THE ROLE OF THE AUDIT COMMITTEE IN SUPPORTING THE EXTERNAL AUDITOR’S INDEPENDENCE AND EFFECTIVENESS

B. MARX AND D. LUBBE

ABSTRACT

This article discusses the developments and factors that impact on the external audit function, and analyses the role that an effectively functioning audit committee can play in supporting the external auditor's independence and effectiveness. This is done through a literature review of external audit and audit committee developments, and is supported by empirical evidence obtained from assessing the annual reports and from questionnaires sent to the audit committee chairs of the Top 40 listed companies in South Africa. The main findings of the study are that audit committees at the largest listed companies in South Africa are taking responsibility for overseeing the external audit function, but that the disclosure thereof in annual reports was found to be lacking. These findings are of significance as they provide support for the recommendations of King III (effective from 1 March 2010) that all companies should form audit committees and that external audit should be given oversight responsibilities in this regard.

Keywords: Audit committees, Audit committee responsibilities, Audit committee disclosure, Auditor’s independence, Auditor’s effectiveness

1. INTRODUCTION

External audit is an independent assurance function performed primarily for the benefit of shareholders. The objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework (South African Institute of Chartered Accountants (hereafter SAICA), 2008: par. 2; SAICA, 2009: par. 3). The auditor’s audit opinion enhances the credibility of the financial statements, but does not guarantee the future viability of the entity or the effectiveness or efficiency with which management has conducted the affairs of the entity (Institute of Directors (hereafter IoD), 2009: chapter 3, par. 33; SAICA 2008; SAICA 2009).

The important role of the external audit function in the corporate governance structure of entities has also long been recognised. As far back as 1994, the Cadbury Report emphasised the value of the external audit function as “one of the cornerstones of corporate governance” and states that “the audit provides an external and objective check on the way in which the financial statements have been prepared and presented, and it is an essential part of the checks and balances required … the question is not whether there should be an audit,
but how to ensure its objectivity and effectiveness” (Cadbury as quoted by Du Plessis, McConvill, & Bagaric, 2005:240). The Blue Ribbon Committee in the United States of America (hereafter USA) also recognised the importance of an independent and effective external audit function and the need for an effective audit committee to ensure that entities produce credible and reliable financial reporting. In this regard the Committee stated that “a proper and well-functioning system for financial reporting depends on a three-legged stool comprising firstly the full board including the audit committee, secondly financial management including the internal auditors and thirdly the external auditors” (Blue Ribbon Committee, 1999:7).

The corporate governance codes and legislation issued in response to the many well-known corporate collapses (like that of Enron, Worldcom, Parmalat, and LeisureNet) of the 20th and 21st centuries now require audit committees to review and monitor the engagement, remuneration, independence and objectivity and the effectiveness of the audit process (IoD, 2009: Chapter 3; par. 75-82; King, 2006:2; Lander, 2004). In this regard Jim Turley, global chairman and CEO of Ernst & Young (Turley, 2006:1), described the important role of the audit committee with regard to the external auditor as follows: “today, audit committees – not management – hire and fire auditors, they evaluate us, and they pre-approve every service we provide. This is yet another fundamental and meaningful change and we are all adjusting to it.” Similarly, the responsibility of the audit committee as an “oversight watchdog” of the board regarding the financial reporting process and the system of internal control and risk management has grown.

This article discusses the factors that impact on the external auditor's work and effectiveness, and analyses the role that an effectively functioning audit committee can play in supporting the external auditor’s independence and effectiveness. Empirical evidence on the responsibilities actually performed regarding the external audit function by audit committees at the large listed companies in South Africa, as well as those disclosed to be performed, is also provided and discussed. The remainder of the paper is organised as follows. The next section presents the research outline and methodology of the study. The sections that then follow describe the theoretical background of the paper, and the empirical findings and deductions. Conclusions drawn from the study and recommendations are presented in the last section.

2. RESEARCH OUTLINE AND METHODOLOGY

2.1. Research problem

The external audit function forms one of the cornerstones of the corporate governance structure of entities, but is today confronted with many challenges that may have an impact on its independence and effectiveness. The audit committee has established itself in the modern corporate environment as a key component of the governance structure of the board that can fulfil an
important role in supporting the external auditor's independence and the effectiveness of the external audit function. Although a considerable amount of literature is available on audit committee best practice (Ferreira, 2008:90; Marx, 2008:38-207), a review of the South African studies on audit committees indicated that limited research has been done to date in this regard (Marx, 2008:557-563). Similarly, a review of the findings of firm surveys on audit committees in South Africa indicated that, although they are an established and accepted governance structure in South Africa, they are not always as effective as they need to be (Marx, 2008:564-568). Accordingly, the research problem identified is whether audit committees at the large listed companies in South Africa effectively perform and disclose their external audit responsibilities, and through this support the external auditor's independence and effectiveness.

