

# **Audit committee effectiveness within a New Zealand district health board: linking best practice guidelines to actual processes and perceptions**

## **Abstract**

The purpose of this paper is to examine the conditions and processes affecting the operation of an audit committee within the context of a New Zealand District Health Board (DHB). Using the New Zealand Auditor-General's best practice guidelines for a public sector audit committee as a benchmark, the authors found that the DHB rates moderately well in terms of 'effectiveness potential'. Over recent years, the DHB has successfully implemented many of these guidelines and the audit committee members report an improvement in audit committee operation as a result. However, factors are identified concerning the audit committee members' independence, competence, tenure, and remuneration, which may potentially impinge upon the overall effectiveness of the audit committee. Despite apparent shortcomings in these areas, the informal networks between audit committee members (particularly the chair) and management serve to maximise the 'realisation' of what potential effectiveness exists. As a result, the audit committee is perceived by its stakeholders (management, auditors and committee members) to play an important and effective role in the governance structure and operations of the DHB.

**Key Words:** Audit committees; district health boards

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## **1. Introduction**

The aim of an audit committee is to improve organisational governance, regardless of whether the organisation is in the private or the public sector. As a subcommittee of the governing body, an audit committee aims to provide assurance on financial and compliance issues through increased scrutiny, accountability, and the efficient use of resources. An audit committee may also serve an advisory function aimed at performance improvement within the organisation.

Over the past decade, the role of audit committees has become increasingly relevant, as high profile corporate scandals such as Enron and WorldCom have intensified corporate governance requirements and expectations. The perceived need for more audit committees (and for those audit committees to be more effective) has been galvanised through a combination of legislation and/or supported 'best practice' guidelines. Evidence has shown a significant rise and harmonisation in the use of audit committees internationally, including the European Commission's requirement that all public-interest entities in the European Union (EU) have an audit committee (Collier and Zaman, 2005). Likewise, in the United States (US), the Sarbanes-Oxley Act of 2002 was enacted, which requires, among other things, that companies use audit committees and disclose the composition of their audit committees in their annual reports.

In New Zealand, there is no specific regulatory or legislative requirement for private or public sector entities to establish audit committees. The justification for this position was articulated by the Institute of Chartered Accountants of New

Zealand (ICANZ) when they carried out a review of corporate reporting in 2003, and concluded that “while the existence of audit committees can be regulated for, their effectiveness cannot” (ICANZ, 2003, p.34). Moreover, ICANZ considered that the costs of mandatory compliance may exceed the benefits of an audit committee, particularly when considering the relatively small scale of operations in New Zealand. While this may be true for the majority of private sector businesses in New Zealand, this position is debateable with respect to the public sector, given the size, complexity, and social significance of some public sector operations.

New Zealand’s twenty one district health boards (DHBs), for example, are responsible for administering approximately NZ\$12 billion of health related services annually (New Zealand Treasury, 2008). It would appear that given the considerable size of this sector audit committees are likely to have an important role to play in the internal control structures within New Zealand’s public health care system. In addition to reducing agency costs, the potential for increased organisational performance as a result of audit committee efforts is also significant on this scale. As taxpayers and users of these health services, New Zealanders in general have an interest in ensuring that DHBs are governed and managed properly, and that audit committees are in place and operating effectively. The question is how best to measure audit committee effectiveness.

The aim of this study is to ascertain the perceived effectiveness of an audit committee within the context of a New Zealand public health organisation. In the absence of legislation for audit committees in the public sector, there are a number of ‘best practice’ recommendations for forming and operating audit committees, the most recent and expansive of which was published by New Zealand’s Auditor-General in March 2008. As a means of ascertaining the audit committee’s

effectiveness, this study examines the extent to which the DHB's audit committee follows these guidelines (i.e. how effective *should* the audit committee be) and compares this with actual operations and perceived effectiveness of the committee, as reported by the audit committee's stakeholders, being its members and the DHB's senior management and internal auditors.

