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AUDIT & ASSURANCE FACULTY

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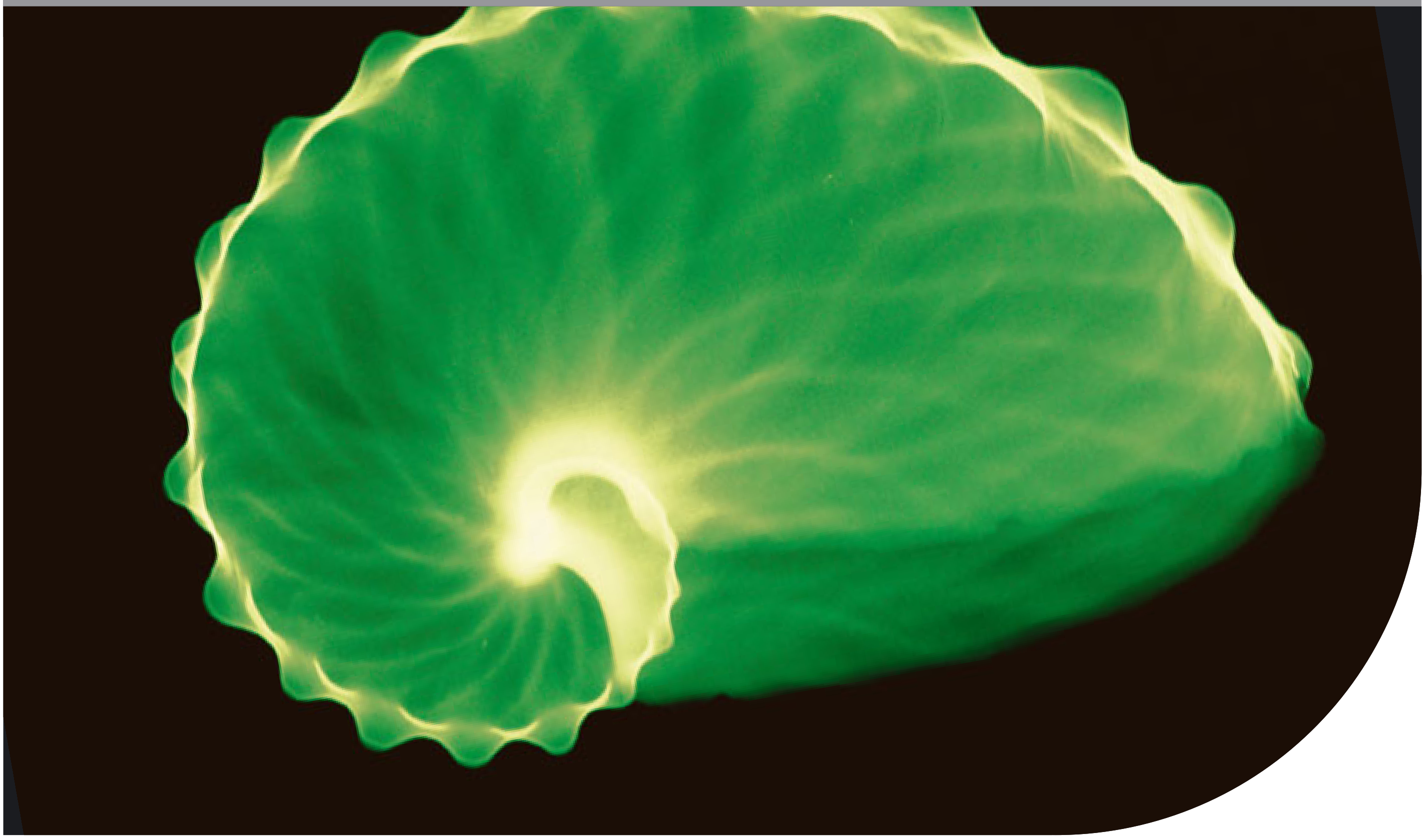
EVOLUTION

THE IMPACT OF AUDIT COMMITTEES ON AUDITING



The *Audit Quality Forum* brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue in order to contribute to the work of governments and regulators and by generating practical ideas for further enhancing confidence in the independent audit.

