

# Audit Committees and Audit Quality: Trends and Possible Areas for Further Consideration

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## 1 Introduction

The audit committee plays an important role in oversight of audit quality and financial reporting. The audit committee may also oversee the risk management system of a company, including financial, operational and compliance risks. Concerns as to the impact of ineffective audit committees in the financial reporting failures at the turn of the 21st century have resulted in tighter regulatory and monitoring frameworks for audit committees across the globe. Even though the importance of audit committees is widely acknowledged, one study - by the University Utara Malaysia - has demonstrated that an independent audit committee is often not opted for voluntarily. Instead, the study noted a trend to have audit committees operate only in accordance with the minimum requirements as prescribed by local law.<sup>1</sup>

Direct supervision on audit committees by audit regulators is uncommon. Many IFIAR members do not have jurisdiction over audit committees or only in a monitoring capacity (EU). At the same time, audit regulators (whether they have jurisdiction or not) and audit committees share a central role in the support of audit quality and might help to improve audit quality by working together, *e.g.* by sharing information. This IFIAR paper provides information with the aim of developing a better understanding of how audit committees function under existing requirements. It also raises questions and identifies areas for further consideration that might provoke discussion among interested parties, such as investors, audit committee members, (audit) regulators and policymakers and also lead to improvement in individual jurisdictions, *e.g.* on whether audit regulators should share their inspection findings directly with audit committees. As such, the paper is intended to provide food for thought for those with jurisdiction over audit committees and all other interested stakeholders. This paper is not binding, nor an IFIAR position paper.

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<sup>1</sup> Strengthening Corporate Governance Through An Audit Committee: An Empirical Study, article in *Wulfenia* 23(2):2-27, February 2016, [https://www.researchgate.net/publication/293826024\\_STRENGTHENING\\_CORPORATE\\_GOVERNANCE\\_THROUGH\\_AN\\_AUDIT\\_COMMITTEE\\_AN\\_EMPIRICAL\\_STUDY](https://www.researchgate.net/publication/293826024_STRENGTHENING_CORPORATE_GOVERNANCE_THROUGH_AN_AUDIT_COMMITTEE_AN_EMPIRICAL_STUDY)

The purpose of this paper is to describe the state of play with respect to existing audit committee requirements around the world. In doing so, the paper draws heavily on a recent survey from the International Organization of Securities Commissions' ("IOSCO"). Secondly, the paper asks questions and identifies areas for further consideration by interested parties, both those IFIAR Members with jurisdiction over audit committees or in a monitoring capacity, as well as other interested stakeholders. For audit regulators that do not have jurisdiction over audit committees, the paper is for information purposes only.

The paper is structured as follows: Chapter 2 provides an executive summary. Chapter 3 elaborates on the results from the IOSCO Survey Report on Audit Committee Oversight of Auditors ("the 2016 Survey") on requirements related to audit committees. Chapter 3 also includes observations about the operation of audit committees in various jurisdictions around the world. Based on the information provided in the previous chapter, Chapter 4 raises various questions related to the oversight role of audit committees and their interaction with audit regulators, and also identifies areas for further consideration that might further enhance audit quality. Chapter 5 offers some brief concluding remarks.

**Disclaimer**

*The content of this paper, including the questions raised and areas for consideration suggested in this paper, reflect the views expressed by some, but not necessarily all, of the Members of IFIAR. They are not intended to include, or reflect, any or all the views of individual Members. Nothing in this paper is binding on any Member nor gives rise to any legal rights or obligations. Members participate in IFIAR in accordance with their respective legal and policy frameworks, which are in no way affected by anything in this paper.*

## 2 Executive Summary

Audit committees play an important role in audit quality oversight and in improving audit quality globally. A recent IOSCO survey of audit committee requirements around the world demonstrates that there is much common ground with respect to such requirements.

For example, in many jurisdictions:

- Audit committees (or some similar governance entity) are required within listed companies, and there are also requirements regarding the independence, special skills and expertise of audit committee members;
- The audit committee is responsible for or should at least play an active role in the selection of the external auditor, determination of the audit fees and the periodic assessment of auditor performance;
- The audit committee should set the policy for and monitor the provision of non-audit services by the auditor, including specific tax or advisory services to the audited entity; and
- Effective engagement and communication between the audit committee and the auditor is encouraged.