## **2. Literature review**

### ***2.1 Development of audit committees, regulations and legislative context***

The concept of an audit committee was first proposed in the US by the Securities and Exchange Commission (SEC) in 1938, following the McKesson and Robbins scandal (Spira, 2006). However, it was not until the 1970s that any significant progress was made toward implementing audit committees in practice. In 1974, the New York Stock Exchange (NYSE) stated that an audit committee could stimulate improvements in financial reporting; and in 1978, the NYSE required the establishment of audit committees of independent directors for its listed companies.

Over the past two decades, numerous professional and regulatory committees in many countries have called for more universal adoption of audit committees with expanded roles in order to address perceived weaknesses in governance (for example, the Cadbury Committee in the UK (1992), the Australian Accounting Research Foundation (1997) and the Blue Ribbon Committee in the US (1999)). After the occurrence in 2001 of the high profile corporate failures of Enron and WorldCom, despite the existence of audit committees, the adequacy of audit committees was again questioned. Since then there has been a renewed focus on audit committee responsibility and the qualities necessary for effectiveness, including the Sarbanes-Oxley Act of 2002 in the US, the report of the Australian Treasury (2002) and the

recommendations of the Smith Committee (2003). The Sarbanes-Oxley Act of 2002, in particular, requires the formation of audit committees for all issuers registered with the SEC, and specifies the powers and independence requirements of audit committees.

In 2003, ICANZ formalised its recommendations on audit committees in a report, proposing only guidance (not regulation) for audit committee operations. Among the reasons stated for this was that regulations are no guarantee for audit committee effectiveness and regulations “can be cosmetic, giving investors a false sense of security [in some circumstances]” (ICANZ, 2003, p.42). Moreover, it was noted that the average size of listed companies in New Zealand is much smaller than the top 500 in the US or Australia, with New Zealand issuers less able to bear the costs of compliance. Despite these reasons, the New Zealand Stock Exchange (NZX) subsequently required its listed issuers to establish audit committees (rule 3.6), following the lead of the US and Australian markets (NZX, 2003).

In the New Zealand public sector, there are no specific regulatory or legislative requirements for establishing audit committees. By proxy, there are pieces of public sector legislation (such as the Public Finance Act 1989, Crown Entities Act 2004, and Local Government Act 2002) which require public entities to maintain a “system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial reporting” (Crown Entities Act 2004, s21). However, the legislation stops short of defining ‘internal control’.

The Institute of Internal Auditors (IIA) and Big-4 firm KPMG conducted a survey of audit committee practices across ministries and government departments in 2005. The survey found that audit committees are a relatively new phenomenon in the New Zealand public sector, with 18 departments of the 24 respondents having audit

committees in place (total 42 departments). These audit committees were chaired by the chief executive in 55 percent of the cases and were found to be typically bigger than their overseas counterparts, with a membership of six to eight; internationally three to five is normal. Souella Cumming, KPMG Partner for Government and Public Sector believes that “the disparity comes about because in New Zealand the senior management team are participating members, whereas overseas they are observers” (KPMG and Institute of Internal Auditors, 2005, p.1).

## ***2.2 Best practice characteristics – codification into guidelines***

Since audit committee formation began, best practice guidelines have been established by a number of parties internationally. Outside of New Zealand, notable best practice recommendations have been issued by the the National Commission on Fraudulent Financial Reporting in the US (the Treadway Commission) (1987), the Cadbury Committee (1992), the Blue Ribbon Commission (BRC) (1999), the Australian National Audit Office (2005), and all the Big-4 accounting firms. Within New Zealand, the Institute of Directors has issued a best practice statement pertaining to audit committees (1996), and the Securities Commission issued a number of principles and guidelines for corporate governance, which include some recommendations for audit committees (2004). Most recently the Office of the Auditor-General has issued a good practice guide for audit committees in the public sector (2008).

While there are minor variations in prescribed best practice recommendations, audit committee guidelines are becoming increasingly standardised as the perceived need for effective audit committees has intensified. In general, best practice guidelines consider audit committee members’ independence from management and

the governing body, financial literacy and expertise, experience with organisations, relationships with stakeholders, clarity of purpose, and willingness to commit time to the audit committee. Particular attention is given to the audit committee chair, as the 'tone from the top' and member attitudes are also considered by many best practice recommendations.