2.2. Research methodology

The role of the audit committee in supporting the external auditor's independence and effectiveness was empirically tested (as part of a bigger study) through content analysis. This took the form of an inspection of companies' annual reports and through questionnaires that were sent to audit committee chairs for completion. The empirical study was descriptive in nature: it focused on the quality of information obtained rather than the quantitative nature of the data. This approach is supported by Henning, Van Rensburg and Smit (2004), who stress the importance of capturing the views of the subjects in the population. Holsti (1969) offers a broad definition of content analysis as “any technique for making inferences by objectively and systematically identifying specified characteristics of messages.” Content analysis has limitations (as noted by Unerman, 2000:667), but it is also widely recognised and accepted as a research instrument (Ackers, 2009:3; Barack 2010:4–5; Brennan & Solomon, 2008:893; Dawkins & Ngunjiri, 2008:291–292). When used in conjunction with well-designed and controlled questionnaires it can enhance the researcher’s understanding of the characteristics of a population.

2.3. Population used in the empirical study

The empirical study focused on audit committees at large listed companies in South Africa and accordingly the population for the empirical study was selected as the largest 40 companies ranked by market capitalisation in the JSE’s All-Share Index (referred to as the FTSE/JSE Top 40 Index) (JSE 2007b:12-13). On 28 November 2007 the companies of the FTSE/JSE Top 40 Index represented 86.39% of the total market value of the JSE’s All-Share Index (JSE, 2007a) and on 27 February 2008 they represented 87.64% (JSE, 2008a; JSE, 2008b). From these statistics it is evident that the companies included in the population represent the largest companies in market value (almost 90% in total) on the JSE and as such would represent a wide spectrum of stakeholders' interests in South Africa. All 40 companies in the stated
population were included in the empirical study (their names are listed in Annexure 1).

On 27 February 2008 both Investec Ltd and Investec PLC, being a dual-listed company, were included in the Index, bringing the Index total to 41 companies. Because both companies have the same persons acting as chief financial officer and audit committee chair, only Investec Ltd was included in the population, bringing the total number of companies in the population back to 40.

3. **AN OVERVIEW OF FACTORS AND DEVELOPMENTS THAT IMPACT ON THE EXTERNAL AUDIT FUNCTION**

3.1 **Introduction and background**

The factors impacting on the work and effectiveness of the external auditor are ever evolving and undergoing constant change, and the increase in the volume and complexity of the international standards on auditing (ISAs) is proof of this. Various factors, such as the increase in volume of transactions, developments in IT and other technology, globalisation and the constant increase in the complexity and number of laws, regulations and standards governing entities and their auditors, are responsible for this.

The corporate collapses, business failures and fraudulent financial reporting of the late 1990s and early 2000s also led to a very turbulent time and resulted in a credibility crisis for the external audit profession. One of the consequences of this was the demise of Arthur Andersen and the resultant decrease in the number of big audit firms from five to four. A further consequence was the drastic interventions by governments, regulators and the audit profession, which have given rise to various and onerous new laws, regulations and standards that govern financial reporting and the audit thereof. This is described as follows by Knechel, Salterio and Ballou (2007:xiii):

“The period 2000 through 2006 has been a very turbulent time for the auditing profession, a period that witnessed numerous scandals and their aftermath (Enron, WorldCom, Parmalat), strident calls for changes in the way that auditors practice their profession, and regulatory initiatives that significantly change the way the profession is governed. Long-held attitudes and customary practices have been challenged and found to be deficient by the media, the investing public, and those charged with regulating financial reporting and auditing. Issues of auditor independence, the role of corporate governance, the responsibilities of management, the appropriateness of consulting services, and the overall professional obligations of auditors have all been discussed and debated by a broad array of interested groups and individuals. The theme linking
these debates has often been 'what is wrong with the auditing profession?' and its close relative 'what can be done to improve the auditing profession?' As a result, this period has probably resulted in more substantive changes to the auditing profession than any other period in modern day business history.