The completed programmes of *Shareholder Involvement* and *Fundamentals* lead naturally to further work on the evolution of the audit. The *Forum's Evolution* work programme covers the changing reporting environment in which auditors work, the relationship between auditors and the audit committee and how the differing interests of stakeholders and their expectations of audit can be reconciled.

Anyone interested in providing feedback on this paper should send their comments to henry.irving@icaew.com.

Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at **www.auditqualityforum.com** or telephone +44 (0)20 7920 8493.

Laws and regulations referred to in this report are stated as of September 2008.

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The impact of audit committees on the evolution of financial reporting and auditing in recent years has been profound and has enhanced confidence in independent audit according to:

- participants from all UK groups with an interest in audit represented at the September 2007 *Audit Quality Forum* debate on *The impact of audit committees on auditing*;
- the UK FRC report on audit quality published in October 2007;
- comments on US experience in a January 2008 publication from the CEOs of the six largest international audit networks; and
- the results of recent surveys of UK finance directors, audit committee chairs and audit engagement partners and US audit committee members.

Given the overall positive change in audit practice brought about by audit committees, the *Audit Quality Forum* has considered whether:

- all entities subject to audit should have audit committees;
- auditors' interaction with audit committees should be an explicit part of the audit process of assessing and responding to risks as set out in auditing standards; and
- auditors should evaluate whether audit committees are effective in supporting the quality of audited financial statements.

This paper considers these public policy options. However, it does not support general international implementation of any of them through new regulatory requirements. This is on the basis of principles of good regulation and the benefits of learning from experience in the area of audit committees.

The policy option of requiring audit committees for all entities subject to an audit is rejected and the paper argues that it should remain possible to audit the financial statements of an entity which does not have an audit committee. An audit committee is a means of promoting the appropriate discharge of financial reporting responsibilities but it would be wrong to presume that it is an effective and efficient solution in all cases. This position is based on a recognition that:

- the *OECD Principles of Corporate Governance* do not advocate audit committees for all companies but expect board members to have the objectivity and competence to carry out key functions such as ensuring the integrity of accounting and reporting systems; and
- it is only appropriate to require audit committees where the costs are proportionate to the benefits.

It is important to learn from the experience of implementing new audit committee requirements, from understanding how audit committees differ in important ways between different business environments and from the success of alternative governance arrangements to support high quality audited financial statements. Further academic research in these areas would also be helpful.

Although it is noted that auditing standards do not specify how audit committees affect the substance of how an audit is carried out, this paper does not support the policy option of making auditors' interaction with audit committees an explicit part of the audit process of assessing and responding to risks as set out in auditing standards because:

- there is no evidence of any practical problems caused by not reflecting more specifically in auditing standards the importance of audit committees;
- abandoning governance-neutral auditing standards and establishing standards for entities with audit committees would challenge the concept of 'an audit is an audit';
- there are limits to what can be included in auditing standards in relation to governance and drivers of audit quality; and
- the scale of the forthcoming implementation effort required by the IAASB's Clarity Project limits the scope for further changes to auditing standards in the short to medium term.

While rejecting any presumption that auditing standards should be fundamentally changed to reflect the growing importance of audit committees, *Forum* participants should remain alert to other possibilities. For example, guidance may help to ensure that the impact of audit committee quality on the nature, timing and extent of audit work to address risks of fraud and error is well understood in the context of auditing standards on risk assessment. Here there is an important potential role for national standard setters to produce additional material to help auditors.

Persuasive arguments against the policy option of having auditors evaluate the effectiveness of audit committees (or directors generally) in supporting high quality financial reporting are that:

- audit committee performance would increasingly become the subject of a box-ticking compliance exercise;
- there is a significant risk of unintended consequences for the quality of audited financial information; and
- there is as yet no clear evidence from US experience of the value of such assessments.

Nevertheless, it is suggested that audit practitioners, regulators and standard setters should respond in other ways to public expectations that they comment on whether and how audit committee and other governance activities are contributing to the quality of audited financial statements. In addition, in certain areas of audit committee effectiveness, such as the evaluation of the quality of auditors and communication with investors, other groupings and non-audit regulators may need to take the lead in producing guidance.