### **2.3 Audit committee research**

Most early studies concerning audit committees investigated the reasons for their existence, given that audit committees were initially set up voluntarily. Pincus (*et al.*,1989) identified six characteristics to be associated with voluntary audit committee formation - lower percentage managerial ownership of the company's stock, higher leverage, larger firm size, a greater proportion of outside directors to total directors, Big-8 auditors, and participation in the US National Market System. Bradbury (1990) found voluntary audit committees are unrelated to incentives to reduce agency cost, but found a relation between voluntary formation and directors' incentives, suggesting that audit committees may be created primarily for appearances. In another study illustrating this 'symbolic' reason for forming audit committees, Menon and Williams (1994) found many of the firms they studied that had established voluntary audit committees did not appear to rely on them. Some audit committees did not meet at all or met only once during the year studied.

Later studies examined audit committee characteristics, such as independence, experience, and expertise of members. One study noted that audit committee independence increases with board size (Klein, 2002); another found that audit committees with less financial expertise are likely to be identified with internal control weaknesses (Yan *et al.*, 2007). In a New Zealand study, Porter and Gendall

(1998) examined audit committees in both the public and the private sectors, and found that 70% of audit committees in the public sector and 60% in the private sector have CEOs as a member of the audit committee. Respondents in this study reported that an understanding of the audit committee purpose and ability to exercise sound judgment were the most important attributes of audit committee membership, ahead of independence and financial expertise, and contrary to the BRC recommendations. Rainsbury's study of listed companies in New Zealand (2004) found that members of their audit committees are generally directors with financial expertise and non-executive directors who are independent, as recommended in the New Zealand Securities Commission corporate governance guidelines. A further study of New Zealand listed companies found that as board size increases and the proportion of independent board members increase, the probability of having an audit committee that meets the Securities Commission's best practice guidelines for audit committees increases (Rainsbury *et. al.*, 2008).

More recently, studies have been designed to investigate associations between audit committees and other variables in order to appreciate audit committee effectiveness. Hsueh-En Hsu (2008) showed that audit committee independence is not associated with firm performance, nor was there evidence that audit committee activity is positively related to firm performance. However, firm performance increased with audit committee financial expertise. In a study underscoring the importance of the BRC recommendations, Abbot *et al.* (2004) examined cases of financial reporting restatement, and found that the independence and activity level of the audit committee exhibit a significant and negative association with the occurrence of restatement.

Despite findings of this nature, the research thus far has failed to measure audit committee effectiveness, in part because conceptions and definitions of effectiveness vary (Spira, 2006). For example De Zoort *et al.*, (2002, p. 6) define audit committee effectiveness by describing the characteristics of an effective audit committee as having “qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts”. However, this measure of audit committee effectiveness has been criticised for treating the audit committee as an isolated mechanism which fails to recognise the interdependence of audit committee components in a specific dynamic organisational context (Spira, 2006).

To date only a limited amount of research has been performed on the processes and perceptions surrounding audit committee activity set in specific organisational contexts. In one field study, Gendron *et al.* (2004) focused exclusively on the formal process of audit committee operation, examining what actually happened inside audit committee meetings at three large public corporations listed on the Toronto Stock Exchange.

Turley and Zaman (2007) carried out a case study of a major UK public company, in which they investigated informal processes and behavioural impacts of audit committees. In this study it was found that the most effective audit committee operation was as a result of informal communications and interactions, rather than through formal audit committee meetings. Turley & Zaman also identified three roles of the audit committee - as an ally, an arbiter or a threat. In a similar vein to Turley and Zaman’s research, this study seeks to understand informal as well as formal audit committee processes using a case study. In addition, inputs, processes, and outputs of

the audit committee have been compared to the Auditor-General's recently published good practice recommendations in New Zealand.

To date the majority of studies have considered the operation of audit committees in the corporate sector, both in New Zealand and overseas. This is the first known study that examines the operation of an audit committee within a public sector organisation in New Zealand.