A brief overview of these developments and their implications is presented, as they can significantly affect the external auditor's independence and effectiveness, and the oversight role of the audit committee in this regard, as is discussed in sections 4 and 5.

3.2. Fraudulent financial reporting and audit failures

Many of the various corporate collapses that occurred in the late 1990s and early 2000s were the result of fraudulent financial reporting, and they resulted in significant losses for creditors and serious hardship for shareholders. Many of these business failures were also seen as audit failures, and the audit profession stood accused of not performing its “watchdog function” effectively and with objectivity. This was described as follows by Henderson (2002:3):

“The reputation of the external audit profession is in tatters. Standards and practices of the profession have been found severely wanting in recent times, their contribution to the decline in corporate morality and the erosion of investor confidence is a worldwide talking point.

The question has for most become who to trust? Current trends in auditing practices in South Africa are contributing to a serious erosion of business ethics and standards.”

Questions were also asked about the audit profession's ability to self-regulate, and governments responded by issuing new laws to regulate the auditor's work. The audit profession also implemented vigorous self-regulatory processes such as practice review, as well as other forms of auditor control. Lastly, in this regard it is interesting to note the cynical comments that are sometimes heard that the auditors, through their failure to perform their responsibilities with diligence and care, actually created more work for themselves and benefited substantially from their clients' demise. This was voiced as follows by Whitehead (2007:54):

“According to an article in the Wall Street Journal, the Big Four accounting firms KPMG, PricewaterhouseCoopers, Deloitte & Touche and Ernst & Young are more powerful than ever. The scandal that brought down US-based accountancy firm Arthur Andersen, gave rise to an increase in work generated by the stricter accounting and audit standards in the Sarbanes-Oxley corporate governance bill. The increase in work combined with limited resources in turn
delivered greater leverage for demanding and winning higher fees at the Big Four. So great is the demand that they are turning away work especially when the risks seem to outweigh the potential rewards.”

3.3. **New legislation, regulations and standards**

The response by governments and regulators to the corporate collapses and perceived audit failures gave rise to various new statutory requirements, regulations and standards that were aimed at strengthening the external auditors' independence and improving the quality of their work. Examples of these are the Sarbanes-Oxley Act in the USA, the Corporate Law Economic Reform Program (referred to as CLERP 9) in Australia and the Auditing Profession Act, Company Amendment Act and the new Company Bill of 2008, in South Africa.

In South Africa the new Auditing Profession Act was seen to give effect to government’s intention to ensure that the auditing profession performed its monitoring function and that it could be held accountable for any future corporate bankruptcies (Laschinger, 2006:40). The Auditing Profession Act provided much stricter requirements regulating registered auditors and audit firms and more stringent reporting requirements for reportable irregularities. The Act also expanded the practice review requirement of individual registered auditors to that of audit firms, with the result that every registered auditor performing the attest function and every registered audit firm would receive a practice review by the IRBA at least once every five years. These new requirements were all aimed at improving the quality of audits, but consequently also gave rise to increasing costs for the profession. Grant Gelink, CEO of Deloitte South Africa, said the following on the subject: “the review process is an excellent idea and the committee is very thorough having gone through the files of our biggest clients and inspected our regional offices … (But) it is costly and time consuming, taking more than two months and likely to cost the firm more than R1m” (Temkin, 2006:1-2).

The International Federation of Accountants (hereafter IFAC) also issued new accounting standards that are very complex and onerous and new auditing standards that introduced a new risk-based audit methodology and more stringent documentation and reporting requirements. These new standards, regulations and requirements increased not only the cost of audits, but also the legal exposure of auditors, an aspect that is also often criticised and blamed for harming the audit profession’s ability to attract and retain staff (Laschinger, 2006:40). Allen Blewitt, chief executive of the Association of Certified Chartered Accountants (ACCA), concurs and in this regard stated that “the auditing profession stands to lose most of its members by 2013 due to overregulation in the light of corporate scandals worldwide. Only the big four auditing firms (PricewaterhouseCoopers, Deloitte, KPMG and Ernst & Young) will be viable in the next several years. Sheer numbers of audits is dropping. Legislators do not understand the auditing profession. When they regulate the
profession all they see is red tape. The regulators have a blinkered view of audit” (Temkin, 2008).