This paper also raises questions and identifies areas for further consideration that could enhance the role of audit committees in improving audit quality. For example, the following areas might benefit from further consideration, discussion and research by regulators, audit committees, shareholders and audit firms:

- The desirability of criteria that define and determine the independence, special skills and expertise of audit committees.
- To enable the audit committee to make more appropriate assessment of the auditor's performance, the utility of:
  - having a set of Audit Quality Indicators ("AQIs") which audit committees could use to engage auditors in audit quality matters;
  - asking audit firms and audit committees to consult with each other regarding the findings by the independent audit regulator of the reviews of the quality of statutory audits;
  - providing more detailed expectations for periodic assessments of auditor performance; and/or
  - asking audit committees to make use of other sources of information besides their own experiences and information from the company's management, which may not always be complete and objective.
- Engaging shareholders in auditor selection.
- Involving investors with audit committees as a way to incentivize audit firms to sharpen their focus on audit quality.
- How communications from audit regulators, the audit firms and shareholders to the audit committee can serve to improve audit quality.
- The use of a "comply or explain" procedure in carrying out various responsibilities of the audit committee, for example when an audit failure is exposed

The following chapter reviews the IOSCO Survey on requirements related to audit committees and provides a number of observations about the operation of audit committees in various jurisdictions around the world.

### **3 IOSCO's Survey provides a good starting point for understanding existing requirements for audit committees and identifying possible areas for further consideration**

In 2016, the Audit Quality Task Force ("AQTF") of IOSCO's Board surveyed its ordinary members to gain a better understanding of the current requirements of its members related to the audit committee's oversight of the auditor and the audit process of publicly listed entities in IOSCO member jurisdictions ("the 2016 Survey").<sup>2</sup> These requirements include both existing legal and regulatory requirements, as well as soft law requirements, such as self-regulatory codes or best practices documents. In total, 47 IOSCO members took part in the survey.<sup>3</sup> The core areas covered by the 2016 Survey are the following: Audit Committee Requirements; Selection of the External Auditor and Fee Determination; Audit Committee's Role and requirements to Oversee the Audit and the Auditor; Periodic Assessment of auditor performance; Auditor's Communication with the Audit Committee; and Audit Committee Reporting to Shareholders.

A comparison of the 2016 Survey with IOSCO's previous survey of audit committee requirements in 2004 ("the 2004 Survey") illustrates that audit committees have been established in a growing number of jurisdictions. It indicates a promising progress which is welcomed by IFIAR. The information provided by the 2016 Survey have also helped in the identification of possible areas for further consideration related to audit committees.

#### **3.1 Audit committees often require independence, special skills and expertise**

Most of the responding jurisdictions in the 2016 Survey require an audit committee or a committee with similar functions. In all jurisdictions that have such a requirement, it is compulsory that at least one audit committee member is an independent non-executive director. Some require more than one, or all, audit committee members to be independent. The respondents reported various criteria which they apply to determine independence. Some take an objective approach (e.g. by considering share ownership percentage), while others take a more subjective approach (e.g. whether the audit committee member is independent of management and free from any business or other relationship that could interfere with the exercise of independent judgement or the ability to act in the best interest of a publicly listed entity). In addition, some jurisdictions limit the maximum total term for an audit committee member's (re-)appointment. These terms normally range from 6 to 12 years and may in some cases be aligned with other corporate governance requirements.

<sup>2</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD531.pdf>

<sup>3</sup> Argentina, Australia, The Bahamas, Belgium, Brazil, Canada, Chile, China, Czech Republic, Denmark, Dominican Republic, El Salvador, France, Germany, Greece, Hong Kong, Hungary, India, Ireland, Israel, Jamaica, Japan, Lithuania, Luxembourg, Malawi, Malaysia, Mauritius, Mexico, The Netherlands, Oman, Pakistan, Poland, Portugal, Russia, Slovenia, Spain, Sri Lanka, Republic of Srpska, Sweden, Switzerland, Chinese Taipei, Thailand, Tunisia, Turkey, United Arab Emirates, United Kingdom, United States of America.

In the vast majority of the responding jurisdictions, one or more member(s) of the audit committee must possess special skills or experience. However, there is not a uniform approach as to whether the requirement is applicable to one member, several members, or all members of the audit committee. A limited number of jurisdictions apply incremental requirements only to the chair of the audit committee.

#### *Independence*

Ensuring the independence, objectivity and professional scepticism of the audit committee can be facilitated, for instance, by requiring the chair as well as the majority of the audit committee to be independent. Such a practice is in place in a number of jurisdictions.