### **3. Research objective**

Clearly, audit committees are potentially beneficial to DHBs—the fundamental question is whether their purported benefits are being realised in practice. The objective of this study is to ascertain how effective the audit committee is, as evidenced by its actual operations and as perceived by its stakeholders. This study will firstly ascertain the *purported* effectiveness of the audit committee by comparing the structure and operation of the audit committee against an external framework of best practice principles and recommendations which claim to support an effective audit committee. Secondly this study will ascertain how the audit committee actually operates by carrying out an internal review of the actual internal processes and operations of the audit committee. Finally the study will ascertain how effective the audit committee is perceived to be by interviewing its stakeholders.

The audit committee will be evaluated based upon the extent to which best practice guidelines are being followed with respect to audit committee structure and operation. This assessment emphasises potential—whether the audit committee *should* be effective based upon its formal attributes and external signals. For this purpose, the New Zealand Auditor-General's good practice guide has been used, as these guidelines are the most recent in New Zealand and arguably most relevant for

New Zealand public entities. This research therefore investigates the following areas with respect to the audit committee's composition: (i) the extent to which members are independent of management and (ii) possess requisite financial skills, (iii) the size of the audit committee, (iv) how members are remunerated, (v) appointed, and (vi) subsequently inducted into the audit committee process; the (vii) tenure of members, and (viii) the extent to which independent contractors are used. Additionally, activity-based audit committee characteristics are examined and compared to the Auditor-General's guidelines, including ensuring (ix) clarity of purpose (are audit committee roles clearly defined and activities linked to risk management), and (x) maintaining open and effective relationships among stakeholders. Comparisons to best practice guidelines arguably give some indication of the audit committee's 'effectiveness potential'.

Secondly, the factors which influence the audit committee's operations as a result of its unique organisational and interpersonal context will be ascertained, with the aim of seeking to understand the extent to which this 'effectiveness potential' is being realised. Formal and informal audit committee processes will be investigated, with a view to understanding how audit committee effectiveness may be tempered or enhanced by internal factors including organisational and behavioural considerations. The audit committee's stakeholders' perceptions and interactions will be examined in order to assess the extent to which the audit committee's activity is benefiting governance. In ascertaining the audit committee's effectiveness from both an external and an internal perspective, this research aims to assess the link between the audit committee's prescribed 'form' and resulting 'substance'.

#### 4. Method

This research is a case study, which investigates the operation of the audit committee of a single DHB. The case study approach allows investigation beyond the formal constitution and official policies so that the behavioural effects and informal processes that influence an audit committee's impact on governance can be more fully appreciated. It also allows closer analysis of the audit committee's operations within an organisational context. The term "audit committee stakeholder" that is used in this study refers to audit committee members, internal and external auditors, and senior management of the DHB, which mirrors the term used in the Auditor-General's guidelines.

Data for the case study was gathered from both primary and secondary sources, including:

1. Semi-structured interviews with relevant personnel affected by the audit committee's activities – Four DHB personnel were asked to describe compositional and procedural characteristics of the audit committee, their involvement with the committee's operations, and their perceptions of how the audit committee has impacted on the organisation. The personnel included the audit committee chairperson, an additional audit committee member, the internal auditor, and the chief financial officer<sup>1</sup>. All interviews were tape-recorded and transcribed for analysis.
2. Publicly available information – Annual reports, general board minutes, and the DHB website were used in this study.

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<sup>1</sup> The external auditor declined to participate in this study for confidentiality reasons.

3. Internally generated documents made available by the DHB – Information such as the internal auditor’s work programme and the audit committee charter were made available for the purpose of this study.

While this study is more descriptive than causal, the relationship between (a) the extent to which good practice recommendations are satisfied and (b) the actual audit committee operations and stakeholder perceptions of effectiveness has been considered. Interviews have been conducted to ascertain stakeholders’ perceptions of the audit committee effectiveness, as well as the informal processes and behavioural considerations affecting the audit committee operation.