3.4. Audit costs and audit fees

The cost of doing audits has significantly increased over the last number of years. This is attributed to factors such as the drastic increase in staff salaries, professional and indemnity insurance, increasing technology costs as well as the impact (discussed in the previous section) of changing audit methodologies and new accounting standards, which are time consuming to understand and to audit (Kana, 2006:35; Sehoole, 2006).

On the other end of the scale are the clients who are often reluctant to accept increases in audit fees in excess of inflation. According to Kana (CEO of PricewaterhouseCoopers, South Africa), this forces auditors to do extra work without being paid for it, which in the long run will affect the firm’s ability to retain such clients. The dilemma that auditors face because of higher costs and lower fees is reflected in the following remark by Moore (2003:1-2) in The CPA Journal:

“Efficiency is one thing, but audit fees have been so drastically reduced by factors such as bidding and price competition that firms have been forced to think of ways to reduce the time spent working on audits. Accountants are under pressure to fit the expenses of the job into the fees they can charge. Many of the firms involved in the continuing high-profile accounting scandals had their work papers done by firms that easily passed peer review. The auditors probably did their jobs efficiently, but didn’t have the luxury of thinking about what might be wrong. Auditing fees should be high enough so that auditors can think on the job instead of quickly and mindlessly doing paperwork that will pass inspection.”

King II recognises this and, warning against management's practice of putting audit fees under pressure, states that audit fees should be set in a manner that will ensure an effective external audit, and adds that the targeting of audit fees as a means of cost savings should be discouraged (IoD, 2002:125). King III supports this further by stating that the audit committee should “satisfy itself that the level of fee payable is appropriate to enable an effective audit to be conducted” (IoD, 2009: chapter 3: par. 76).

3.5. Staffing, training and transformation

Audit firms in South Africa, like their counterparts overseas, are experiencing significant shortages of trainee accountants and qualified staff. South African audit firms have the added complexities of transformation challenges and targets to deal with. Accordingly, there is a high demand for staff amongst audit firms, and especially as regards attracting and retaining black trainees and
accountants (Anonymous, 2005:1; Anonymous, 2008:58-60; Laschinger, 2006:40; Mabotja, 2003:10). As discussed in the previous section, this shortage of audit staff has driven up salary costs, and consequently audit costs and audit fees.

The skills requirement of auditors has also undergone significant changes over the last number of years. Nowadays audit staff face many new challenges, and in order to overcome these they should be schooled and trained in techniques that surpass traditional accounting and auditing procedures. These include, *inter alia*, computer skills, communication and presentation skills, and professional and business ethics (Els, 2007:v; Van Staden, Marx & Erasmus-Kritzinger, 2007:xiii; Williams, 2006:14). All of these aspects involve costs, affect the firm's recruiting, training and retaining of staff, and ultimately impact on the audit fee.

### 3.6. Auditor independence and the providing of non-audit services

The provision of non-audit services by external auditors to audit clients has had a significant impact on external auditors' independence and the profitability of their firms. Normally these non-audit services are very profitable and sought after, with the effect that in the past auditors were tempted to succumb to management pressures on external audit issues in order to retain the audit engagement, and so to provide the very profitable non-audit services. The following two quotations explain this unacceptable state of affairs:

> “They should never have been in a position where there is ever a potential conflict of interest. The fact that Andersens received US$23 million in non-audit services [from Enron] on top of a US$25 million audit fee, has led to the questioning of whether or not Andersen could really be independent” (Terry, as quoted by Steyn, 2003:58).

> “The [Enron] debacle highlighted a series of other cases where the financial services industry had been found wanting. Lax auditing had contributed to failures at Cendant, Sunbeam, Waste Management and Global Crossing (for every $1 which the 'big five' accountants earn from their audit work, they earn $2.69 from consultancy fees)” (Blackburn, 2002).

The various regulations issued and legislation passed since Enron, as well as the various corporate governance codes, now all include stringent rules that either prohibit or strictly control non-audit services rendered by external auditors to their audit clients. This is also the case with the new Companies Act issued in South Africa, which is expected to come into effect in 2010 (Republic of South Africa, 2008: section 90 and 94).
3.7. The audit expectation gap and auditor litigation

The audit expectation gap refers to a difference in opinion or understanding among the participants in the financial reporting process as to what management’s duties and responsibilities are regarding the financial statements, as opposed to those of the auditor. In this regard Prinsloo (1998), in reporting on SAICA’s response to the Nel Commission’s Report on the Masterbond collapse, stated that “when corporations fail the blame is often laid at the door of the auditors when, in fact, the real problem rests with management.”