Background

Key points

The impact of audit committees on the evolution of financial reporting and auditing in recent years has been profound and has enhanced confidence in independent audit according to:

- participants from all UK groups with an interest in audit represented at the September 2007 *Audit Quality Forum* debate on *The impact of audit committees on auditing*;
- the UK FRC report on audit quality published in October 2007;
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Given the overall positive change in audit practice brought about by audit committees, the *Audit Quality Forum* has considered whether:

- all entities subject to audit should have audit committees;
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- auditors should evaluate whether audit committees are effective in supporting the quality of audited financial statements.

This paper considers these public policy options. However, it does not support general international implementation of any of them through new regulatory requirements. This is on the basis of principles of good regulation and the benefits of learning from experience in the area of audit committees.

This paper builds on the results of the *Audit Quality Forum's* September 2007 debate and survey on *The impact of audit committees on auditing* details of which are available on **www.auditqualityforum.com**. The *Forum* is publishing the paper in line with the objectives of its *Evolution* programme to promote dialogue about the changing environment in which auditors work.

The paper considers the role of companies' governance practices in promoting audit quality and raises issues relevant to an international audience of business, investors and auditors, as well as audit legislators, regulators and standard setters. The *Audit Quality Forum* is grateful to everyone who took part in its debate and survey and who contributed to this paper and trusts that the paper will be useful to anyone with an interest in promoting confidence in independent audit.

Audit committees are increasingly a feature of the international landscape in which auditors operate. Audit committee requirements around the world have been introduced in the belief that audit committees make an important contribution to the quality of audited financial statements and evidence on this issue from the UK and the US is encouraging.

The UK Combined Code

Audit committees have been an important part of UK corporate governance practice since 1992 when the Cadbury Code recommended that the board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties. Subsequent UK experience of audit committees was consolidated and given additional authority through the publication in January 2003 of *Audit committees – Combined Code guidance* by a group chaired by Sir Robert Smith (the Smith guidance). This is now incorporated into *The Combined Code on Corporate Governance* against which UK companies report on a 'comply or explain' basis if they are listed on the Main Market of the London Stock Exchange.

The Combined Code, published in June 2008, contains provisions calling for:

- an audit committee of at least three (or two in the case of companies outside the FTSE 350) members who should all be independent non-executive directors;
- at least one member of the audit committee to have recent and relevant financial experience;
- audit committee responsibilities to include making recommendations to the board on the appointment, re-appointment and removal of the external auditor, reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process, and developing and implementing policy on the engagement of the external auditor to provide non-audit services; and
- a separate section of the annual report describing the work of the audit committee.

The *Audit Quality Forum* survey and debate

Most respondents to the *Audit Quality Forum* survey and most participants at the *Forum* debate in September 2007 agreed that audit committees are an essential element of listed company governance. Audit committees were seen as protecting the integrity of financial statements and being well placed to monitor risks that are relevant to auditors in their work.

Participants at the debate from the business, auditor and investor communities were given an opportunity to express their views on what made audit committees effective. They believed that:

- relationships between audit committees and external audit teams are important and need to be actively managed by audit committee chairmen and audit engagement partners;
- the audit committee acts as an additional control mechanism to review major financial judgments made by management and to ensure that messages are consistent with the company's performance and that there is integrity around the financial reporting process;
- audit committees play a vital role in ensuring that auditors know and understand that shareholders are their real clients;
- the quality of audit committee members is essential in giving shareholders confidence and, to be effective, audit committee members need to understand their role and have a positive impact on management, internal controls and processes;
- audit committee activities should not be viewed in isolation but as part of a wider governance process that culminates in the approval of financial statements that meet the needs of shareholders; and
- audit committees can provide a forum in which to discuss strategic issues related to the quality of financial reporting, such as the complexity of reporting standards and concern that this is pushing real understanding of the numbers further down the organisation.

Notwithstanding a natural wish among participants to manage expectations, the debate and the survey gave a clear message that audit committees in the UK are generally seen as working well and have become central to the quality of UK listed market financial reporting and auditing.