As a case study, generalisation of these findings may be problematic—the evidence reported is specific only to the DHB studied. Further research into audit committees would be beneficial in establishing and appreciating any trends, particularly using a case study approach to appreciate internal processes. Moreover, assessments of effectiveness are inherently subjective—although basing effectiveness in part upon specifically prescribed external criteria (e.g. best practice guidelines) this study has not attempted to reconcile what relative weightings might be given to individual criteria when assessing ‘overall effectiveness’. Further, ‘self-reported’ information is prone to exaggeration or suppression given political pressures.

## **5. Results and analysis**

### ***5.1 The case study organisation***

The DHB studied has eleven independent members on its board, who are in charge of allocating NZ\$350M of health services annually (being one of New

Zealand's smaller health districts in terms of funding)<sup>2</sup> . Of these eleven board members, four members (plus the DHB's 'ex officio' chair) comprise the organisation's audit committee. Audit committee members are appointed from within the board and any board member interested in becoming a member of the audit committee may volunteer. Pursuant to the charter the audit committee meets quarterly for two to three hours at a time, 'behind closed doors', even though there is no specific mention of excluding the public from such meetings in the charter. Audit committee meetings are the only meetings of the health board that are not open to the public and the audit committee chair reports that this is due to the sensitive nature of what is often discussed.

According to the charter, the audit committee is responsible for oversight in four primary areas:

1. External financial reporting – reviewing and discussing the external financial reports with management (ensuring compliance with standards and that they are adequate for stakeholder needs)
2. Internal controls – considering their adequacy, reviewing management's reports on fraud and the effectiveness of internal controls
3. Risk management – reviewing the principal risks faced by the organisation and the effectiveness of the risk management system
4. Internal and external audits – evaluating the internal audit plan, and confirming/reviewing the external auditor's appointment, work programme, and fees

Regarding the above, it should be noted that while audit committees are often responsible for appointing the external auditor (and changing the appointment as

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<sup>2</sup> This was at the time contact was made with the organisation and the data was collected.

necessary to preserve objectivity) this discretion is not always an option in New Zealand's public sector as the Auditor-General allocates most audits of public entities to Audit New Zealand, and only uses competitive tendering for the audits of some of the more commercial public entities. Also, as this audit committee operates in the health sector, its scope has been expanded to consider clinical risk as well as the traditional business risks facing the organisation (although interestingly this is not specifically mentioned in their charter).

In carrying out these responsibilities, audit committee meetings adhere to a structured agenda, the largest part of which is set by the internal auditor through her annual programme, which also includes reviewing reports generated by the CEO and CFO. While the CEO, the CFO and the internal auditor are not audit committee members they are specifically granted a 'standing invitation' in the charter to attend audit committee meetings. Once a year, the external auditor's report to management is evaluated. Thus, the audit committee's primary interactions occur with the internal auditor, CEO, CFO and external auditor, with periodic reporting back to the full board.

## ***5.2 Observing best practice guidelines***

The audit committee adheres closely to the Auditor-General's more 'procedural' best practice guidelines. The audit committee's size, frequency of meetings, and existence of a charter (which clearly defines roles and responsibilities) are all in line with these guidelines. Since the beginning of its term last year, the audit committee consciously structured its operations in line with the audit committee guidelines, which were issued by the Institute of Directors in 1996, which are very similar to the Auditor-General's guidelines. However, there are some apparent

discrepancies between the Auditor-General's recommendations for best practice and the audit committee's actual operations. Discrepancies were found in the areas of tenure/rotation, independence, competence, remuneration, and effective relationships. These are discussed in more detail below.

### *Tenure/rotation*

The Auditor-General recommends that an individual's tenure on an audit committee should be two to three years, with an option for reappointment for independent members, and that changes to membership be staggered to prevent a significant reduction in the knowledge and skills of the audit committee occurring at one time.

DHB members are elected and appointed every three years, so it is possible to have an entirely new board (and thus entirely new audit committee) every three years. The audit committee members studied were in fact all first-term members to the committee with no 'staggering' of members. While full member rotation may be advantageous for obtaining fresh perspectives, it is recognised that it may not be beneficial in terms of maintaining the consistency necessary for effective operation. This criticism was made by the audit committee chair about the DHB board in general, and the audit committee specifically.