With the changing business environment, new laws and regulations and the ever increasing occurrence of fraud, auditors are often blamed for not detecting fraud, errors or non-compliance with laws and regulations – responsibilities that reside with management. Such misunderstandings not only result in loss of confidence in the audit profession, but also often give rise to lawsuits against audit firms, resulting in legal fees and productive management and auditors' time lost in the litigation processes (Labuschagne & Els, 2006:30; Van der Linde, 2006:15; Van der Watt, 2002:22-25; Van Rensburg, 2008:1).

4. THE ROLE OF THE AUDIT COMMITTEE IN STRENGTHENING THE EXTERNAL AUDITOR’S INDEPENDENCE

The audit committee has a very important role to play in strengthening the external auditor's independence and thus ensuring they can perform their work objectively and without interference or pressure from management (King, 2006:73). This oversight role should significantly increase the effectiveness of the audit and the reporting by the auditor, and contribute to ensuring financial reporting that is accurate, credible and reliable. This is echoed as follows by the Institute of Chartered Accountants in England and Wales (hereafter ICAEW) (2003:3), who stated:

“The quality of the audit opinion is a vital element in maintaining confidence in financial reporting. A key element is that the audit opinion should be free from bias. If the auditors are to achieve this, they must be objective in reaching their opinion. This requires independence of mind from the company being audited. In addition, particularly in respect of listed and other public interest companies, they need to consider external perception of independence.”

In order to strengthen the external auditor's independence, the audit committee should have oversight responsibilities for the following functions:
Appointment and dismissal of the external auditors

The audit committee should be responsible for considering the external auditors for appointment or re-appointment and to recommend to the board the firm of auditors that they should present to the shareholders for appointment. If the decision as to whether or not the external auditors will continue in office is the responsibility of an independent and objective audit committee, this will create an environment for open, honest and robust dialogue between the auditors and the audit committee without fear of losing the audit when disagreeing with management on the fair presentation of the financial statements (KPMG, 2005: 65-67; PricewaterhouseCoopers, 2005:48-53). The audit committee should also ensure the external auditor is approved by the JSE (IoD, 2009, chapter 3: par. 75).

The importance of an effective audit committee in acting as a safeguard against unfair external auditor dismissals was highlighted by Carcello (2003), who researched the relationship between audit committee characteristics and auditor dismissals and concluded that “one important role of audit committees is to protect external auditors from dismissal following the issuance of an unfavourable report. Our findings suggest that audit committees with greater independence, greater governance expertise, and lower stockholdings are more effective in shielding auditors from dismissal after the issuance of new going concern reports.”

Approval of audit fees

The audit committee should review the reasonableness of the external audit fee. In this regard factors affecting the audit fee such as the complexity of the audit, cross-border activities, use of technology and specific legislative and regulatory requirements should be considered. Attention should also be given to the extent of external audit's coordination with and reliance upon internal audit's work and the impact thereof on the audit fee. As recommended by King II and King III (and discussed above), the audit committee should however be careful not to place undue pressure on audit fees to the extent that this hampers the effectiveness of the external audit process (IoD, 2002:125; IoD, 2009: chapter 3, par. 76; King, 2006:140).

Of concern are the findings of Ernst & Young (2005:7), who in their survey on audit committee practices in South Africa found that 52% of audit committees approve the audit fee recommended by management and that only 44% approve the audit fee on their own, with or without management buy-in. This state of affairs can affect the external auditor's independence and quality of work.
Approval of non-audit services and fees

The audit committee should review and approve any non-audit services to be provided by the external auditors to the company, as well as the fee for these. In approving such services and fees consideration should be given to, *inter alia*, the nature of the service, whether it is prohibited by legislation or regulations, the expertise it requires and, if provided by the external auditors, the possible impact of this on their independence. Specific care should be taken to avoid situations where such non-audit services might impact on the external auditor's independence and quality of work (IoD, 2005: 2-4; IoD, 2009: chapter 3: par 78; King, 2006:140).

5. THE ROLE OF THE AUDIT COMMITTEE IN OVERSEEING THE EXTERNAL AUDITOR'S WORK

The audit committee has an important role to play in overseeing the external auditor's work and findings. This oversight role, when effectively performed, can significantly contribute to improving the credibility and reliability of the financial reporting process and the protection of the interests of various stakeholders (IoD, 2009: chapter 3, par 75-82; Marx, 2008: 313). These aspects are discussed below.