#### *Observed practice in many jurisdictions*

*Before a former audit practitioner can become an audit committee member, full departure and financial separation from the audit firm is required. Stock exchange listing rules require that the publicly listed entity itself establish clear hiring policies for employees or former employees of the independent auditor. It is also observed that further restrictions apply in the auditing and ethics standards.*

#### *Special skills and expertise*

Specifying the required skills and expertise of audit committee members can contribute to the effectiveness of the audit committee. The increasing complexity of businesses, financial reporting, internal controls and the audit has an impact on both the scope and nature of the responsibilities of the audit committee. Therefore, it is important that the individual audit committee members possess appropriate expertise. Furthermore, the collective competence of an audit committee should be such that it is able to effectively carry out its responsibilities. Thus, it is important that the audit committee as a whole possesses the appropriate skills needed to carry out its work in a responsible manner.<sup>4</sup> Various stakeholders have emphasized the benefit of an audit committee composed of members with diverse experience and expertise and encourage a complement of financial and non-financial expertise to enhance the objectivity and scepticism of committee members.<sup>5</sup> In considering financial expertise, there should not be an undue emphasis on qualifications, but current and relevant experience should also be considered, for instance by having a background as a Chief Financial Officer (CFO).

#### *Chair*

The importance of strong leadership qualities for the chair of the audit committee has been emphasized by various commentators.<sup>6</sup>

<sup>4</sup> Accountancy Europe recommendation for improvements of audit committees no. 4 [http://www.accountancyeurope.eu/wp-content/uploads/Discussion\\_Paper\\_on\\_Audit\\_Committees\\_120615.pdf](http://www.accountancyeurope.eu/wp-content/uploads/Discussion_Paper_on_Audit_Committees_120615.pdf)

<sup>5</sup> Global Observations on the Role of the Audit Committee, A summary of Roundtable Discussions <http://thecaq.org/sites/default/files/globalobservationsontheroleoftheauditcommittee.pdf>

<sup>6</sup> Global Observations on the Role of the Audit Committee, A summary of Roundtable Discussions <http://thecaq.org/sites/default/files/globalobservationsontheroleoftheauditcommittee.pdf>

### **3.2 The audit committee often plays an active role in the selection of the external auditor and in fee determination**

The audit committee is involved in the initial selection and the subsequent re-appointment of the external auditor in the vast majority of responding jurisdictions in the 2016 Survey. They are either directly responsible or they are involved by means of making a recommendation to the board of directors (or equivalent body). For instance, the EU audit reform legislation requires that the audit committee be responsible for auditor selection procedure and also define the selection procedure.<sup>7</sup> On the other hand, the audit committee is often *not* involved in the determination of the audit fee. According again to the 2016 Survey, in only some of the reporting jurisdictions is the audit committee required to make a recommendation or assessment of the audit fee for the consideration of the board of directors and in only a minority of the reporting jurisdictions is the audit committee directly responsible for the determination or approval of the audit fee, without further consideration by the board of directors.

#### **Observed practice in many jurisdictions**

*The audit committee, in its capacity as a committee of the board of directors, is directly responsible for the selection and re-appointment of the auditor.*

#### **Quality First**

It is a widely accepted view that it is not appropriate for the audited entity's **management** to appoint its own auditor. The selection of the auditor should be based more on the quality of the auditor than on fee considerations. In cases where the selection process is determined or significantly influenced by audit committees, this generally results in a more in-depth external audit (*e.g.* lower materiality threshold, greater degree of professional scepticism). It has also been suggested that auditors should not accept engagements where the audit committee is not leading the selection process.

In addition, it has also been suggested that, given the significance and complexity of the selection of an auditor, and recognizing that investors are the ultimate clients for a statutory audit, investors should be engaged in the selection process for the auditor. The audit committee could, for instance, include shareholder views and perceptions in risk indicator analyses. Moreover, by not including observations and perceptions from investors in the selection and evaluation of the auditor, investors may build in extra cost of capital for the audited entity.<sup>8</sup> A recent investor perception study carried out in Singapore also indicated that investors would like to engage with audit committees more and would like audit committees to explain to them the basis for selecting auditors.<sup>9</sup> This also comes from notes on good practice on audit tenders published recently by the Financial Reporting Council (FRC)<sup>10</sup>.