### *Independence*

It is recommended that most members of the audit committee should be independent from management; the greater its collective independence, the better it is able to add value through objective, impartial advice. With this in mind, it is also

recommended that the audit committee should have ‘committee-only’ time when senior management and other non-audit committee members are absent.

All members of the audit committee are independent, but potentially concerning is that the internal auditor, who has 15 years experience at the DHB, could not recall a meeting where neither the CEO or the CFO were present, since the inception of the audit committee. The audit committee chair said that the committee “reserves the right to meet privately, but hasn’t yet found it necessary to do so”. All of the interviewees in the study believe there is an atmosphere of free and frank debate at the meetings, so this may not be an issue (but is potentially a concern).

### *Competence*

Guidelines in this area are naturally subjective but suggest that audit committee members should have adequate experience and expertise for their role on the committee. This includes a collective need for: financial expertise; knowledge of governance, assurance, and risk management best practice; knowledge of the sector in which the entity operates; and other business acumen as deemed appropriate (e.g. legal or IT experience). Where members of the governing body do not have the requisite skills to be on the audit committee additional skills should be obtained by appointing independent expertise to the committee. The guidelines further recognise the audit committee chairperson as the most important appointee, who needs to have governance experience and good communication skills.

A DHB, like other public entities, differs from private entities in that most members of a board are elected rather than appointed. While democracy has its advantages, there is no guarantee that a public election process will yield competent representation. Thus, the DHBs in New Zealand include a number of ministerial

appointments, being the only mechanism by which the necessary degree of competence is ensured.

The DHB studied has four elected members; the audit committee chair being the only appointee on the committee. The audit committee chair is a Chartered Accountant, has been a company secretary of a New Zealand listed company, and has spent many years as a director in various sectors, demonstrating a strong legal and administrative background. While the internal auditor describes the audit committee as usually “at the sharp end of the board”, the audit committee chair is nonetheless the only person presently on the committee with this quality of background. Although the audit committee chair notes that “each member contributes in their own way”, he describes the other members as “essentially laypeople” with little or no experience in audit committee-related activities (although one member operates a small business, and another acts as a trustee). As a result, the chair reports feeling a tremendous amount of personal pressure, considering it a “huge burden because the rest of board rely on [him] for financial expertise”.

Further, the chair is critical of other audit committee members insofar as he feels that they frequently pass responsibility to him rather than participating in the collective ownership of their duties. However, given the complexity of the DHB’s operations and the apparent deficit in some members’ skills and experience, it is understandable why this may be occurring. Despite feeling this pressure, the chair had not seriously considered obtaining additional skills by appointing an independent member to the audit committee (nor has there been any precedent for doing so over the history of the DHB’s various audit committees).

### *Remuneration*

The general recommendation is that audit committee members should be paid at a level that reflects the time it takes to carry out duties, with an allowance for particular skills brought to the committee.

With remuneration for DHB members fixed by the Minister of Health, under the Crown Entities Act 2004 there is little room for negotiation. Board members are paid \$19,500 each year, with an extra \$2,500 paid for work on subcommittees. The audit committee members who were interviewed stated that they personally did not consider the money a factor in influencing their participation on the audit committee. However, the chair noted that insufficient remuneration could indeed be an issue for others "depending upon their motivations", as he considered the pay "a joke given the DHB's scale of operations and considering what a similar position would pay in the private sector". Further, the internal auditor described occasions where past board members would not show up to meetings, "perhaps because it wasn't worth their time". Even allowing for an element of public service, the Auditor-General is likewise concerned that this compensation may be too low to attract people with the required skills, a particular concern should the audit committee ever deem it necessary to appoint an independent member to the committee to supplement its expertise (Office of the Auditor-General, 2008).

### *Open and effective relationships*

In order to achieve an environment of cooperation and trust, it is recommended in the Auditor-General's guidelines that the audit committee chair specifically promotes open and proactive dialogue with management and other governance committees.

By and large, all interviewees reported a ‘good’ and ‘open’ working relationship between the audit committee and other stakeholders (including management and the external auditors). While the CFO reported that there had been “a bit of tension between [him] and the audit committee chair over report presentation issues”, he acknowledged that this sort of tension is necessary and “the key is not to take things personally”. Further evidence of how interpersonal relationships impact the audit committee’s operations is apparent when recognising the informal processes surrounding the committee.