Engagement activities

The audit committee should be tasked with the responsibility of nominating the external auditors for appointment or re-appointment. Over and above independence considerations, the audit committee should also consider factors such as the audit firm's reputation and standing, involvement in litigation, low balling practices and other forms of improper conduct. A consideration specifically relevant to South Africa will be the firm's transformation credentials (King, 2006:140; Marx, 2008: 396).

Although the staffing of the audit is the responsibility of the engagement partner, consideration should be given by the audit committee to the qualifications, experience and continuity of staff who will be involved in the audit, as well as the firm's resources regarding the technical and professional support necessary to fulfil its oversight role and ensure that a quality audit is provided by staff familiar with the company. The audit committee should also request a letter of confirmation from the engagement partner that the firm and the engagement partner and staff are independent of the company. The audit engagement letter should be presented by the external auditor to the audit committee for its review, approval and sign-off. To further strengthen the external auditor's independence it is recommended that the chair of the audit committee should sign the engagement letter (Ernst & Young, 2005:19; PricewaterhouseCoopers, 2005:xiii, 56).
Planning of the audit

The external auditor should present the audit plan and proposed audit strategy to the audit committee for consideration and noting. The objective of this is to ensure that the audit committee fully understands the scope and extent of the audit. The proposed timing of the audit as well as the cooperation with internal audit and other client staff should also be discussed. The external auditor should also inform the audit committee of the planning materiality figure, as well as specific legislation, industry, accounting or other developments that could affect the financial statements and the audit thereof (KPMG, 2005: 67-68, 79; PricewaterhouseCoopers, 2005: 4, 53-58).

Audit findings and reporting

The external auditors should report their findings to the audit committee. In doing this they will be complying with their responsibilities in terms of the audit standards and provide the audit committee members with the information they need to effectively perform their primarily responsibility, namely the oversight of the financial reporting process. In this regard PricewaterhouseCoopers stresses the important role of the audit committee regarding financial reporting by stating that although audit committees may take on numerous additional responsibilities, the central reason for the committee is to oversee the integrity of the financial statements (PricewaterhouseCoopers, 2005:1-2).

Lastly, note should be taken of PricewaterhouseCoopers' 2006 findings of audit committee developments in the USA, in which it identified and stressed the need for audit committees to bring “discipline” to the financial statement reporting process and to ensure that “companies provide information to the investors that is digestible and reliable” (PricewaterhouseCoopers, 2006:8). Given the volume and complexity of IFRS, this is a daunting task and will not be possible for audit committees to achieve without an independent and effective external audit to rely on.

6. FINDINGS OF THE EMPIRICAL STUDY

6.1. Analysis of the annual reports

All the annual reports of the companies in the population (see Annexure 1) were inspected (100% coverage), and these were the most recent reports that were available at the time of conducting the research.

i) Objective of the analysis

The objective with the analysis of the responsibilities disclosed by the audit committees in the population regarding external audit was firstly to explore what responsibilities the audit committees are performing, and secondly to explore the quality and sufficiency of such disclosure. The latter was done by
comparing the responsibilities of the audit committee as disclosed to those actually performed according to the response of the audit committee chairs on the questionnaires.

ii) Findings

Table 1: Responsibilities disclosed in the annual reports that the audit committee perform regarding the external audit function

<table>
<thead>
<tr>
<th>External audit</th>
<th>Number</th>
<th>%</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Yes</td>
</tr>
<tr>
<td>Review the appointment of the external auditor</td>
<td>40</td>
<td>32</td>
</tr>
<tr>
<td>Review the proposed audit fee</td>
<td>40</td>
<td>28</td>
</tr>
<tr>
<td>Review the approval of non-audit services</td>
<td>40</td>
<td>26</td>
</tr>
<tr>
<td>Review the approval of non-audit fees</td>
<td>40</td>
<td>22</td>
</tr>
<tr>
<td>Review the external auditor's independence</td>
<td>40</td>
<td>31</td>
</tr>
<tr>
<td>Review the external auditor's professional ethics</td>
<td>40</td>
<td>11</td>
</tr>
<tr>
<td>Review the scope of the external audit</td>
<td>40</td>
<td>28</td>
</tr>
<tr>
<td>Review the findings of the external audit</td>
<td>40</td>
<td>30</td>
</tr>
<tr>
<td>The fact that that external audit has unrestricted access to the audit committee</td>
<td>40</td>
<td>17</td>
</tr>
</tbody>
</table>

Other external audit-related responsibilities disclosed that the audit committee perform include that of approving (and not reviewing) the auditor’s materiality figures, reviewing of taxation aspects with the external auditor, and entering into arbitration in the event of disagreements between the board and the external auditor.