<sup>7</sup> Directive 2014/56/EU – Article 39.6 (f), Regulation 537/2014 – Article 16

<sup>8</sup> Panel session with the Advisory Group to the IOSWG, IFIAR plenary meeting, 20 April 2016

<sup>9</sup> ACRA-SGX-SID Investor Perception Study [https://www.acra.gov.sg/Into\\_the\\_Minds\\_of\\_Investors/](https://www.acra.gov.sg/Into_the_Minds_of_Investors/)

<sup>10</sup> Audit Tenders Notes on Best Practice, FRC, February 2017, <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Tenders-notes-on-best-practice.pdf>

Once the selection of the auditor is made, the determination of the audit fee can be the outcome of a careful consideration of different factors. Since investors pay the auditor's fee in their capacity as shareholders of the audited entity, this is often presented as the reason why the audit committee should actively engage with investors over the level of the fee. Ultimately, the fee should be dependent on the scope and quality of the audit and investors are not likely to accept a fee level that only delivers a low quality, high risk audit.

### ***3.3 The role of the audit committee with respect to auditor independence and the provision of non-audit services by the auditor, including tax or advisory services, to the audited entity***

In almost every reporting jurisdiction in the 2016 Survey, the audit committee is responsible for assessing and ensuring the independence of the auditor. In most cases, this assessment occurs only upon the appointment and re-appointment of the auditor. Many jurisdictions also noted that the applicable audit standards require the auditor to report to the audit committee whenever his or her independence is potentially impaired and to explain the safeguards in place to protect independence. In addition, in order to ensure auditor independence, the vast majority of the respondents prohibit the provision of certain non-audit services or, alternatively, require approval for certain non-audit services by the audit committee.

### ***3.4 Periodic assessment of auditor performance is an important task of the audit committee in many jurisdictions***

In approximately three quarters of the responding jurisdictions in the 2016 Survey, audit committees are responsible for periodically assessing auditor performance. In the majority of those jurisdictions, however, the specific factors to be considered are not set out in the relevant laws and regulations. Most audit committees choose to take into account the overall effectiveness of the audit process and their experience with the auditors by looking at quality and service.

Assessing audit quality can be a challenge for the audit committee. For example, research by the Dutch Authority for the Financial Markets ("AFM") revealed that audit committees in the Netherlands tend to use their own experiences and information from the company's executive board for this purpose. They have

#### ***Observed practice in many jurisdictions***

*Audit committees are required to establish and subsequently monitor a mechanism by which the audit committee can be alerted to complaints related to accounting, internal controls or auditing matters. Such a complaint monitoring mechanism (e.g. a whistle-blower hotline) can be used to monitor auditor performance, in addition to management's performance.*

limited access to or awareness of the findings of the internal quality reviews carried out by the audit firm on audit files or of the findings of reviews of the audit firm by the AFM or other supervisors.



On the other hand, drawing on evidence from own enquiries of the audit committee is also very valid. UK's FRC has developed a practice aid at the request of and with the input of audit committee members, which asked for guidance as to how to structure and obtain evidence to support their assessment of the external audit. The practice aid sets out how audit committees might obtain such evidence in the course of undertaking normal oversight of the financial reporting process; including drawing on the audit committee's observations of, and interactions with, the auditors and through interactions with management, company personnel and from external parties such as regulators.<sup>11</sup>

In recent times, greater emphasis has also been placed on measuring audit quality through the development of audit quality indicators ("AQIs") by some regulators, oversight bodies, professional bodies and audit firms<sup>12</sup>. Such indicators may help audit committees to make a more objective evaluation of the auditor's performance on audit quality, although it is recognised that selection of appropriate AQIs is key and that a range of more subjective factors will also be relevant.

#### *Observed practice in the European Union*

*Jurisdictions that advocate transparency to all stakeholders require a Transparency Report. Recent European Audit Regulation contains specific requirements for the statutory audit of Public Interest Entities (PIE) and requires the auditor to prepare an additional report for the audit committee. In this additional report, the auditor explains the results of the statutory audit performed and includes information with respect to his communication with the audit committee, his findings in relation to (suspected or identified) non-compliance, to the extent these findings are considered to be relevant to the ability of the audit committee to perform its duties.*

<sup>11</sup> Audit Quality Practice Aid for Audit Committees, FRC, May 2015, <https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Audit-Quality-Practice-Aid-for-Audit-Committees.pdf>

<sup>12</sup> Accountancy Europe's Overview of Audit Quality Indicators Initiative: [http://www.accountancyeurope.eu/wp-content/uploads/1607\\_Update\\_of\\_Overview\\_of\\_AQIs.pdf](http://www.accountancyeurope.eu/wp-content/uploads/1607_Update_of_Overview_of_AQIs.pdf)