### ***5.3 Formal and informal processes, perceptions, and behavioural considerations***

Overall, the formal processes associated with audit committee operations indicate that the committee plays a very reactive role, much like a ‘monitor’; largely dependent upon the manner in which other parties choose to interact with it, rather than taking a proactive role. However, formal audit committee meetings are recognised by management as a valuable mechanism to use the committee as a ‘sounding board’. Because audit committee meetings are closed to the public and as such are a completely undiscoverable process, it is common for management to use these occasions to ‘test the waters’ to see how the board is likely to react to a management proposal without involving the whole board (especially if it is likely to be a contentious issue); management can essentially say things ‘off the record’.

However, it is outside of the formal quarterly meetings where the audit committee seems to have the strongest impact on the organisation. The internal auditor and audit committee chair meet monthly on average for ad hoc discussions, and the chair reports that he receives emails on a daily basis for some sort of advice in his capacity as chair. He states that the CEO telephones him every six to eight weeks

for an 'off the record' chat, as does the CFO to discuss accounting matters (e.g. IFRS treatment of balance sheet items).

The importance of informal interactions is illustrated by evidence from several occasions when the authority of the audit committee was influential in resolving organisational issues. On several occasions, the internal auditor has telephoned the audit committee chair to express her concerns that the CEO may be overstepping his role, "by not taking things to the board when he should". In the DHB's normal reporting chain, the internal auditor reports directly to the CEO, but in these instances she approached the audit committee chair with the issue, knowing that he would help to resolve the matter "in a way which did not come back to hurt [her] personally". She believes that she can go to the audit committee chair with any issue, feeling 'safe' considering his diplomatic abilities.

The internal auditor stated that she does not "go running to the audit committee in every instance, but just with key issues" as she feels if she used this power frequently it would "loose its effect". As a result, she believes that management now views her involvement with the audit committee as an implicit threat. In other words, management knows that she may decide to take information to the committee, which is then passed on to the board, and the board is likely to ensure management has dealt with the issue. She contends that it is often precisely because of this implied threat that management takes action to address her concerns; without her interaction with the audit committee, she believes some of her concerns may go unheeded by management.

While the audit committee may sometimes be used as a threat, other occasions demonstrate its function as both arbiter and ally. During the past year's external audit, the audit committee played a part in affecting the balance of power between

management and the external auditor. Here, when the external auditor questioned the CFO's treatment of an item on the annual report, the CFO contacted the audit committee chair for advice, and the chair then helped persuade the external auditor to agree with the CFO's position. On another occasion, a board resolution which was to be signed by the CEO was worded incorrectly (the wording of the resolution was contrary to the Board's intention when passing it). The CEO, after receiving legal advice, was therefore reluctant to sign the misstated resolution, so instead contacted the audit committee chair to discuss the matter. The chair acted as arbiter between the Board and the CEO to convince the CEO to sign and follow the resolution as it was intended (rather than as it was stated) to expedite the process (rather than waiting until the next full Board meeting). Regardless of the role assumed by the audit committee, it appears that its impact on the organisation is largely through dealing with non-routine situations, consisting of informal communications between the committee's stakeholders.

All interviewees perceived the audit committee as having an important and necessary role in the organisation. There are, in fact, four subcommittees of the DHB including the audit committee; the other three are required by statute and include the Community and Public Health Advisory Committee, the Hospital Advisory Committee, and the Disability Support Advisory Committee. Ironically, some interviewees perceived the audit committee, which is the only non-mandatory committee, to be the most valuable committee of the DHB. The CFO was perhaps the most critical of the audit committee; he thought that it would be better if its members had greater collective expertise and understanding of financial matters in order to offer more productive advice and assurance. In the absence of a dedicated 'finance committee' at the DHB, he wanted the audit committee to assume a stronger financial

focus and act as a ‘sounding board’ to support him in ensuring the organisation’s financial integrity. In his view, the board should consider appointing one or more independent ‘experts’ to the audit committee, in addition to the chair, to supplement the apparent ‘competence deficit’.