Other UK evidence

At the September 2007 debate it was also noted that the work of the UK Financial Reporting Council (FRC) on promoting audit quality highlighted the importance of audit committees to the FRC's overall aim of promoting confidence in corporate reporting and governance. Subsequently, in October 2007, the FRC published its report *Promoting Audit Quality* following a discussion paper on the subject and in February 2008 published *The Audit Quality Framework*. The report acknowledges a high degree of commentator support for the FRC's framework of five drivers of audit quality, namely:

- the culture within an audit firm;
- the skills and personal qualities of audit partners and staff;
- the effectiveness of the audit process;
- the reliability and usefulness of audit reporting; and
- factors outside the control of auditors affecting audit quality.

The FRC states that its framework 'is designed to support effective communication between auditors, audit committees, preparers, investors and other stakeholders on audit quality.' Under the heading of 'factors outside the control of auditors', the FRC identifies audit committees as indicators of audit quality when they 'are active, professional and robust in dealing with issues identified during the audit.'

Academic evidence on the impact of audit committees on UK audit practice is limited but in 2007 Stuart Turley and Mahbub Zaman published the results of a case study approach to the operation and effectiveness of audit committees. In explaining audit committee effectiveness, they stress the importance of informal processes and communications and factors such as the standing of individuals, rather than just externally verifiable characteristics such as membership and meeting frequency. These findings build on a conclusion from a 2004 review of the academic literature by the same authors which found that 'there is no automatic relation between the adoption of audit committee structures or characteristics and the achievement of particular governance effects.'

An important contribution is also expected from the academic research begun in 2007 by Vivien Beattie, Stella Fearnley and Tony Hines. This follows up earlier research performed by Vivien Beattie, Richard Brandt and Stella Fearnley. The main output was a book published in 2001 *Behind Closed Doors: What company audit is really about* which analyses six case studies of the relationships between finance directors and audit engagement partners and the resulting financial reporting outcomes.

In the research begun in 2007, the approach has been amended to include audit committee chairs and reflect the increased importance of audit committees. The work is investigating the discussion and negotiation that take place around financial reporting and auditing issues between finance directors, audit committee chairs and audit engagement partners and their impact on what is reported.

Findings from an initial survey of finance directors, audit committee chairs and audit engagement partners by Vivien Beattie, Stella Fearnley and Tony Hines were published in April 2008 in *Auditor/company interactions in the 2007 regulatory environment*. A total of 498 replies were received and comments in response to open survey questions were generally positive regarding the impact of audit committees on the financial reporting process.

US experience

Recent US experience provides fertile ground for studies to test the importance of audit committees and perceptions that the quality of auditing has been significantly improved by the new accountability of auditors to audit committees under the Sarbanes-Oxley Act passed in July 2002 in the aftermath of the collapse of Enron.

The listing rules of the New York Stock Exchange (NYSE) and the NASDAQ Stock Market require issuers of listed securities to have an audit committee. Under Section 301 of the Sarbanes-Oxley Act, these listing rules must require the audit committee to be comprised of independent members and to have specified responsibilities related to the appointment, compensation and oversight of auditors. Section 301 also requires audit committees to establish procedures for handling complaints regarding accounting, internal accounting controls and auditing matters and for employee whistle-blowing regarding questionable accounting or auditing matters. In addition, Section 204 sets out those matters which auditors are required to communicate to audit committees in a timely manner.

A report from the CEOs of the six largest international audit networks published in January 2008 *Global Dialogue with Capital Market Stakeholders* noted: ‘In several discussions, stakeholders emphasized the importance of auditors being held accountable to shareholders, rather than management, suggesting that otherwise, quality can be compromised. In particular, numerous stakeholders expressed support for strengthening the role of the audit committee as a way to strengthen audit quality. On several occasions, it was suggested that in the US, the Sarbanes-Oxley Act had contributed to improved audit quality by changing the relationship between the auditor, management and shareholders, to one where the external auditors are hired by and report to audit committees, rather than management.’

