which at least one has to meet the independence requirement and present adequate qualifications in accounting or financial auditing. In practice it should mean that in order to follow statutory requirements an audit committee should include experts presenting specific qualifications and skills, who not only are capable of risk symptoms detecting but also assure higher quality of financial statements, as well as function firmly and maintain an independent approach in contacts with a given company management executives [Zorde 2010].

The independence of one of audit committee members is an important condition defined in Art. 56, par. 3, pt. 1,4 and pt. 5 of the Act [Ustawa z dnia 7 maja 2009…]. Following this regulation an independent committee member violates impartiality and independence rule if he/she:

- is in the possession of equity shares and other property titles of an entity in the audit committee of which he/she participates, or in any other related entity,
- participated, in the period of recent three years, in bookkeeping procedures or in preparing financial statements for an entity of which audit committees he/she is a member,
- is a spouse, a relative or presents affinity to the second degree of kinship in a straight line, or is related as the result of performed care, custody or guardianship with a person acting as a member of supervisory, management or administration units of an entity the audit committee of which he/she is a member.

The requirements in this matter are not identical with other regulations of both mandatory and non-mandatory nature.

In accordance with the European Commission recommendation of 15th February 2005 on the role of non-executive directors, or supervisory board members of listed companies and the (supervisory) board committee to which Best Practices of WSE Listed Companies refer [Uchwała Rady Giełdy… 2012], at least two supervisory board members should meet the criteria of independence from the company and entities bearing any significant connection with the company. An important element of independence is also manifested by the absence of major shares or commercial relations with the company personally, as an owner, or an employee of an entity involved in business relations with the company. These regulations, however, allow an audit committee member to have the right to exercise up to 5% of the total number of votes at the general meeting of shareholders, whereas Polish legislation refers to the ownership of even one share of a company in which the particular person is an audit committee member, as violating the independence rule.

The requirement of at least one audit committee member having adequate qualifications in accounting or financial audit has also been set forth in the Act [Ustawa z dnia 7 maja 2009…], however, it does not specify the type and scope of such requirements. Therefore, it seems justified to take advantage of the provisions put before an audit committee and covered by the Audit Committee Best Practices [*Dobre praktyki*… 2010] which determine as follows:

1) each audit committee member, at the time of appointment, should present adequate knowledge in the field of finance at the level allowing both understanding and interpreting financial statements, whereas an audit committee chairmen should have sufficient qualifications in accounting and financial audit;

2) in the situation when an audit committee has not been appointed by a supervisory board and its tasks are distributed among all board members, the role of a chairman is played by an independent board member presenting adequate qualifications in accounting or financial audit, however, such role should not be performed by the supervisory board chairman;

3) the requirement of presenting adequate qualifications in accounting and financial audit is considered to be met if a supervisory board member presents substantial experience in finance management of commercial companies, internal audit or financial statements audit, and additionally:

a) has obtained the title of a statutory auditor or an equivalent certificate of an international recognition, or

b) has an academic title in accounting, financial audit, or

c) presents a long-standing experience at the position of Chief Financial Officer in public companies or experience in working as an audit committee member in such companies;

4) audit committee members identify their training needs and take advantage of respective education forms in order to continuously improve their knowledge of the changing legal regulations relevant to the company regarding financial reporting, internal control and risk management.

## 3. Tasks of an audit committee

In accordance with Art. 86, par. 7 of the Act on financial audit [Ustawa z dnia 7 maja 2009…] the tasks of an audit committee include in particular:

1) monitoring of financial reporting processes,

2) monitoring of internal control systems efficiency, internal audit and risk management,

3) monitoring of the financial audit procedures implementation,

4) monitoring of a statutory auditor independence and an entity authorized to perform financial statements auditing.

Within the framework of particular oversight areas an audit committee can carry out an extensive range of activities. Their examples have been presented in Table 2.

Apart from the four aforementioned basic tasks to be performed by an audit committee its members also have to monitor mergers and acquisitions of capital companies.