The above findings are provided here for reference purposes only (that is, whether or not companies disclose whether they perform the stated responsibilities), whilst a discussion thereof is provided in section 6.3, where the disclosed responsibilities are compared to those responsibilities actually performed as per the response of the audit committee chairs on the questionnaires.

6.2. Questionnaires

i) Response rate

Table 2: Response rate

<table>
<thead>
<tr>
<th>(Audit committee chair questionnaire)</th>
<th>Number</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>No response</td>
<td>4</td>
<td>10.0</td>
</tr>
<tr>
<td>Correspondence received – policy is not to complete questionnaires or surveys</td>
<td>2</td>
<td>5.0</td>
</tr>
<tr>
<td>Completed and usable questionnaires</td>
<td>34</td>
<td>85.0</td>
</tr>
<tr>
<td>Total and percentage of questionnaires sent out</td>
<td>40</td>
<td>100</td>
</tr>
</tbody>
</table>
The response rate achieved for this part of the study of 85% useable questionnaires received back from the audit committee chairs is deemed to be very high and should contribute to the reliability and usefulness of the information provided. The high response rate could also be seen as support for the importance of audit committees and for corporate governance as a whole at large listed companies in South Africa.

ii) **Objective with the questions**

The objective with these questions was to determine which responsibilities and functions are being performed by audit committees regarding their external audit function.

iii) **Findings and deductions**

<table>
<thead>
<tr>
<th>Table 3</th>
<th>External audit-related responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>External audit-related responsibilities</strong></td>
<td><strong>Number</strong></td>
</tr>
<tr>
<td>Review the appointment of the external auditor?</td>
<td>34</td>
</tr>
<tr>
<td>Review the proposed audit fee?</td>
<td>33</td>
</tr>
<tr>
<td>Review the approval of non-audit services?</td>
<td>34</td>
</tr>
<tr>
<td>Review the approval of non-audit fees?</td>
<td>33</td>
</tr>
<tr>
<td>Review the external auditor's independence?</td>
<td>34</td>
</tr>
<tr>
<td>Review the external auditor's professional ethics?</td>
<td>27</td>
</tr>
<tr>
<td>Review the scope of the external audit process?</td>
<td>34</td>
</tr>
<tr>
<td>Review the findings of the external auditors?</td>
<td>33</td>
</tr>
<tr>
<td>Review whether or not the external auditor has unrestricted access to the audit committee?</td>
<td>34</td>
</tr>
</tbody>
</table>

*Source: Audit committee chair questionnaire (own calculation)*

The above findings indicate that all the audit committees perform the above functions except one that does not review the audit fee (2.9%), one that does not approve non-audit services (2.9%), and seven respondents (20.6%) who do not review the external auditors' professional ethics.

These findings can be interpreted to show strong support for the role that audit committees fulfil in supporting the external auditors' independence and effectiveness, and are in line with those responsibilities advocated in the literature as discussed in sections 4 and 5. An area that needs attention by some audit committees, however, is the review of the external auditors’ professional ethics.

6.3. **Comparative findings**

A comparison was done between the information obtained from the annual reports on audit committee responsibilities regarding external audit and that received from the audit committee chair questionnaires. This was done to enable a comparison between responsibilities actually performed by audit
committees according to the responses by their chairpersons and those disclosed in the annual reports. This comparison was done as it can be argued that accurate and complete reporting by audit committees in the annual report on the responsibilities actually performed by them regarding the external audit can contribute to supporting the external auditor’s independence and perceived effectiveness. Reporting to shareholders on how the audit committee discharged its responsibilities is also a recommendation of King III (IoD, 2009: chapter 3, par. 85).