In March 2008, the Center for Audit Quality, affiliated with the American Institute of Certified Public Accountants, published its *Report on the Survey of Audit Committee Members* which presented the results of a survey of 253 members of audit committees of US publicly traded companies. Increased audit committee oversight was believed to have had a positive impact on the overall quality of audits by 92% of respondents. In addition, 85% believed that increased communication among audit committee members had had a positive impact and 76% were positive about the fact that the external auditor is hired by and directly accountable to the audit committee.

A review of academic research on auditor communications with audit committees performed by Jeffrey Cohen, Lisa Milici Gaynor, Ganesh Krishnamoorthy and Arnold M Wright was published in 2007. A summary published in February 2008, states: ‘Consistent across most studies, audit committees comprised of independent member(s) with a higher degree of financial expertise were associated with stronger internal control environments and higher financial reporting quality.’ However, while the authors note that as a result of the Sarbanes-Oxley Act, audit committees meet more frequently with auditors and have greater financial expertise, they also state that the only post-Sarbanes-Oxley study to address the resolution of disputes finds auditors reporting that audit committees generally play a very passive role. The impact of audit committees on audit quality in the US is an area where further academic research will be of interest.

EU developments

Building on developments in many EU member states, including the UK, and drawing on US post-Enron initiatives, Article 41 of the EU Statutory Audit Directive of 2006 requires public interest entities to have an audit committee or a body performing equivalent functions. This should monitor the financial reporting process and the effectiveness of internal control and internal audit and review and monitor auditor independence. Member states were required to implement the Directive through national legislation by June 2008.

UK companies listed in London are obliged to comply with the Statutory Audit Directive. In practice, little is expected to change because the overwhelming majority of such companies already have an audit committee. More widely, the implementation of Article 41 of the Directive will provide an interesting test across a variety of different business cultures and institutions of the belief that audit committees make an important contribution to the quality of audited financial statements.

Public policy options

The *Audit Quality Forum* brings together investors, business and auditors, as well as audit regulators and standard setters, to generate ideas to enhance confidence in financial reporting and independent audit. Given the apparent overall positive change in audit practice brought about by audit committees, the *Forum* has considered whether:

- all entities subject to audit should have audit committees;
- auditors' interaction with audit committees should be an explicit part of the audit process of assessing and responding to risks as set out in auditing standards; and
- auditors should evaluate whether audit committees are effective in supporting the quality of audited financial statements.

It can be argued that all these public policy options have been taken up in the United States in relation to the audits required of NYSE and NASDAQ listed entities. However, this paper does not support general international implementation of any of these policy options through new regulatory requirements. This is primarily because principles of good regulation call for a proportionate approach that is sensitive to the demands placed on those who have to implement existing regulations and who would have to implement new requirements. Experience with audit committees also shows that learning from shared experience of dealing with practical problems can be as effective as, or more effective than, new requirements in realising benefits that are in the public interest.

Reasons for not pursuing these policy options are offered in the following sections of this paper along with suggested alternative ways in which the contribution of audit committees to the quality of audited financial statements can be enhanced.

Requirements for audit committees

Key points

The policy option of requiring audit committees for all entities subject to an audit is rejected and the paper argues that it should remain possible to audit the financial statements of an entity which does not have an audit committee. An audit committee is a means of promoting the appropriate discharge of financial reporting responsibilities but it would be wrong to presume that it is an effective and efficient solution in all cases. This position is based on a recognition that:

- the *OECD Principles of Corporate Governance* do not advocate audit committees for all companies but expect board members to have the objectivity and competence to carry out key functions such as ensuring the integrity of accounting and reporting systems; and
- it is only appropriate to require audit committees where the costs are proportionate to the benefits.

It is important to learn from the experience of implementing new audit committee requirements, from understanding how audit committees differ in important ways between different business environments and from the success of alternative governance arrangements to support high quality audited financial statements. Further academic research in these areas would also be helpful.

A common understanding that underpins all regimes for the preparation and audit of financial statements is that boards and auditors of audited entities have a common responsibility to users of audited financial statements to promote high quality financial reporting. This needs to be acknowledged and backed up with appropriate commitment and resources and where one party judges that these are not forthcoming from the other then that party will need to take appropriate measures. In the case of auditors, they can change the nature, timing and extent of their audit work, qualify their audit opinion or withdraw from an engagement.