The basic objective of an audit committee appointment is to provide support for supervisory board as the statutory body of the company in performing controlling

**Table 2.** The examples of tasks carried out by an audit committee in particular oversight areas

| Oversight area | Possible activities |
|---|---|
| Financial reporting | – monitoring financial information reliability,<br>– analysis of methods used in significant, abnormal transactions,<br>– timeliness control of particular financial reporting stages,<br>– verification of financial reporting assessment results and the key control procedures carried out by management and suggested corrective measures,<br>– monitoring of vital changes in financial reporting processes. |
| The system of internal control, internal audit and risk management | – oversight of internal control efficiency system,<br>– obtaining detailed information from management staff, an independent auditor, internal audit department and financial department management, regarding: auditing operations, communication and monitoring,<br>– review of the results of an internal control system functioning and internal audit taking into account comments and recommendations of an independent auditor,<br>– obtaining information from management about an increased exposure to particular risk, information about risk identification and monitoring, the assessment of steps undertaken by management in order to reduce such risk. |
| Performing financial audit activities | – ensuring communication possibilities between a statutory auditor, internal auditor and supervisory board,<br>– oversight of the areas indicated by a statutory auditor during an audit as particularly sensitive to risk,<br>– consulting, with a statutory auditor, all issues related to bookkeeping disclosures and presenting abnormal economic events in a financial statement,<br>– discussing, with a statutory auditor, all encountered difficulties posed by management staff while performing an audit. |
| Independence of a statutory auditor and an entity authorized to perform financial auditing | – recommending, to the supervisory board or other supervisory authority of an entity authorized to carry out audits of financial statements, to perform financial audit of an entity taking into account, among others, the requirement of statutory auditor independence and impartiality,<br>– accepting all audit and non-audit type of services rendered by entities authorized to audit financial statements, as well as other entities. |

Source: author's compilation based on [*Rekomendacje*… 2010].

and supervising duties. An audit committee should also play the role of the main contact point for statutory auditors and internal auditors, as well as liaise with the supervisory board.

## 4. Functioning of an audit committee – conclusions

The functioning of an audit committee represents one of the leading topics discussed in relation to corporate governance system. Effective and efficient functioning of these committees is perceived as an opportunity for upgrading the supervision quality of tasks performed by a supervisory board. In spite of short history these committees represent a common component of supervisory boards in many countries. American analyses confirm, e.g., that improved audit committee operations in American companies resulted in fewer errors in financial reporting. On the other hand, Korean studies illustrate that, e.g., higher corporate governance standards (including these referring to audit committees) had positive impact on these companies' share prices.

The identification of both efficiency and effectiveness of an audit committee functioning is very difficult owing to the absence of clear and measurable assessment criteria. The studies covering developed capital markets are based on analysing such characteristics of an audit committee as its: composition, independence, knowledge and experience, efficiency, impact opportunities, obligations and responsibility, as well as the relationship between the supervisory board characteristics and profit manipulation or financial irregularities [Cieślak et al. 2011, p. 64].

Following the research conducted on advanced financial markets it may be concluded that audit committee efficiency is mainly influenced by the following factors [Cieślak et al. 2011, p. 64]:
– the composition of an audit committee,
– powers specified in committee functioning regulations,
– knowledge and experience in financial reporting presented by audit committee members, and
– their involvement in committee operations.

These studies provided information about the manner of audit committee functioning in different entities, however, owing to the absence of particular factors impact identification it turned out impossible to determine the effectiveness and efficiency assessment of particular audit committees functioning, as well as providing adequate comparative analyses [Sawicki 2012, p. 174].

The observations regarding current audit committees functioning, as well as their evolution directions in Poland, were presented in PwC report, prepared in cooperation with The Polish Association of Listed Companies and KomitetyAudytu.pl portal, entitled: "Audit Committees in Poland in 2011" [*Komitety audytu*… 2011].