Table 4: Comparison of audit committee responsibilities and functions performed as disclosed in the annual report and those actually performed as per the audit committee chairperson

<table>
<thead>
<tr>
<th>External audit</th>
<th>Annual report analysis %</th>
<th>Audit committee chair questionnaire %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review the appointment of the external auditor</td>
<td>60.0</td>
<td>100</td>
</tr>
<tr>
<td>Review the proposed audit fee</td>
<td>70.0</td>
<td>97.1</td>
</tr>
<tr>
<td>Review the approval of non-audit services</td>
<td>65.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Review the approval of non-audit fees</td>
<td>55.0</td>
<td>97.0</td>
</tr>
<tr>
<td>Review the external auditor’s independence</td>
<td>77.5</td>
<td>100</td>
</tr>
<tr>
<td>Review external auditor’s professional ethics</td>
<td>27.5</td>
<td>79.4</td>
</tr>
<tr>
<td>Review the scope of the external audit process</td>
<td>70.0</td>
<td>100</td>
</tr>
<tr>
<td>Review the findings of the external auditors</td>
<td>75.0</td>
<td>100</td>
</tr>
<tr>
<td>Review the fact that the external audit has unrestricted access to the audit committee</td>
<td>42.5</td>
<td>100</td>
</tr>
</tbody>
</table>

From the above information it is evident that audit committees are performing more functions and responsibilities than are actually disclosed and reported on in the annual reports. Although the inconsistency between the duties of the audit committees as performed according to the chairpersons and the disclosure thereof in the annual reports should not affect the “real or actual” effective functioning of the external audit, or that of the audit committee, it may affect the “perceived” effectiveness thereof. It may also contribute to an increasing audit and audit committee expectation gap (Griffiths, 2001:172; Marx, 2008: 17-19). These findings further provide support for the recommendations of King III (IoD, 2009: chapter 3, par. 85) that the audit committee report in the integrated report to the shareholders on how it has discharged its responsibilities.

7. CONCLUSION

This article discussed the evolving factors and developments that external auditors are constantly confronted with. The responsibilities that audit committees perform regarding the external audit at the large listed companies in South Africa were then empirically tested. The main findings of the study are that audit committees at the largest listed companies in South Africa are taking responsibility for overseeing the external audit function, but that the disclosure thereof in annual reports was found to be lacking. It is therefore recommended.
that companies should improve their disclosure of their audit committee activities in order to strengthen the independence and value, or perceived independence and value, of the external audit function and to limit possible expectation gaps in this regard. These findings are of significance as they provide support for the recommendations of King III (effective from 1 March 2010) that all companies should form audit committees that should have oversight responsibilities regarding the external audit function, and also that they should report to shareholders in the integrated report on how they have discharged their responsibilities.

A possible limitation of the study is that it was restricted to the largest listed companies in South Africa. The results reported in this paper should therefore not be generalised to smaller listed companies, unlisted entities or public sector institutions. It is recommended that areas for future research should focus on the role and responsibilities of the audit committee and its responsibilities regarding the external audit function, once the new Companies Act of 2008 becomes effective.

8. REFERENCES


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**ANNEXURE 1**

**NAMES OF COMPANIES INCLUDED IN THE POPULATION**

- ABSA Group Limited
- African Rainbow Minerals Limited (ARM)
- Anglo American PLC
- Anglo Platinum PLC (Amplats)
- Anglo Gold Ashanti Limited
- Arcelor Mittal Steel South Africa Limited (Acelormittal)
- Aveng Limited
- Barloworld Limited
- BHP Billing Limited
- Bidvest Group Limited
- Exxaro Resources Limited
- First Rand Limited
- Goldfields Limited
- Harmony Gold Mining Company Limited (Harmony)
- Impala Platinum Holdings Limited (Implats)
- Imperial Holdings Limited
- Investec Limited
Kumba Iron Ore Limited (Kumba)
Liberty Group Limited
Liberty International PLC
Lonmin Limited
Mondi Limited
MTN Group Limited
Murray & Roberts Holdings Limited
Nasionale Pers Limited (Naspers)
Nedbank Group Limited
Network Healthcare Holdings Limited (Netcare)
Old Mutual PLC
Pretoria Portland Cement Limited (PPC)
Remgro Limited
Richemont Securities AG (Richemont)
RMB Holdings Limited
Sanlam Limited
Sappi Limited
Sasol Limited
SAB Miller PLC
Standard Bank Group Limited
Steinhoff International Holdings Limited (Steinhoff)
Telkom Limited
Tiger Brands Limited
(Source: JSE 27 February 2008: Indices: FTSE/JSE CAP 40)