Despite general support for the audit committee’s operations, the interviewees were not unanimous in supporting mandatory regulation of audit committees. The chair felt that audit committees should “definitely” be mandatory for DHBs, while others felt it should simply remain ethically incumbent upon governing bodies to form audit committees. Those reluctant to support regulation pointed to the perceived ineffectiveness of other mandatory committees, mirroring ICANZ’s position that effectiveness cannot be legislated. Another interviewee noted that “most of the DHBs have [audit committees] anyway, so what’s the point in making them mandatory?” Of course, the argument for regulation is that some measure of the audit committee quality can be ensured through prescriptive requirements (e.g. in relation to member competence and independence) in addition to merely requiring the existence of audit committees.

Having been employed by the DHB for many years, the CFO and internal auditor both reported that the audit committee’s effectiveness has been steadily improving. The audit committee is now meeting more regularly, and having a greater positive impact than it had in the past. The general ‘improvement’ in audit committee operations seems to have occurred over the same period of time in which the committee has made a conscious effort to refocus its activities and implement best practice recommendations. As a result, the audit committee is perceived by interviewees as being a valuable tool to assist in achieving proper governance.

## **6. Discussion and conclusions**

This case study has described the actual operations and the impact an audit committee has had on a New Zealand public health organisation at a particular point in time. The structure, role and constitution of the audit committee were first assessed against an external framework of best practice guidelines, and then the actual operations were examined by obtaining evidence of the audit committee's impact on the organisation and its interviewees. The relationship between these two measures of effectiveness is now considered in order to ascertain the extent to which these conditions may impinge upon or support the impact of the audit committee's operations.

Overall, this study suggests there is a strong parallel between the potential effectiveness of the audit committee as determined by best practice guidelines, and the extent to which the audit committee positively impacts upon the organisation, as reported by its stakeholders. The audit committee's composition and activities follow the Auditor-General's best practice recommendations to a large extent (e.g. regarding audit committee size, frequency of meeting, open relationships between stakeholders, and a defined scope of operation); however, the audit committee's potential effectiveness is tempered by other conditions that run contrary to recommendations (e.g. lack of 'committee-only' time, low remuneration of committee members, insufficient overall competence of members and inexperience of the committee due to member rotation practices).

When considering the perceptions of the audit committee stakeholders, the reported criticisms of the audit committee generally reflect the 'deficits' noted from the best practice analysis. In other words, the audit committee stakeholders are most critical of the audit committee's lack of overall financial expertise, and recognise that

this may be limiting its effectiveness. These parallels suggest that regulation which prescribes audit committee composition and activity in compliance with the Auditor-General's recommendations may well address perceived weaknesses within this audit committee's operations. For example, prescribing requisite levels of audit committee member competence may ensure that independent expertise is contracted to the audit committee when necessary; however this will come at an additional financial cost to the DHB.

Despite identifying areas of potential concern, the case study was able to identify a number of instances where the audit committee's influence was significant in resolving organisational issues. On these occasions, it appears that the informal networks between the audit committee's stakeholders are especially important (particularly between the chair and management), serving to maximise the 'realisation' of what potential effectiveness exists. While best practice recommendations emphasise the importance of the audit committee chair as the driving force behind the committee, the informal processes around audit committee operation are largely ignored in guidelines. The importance of informal communications and interactions between the audit chair in particular and management support the results from the previous research into audit committee effectiveness carried out by Turley and Zaman (2007).

This study found that the audit committee served various roles in different circumstances, including a threat, an ally and an arbiter. These findings also support the research carried out by Turley and Zaman (2007) on an audit committee in a private entity and suggest that that roles of an audit committee in a public entity are similar to the roles of an audit committee in a private entity.

Finally, this study shows that the role and influence of the audit committee is impacted by its organisational context and historical development within the organisation. Longitudinal studies could help provide additional evidence about how historical events may shape audit committee operations, for example ministerial policies, implementation of best practice guidelines, and occurrences of fraud.

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