The conducted research allows for the following conclusions.

1. In practice, differences in the quality of audit committee functioning are quite noticeable. On the one hand, there are committees which perform their tasks in an active and professional manner, in line with the best global practices, on the other, however, there formally exist committees which are either too passive in executing their duties or carry out the set goals inadequately.

2. The vital role is played by audit committee members' qualifications. In this matter positive changes can be observed, confirming professional functioning of audit committees. However, in case of many audit committees the number of adequate experts willing to become their members is still insufficient. The underlying reason is not only related to high requirements and extensive experience, but also to inadequate remuneration of supervisory board members for their additional tasks carried out within the framework of audit committee operations.

3. Committees are becoming more and more aware of the role played in performing their tasks by an internal and external auditor which results in more frequent committee interactions, as well as the awareness of the need to improve communication with a statutory auditor and the head of internal audit.

4. The scope of powers defined in committee regulations is being extended and their work organization is improving. However, there still exist such committees which do not meet all expected statutory tasks. Most of them concentrate mainly on two areas: oversight and financial reporting and also the appointment of a statutory auditor, whereas the involvement in supervising risk management systems, internal audit, internal auditor and tax reporting is visibly less intensive.

5. There is a large disproportion in carrying out audit committee tasks by companies having their own audit committees comparing to these in which committee tasks are performed by the entire supervisory board. This results, e.g., from different time frame commitment. Additionally, 1/3 of supervisory boards, which did not appoint an audit committee, do not monitor financial audit operations or check the independence of a statutory auditor and also devote too little time to these tasks.

To sum up the above conclusions it has to be emphasized that positive trends in audit committee functioning can indeed be observed, which confirms their growing professionalisms. However, the quality of tasks assigned to them still persists on an insufficient and unsatisfactory level.

Nevertheless, the conducted analysis proves that although slowly but gradually the evolution of audit committees does occur – from a body perceived as an institution imposed by the statutory requirement towards the role of an important component in the system of risk assessment in an enterprise.

The economic environment in which Polish entrepreneurs will have to function in the coming years will influence the growing interest in the instruments used to make financial issues more transparent, to improve risk management quality and internal control reliability, among both shareholders and management boards. This is the role to be played by audit committees. Additionally, the scope of their activities will keep extending in case of these entities in which it used to be limited, while their establishment will occur in the areas where, so far, they did not exist and result from the actual needs represented by shareholders and supervisory boards, rather than statutory requirements.

It is also vital to undertake further legislative steps aimed at the elimination of inconsistencies with the EU requirements. Such changes should influence larger popularity of audit committees establishment as well as their functioning quality.

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## FUNKCJONOWANIE KOMITETU AUDYTU W JEDNOSTKACH ZAINTERESOWANIA PUBLICZNEGO – STAN OBECNY I PERSPEKTYWY

**Streszczenie:** Ustawowy obowiązek tworzenia komitetu audytu w jednostkach zainteresowania publicznego wynika z Ustawy o biegłych rewidentach z 7 maja 2009 r. Stanowi on bardzo ważny element systemu nadzoru korporacyjnego, jako gwaranta poprawności sprawozdań finansowych, właściwych relacji z biegłym rewidentem i audytem wewnętrznym. Do funkcji komitetu audytu, wynikających z regulacji prawnych, należą więc monitorowanie systemu rachunkowości, a zwłaszcza sprawozdawczości finansowej, systemu kontroli wewnętrznej oraz systemu zarządzania ryzykiem, a także nadzorowanie i koordynowanie prac audytorów wewnętrznych i zewnętrznych. Celem artykułu jest zatem przedstawienie istoty, roli, zadań i zasad funkcjonowania komitetu audytu, a także wskazanie problemów dotyczących oceny efektywności jego działania i kierunków ewolucji.

**Słowa kluczowe:** komitet audytu, jednostka zainteresowania publicznego, rewizja finansowa, sprawozdawczość finansowa.