Alternatives to audit committees

Establishing an effective audit committee is one way for directors to evidence appropriate commitment and resourcing in relation to financial reporting and legislators and regulators may choose to require audited entities to establish audit committees. However, the arguments against doing this for all audited entities were touched upon at the *Audit Quality Forum* debate.

The *OECD Principles of Corporate Governance* do not advocate audit committees for all companies. Instead, they refer to the need for companies to have board members with the objectivity and competence to consider important issues such as audit quality. They also identify key functions of the board such as ensuring the integrity of accounting and reporting systems and of the independent audit and overseeing the process of disclosure and communication. However, the principles do not specify the organisational means by which these functions are fulfilled. In other words, the principles do not advocate audit committees as a 'one size fits all' solution.

Principles of good regulation

Regulatory requirements should only be introduced where the costs are proportionate to the benefits. In this case, it would be inappropriate to focus purely on the benefits of audit committees for the quality of audited financial statements without regard to the scale of those benefits and the related costs.

Such considerations help explain why audit committee requirements currently apply principally to entities accessing public capital markets or which are otherwise deemed to be of public interest. The benefits of audit committees in such circumstances are enhanced because they help address specific risks, such as those arising from the separation of ownership from control in the case of a listed company. Nevertheless, even such companies are permitted by the EU Statutory Audit Directive to establish a body other than an audit committee which performs equivalent functions.

It can nevertheless be argued that there are potential wider benefits beyond the audited entity of a proposal to require audit committees. For example, such a requirement would direct public policy for promoting confidence in audited financial information towards a broad set of governance and capacity issues beyond pure audit-related measures such as the implementation of International Standards on Auditing. However, there is a risk of lapsing into box-ticking if requirements for audit committees distract attention from the underlying need for board member competence and objectivity.

In summary, it seems clear that without establishing audit committees, it must remain possible for directors, including directors of owner-managed businesses, to recognise their responsibility to users of their financial statements and back this up through appropriate resourcing and personal commitment to high quality financial reporting. To deny businesses that do this the ability to benefit from an audit would not be in the public interest.

Suggestions for further action

This paper rejects the presumption that wherever there is an audit there should be an audit committee. However, *Forum* participants may need to refine their views on the scope of audit committee requirements on the basis that implementation of new audit committee requirements, notably under the EU Statutory Audit Directive, will provide greater experience from which to judge the appropriateness of audit committees and the success of alternative arrangements across different business cultures and institutions.

It can already be argued that audit committees in different business and legal environments differ in subtle but important ways. For example, US audit committees of independent board members oversee management's discharge of its responsibility to prepare financial statements whereas UK audit committee members share that responsibility with other non-executive and executive board members. These differences are covered in publications issued by the ICAEW under its initiative *Beyond the myth of Anglo-American corporate governance*.

Therefore, to inform future policy developments, *Forum* participants may want to take further action to learn from experience of the costs and benefits of audit committees and alternative governance arrangements. Further academic research in these areas would be helpful.

Recognition of audit committees in auditing standards

Key points

Although it is noted that auditing standards do not specify how audit committees affect the substance of how an audit is carried out, this paper does not support the policy option of making auditors' interaction with audit committees an explicit part of the audit process of assessing and responding to risks as set out in auditing standards because:

- there is no evidence of any practical problems caused by not reflecting more specifically in auditing standards the importance of audit committees;
- abandoning governance-neutral auditing standards and establishing standards for entities with audit committees would challenge the concept of 'an audit is an audit';
- there are limits to what can be included in auditing standards in relation to governance and drivers of audit quality; and
- the scale of the forthcoming implementation effort required by the IAASB's Clarity Project limits the scope for further changes to auditing standards in the short to medium term.

While rejecting any presumption that auditing standards should be fundamentally changed to reflect the growing importance of audit committees, *Forum* participants should remain alert to other possibilities. For example, guidance may help to ensure that the impact of audit committee quality on the nature, timing and extent of audit work to address risks of fraud and error is well understood in the context of auditing standards on risk assessment. Here there is an important potential role for national standard setters to produce additional material to help auditors.

The appendix to this report analyses how audit committees are covered by international, UK and US auditing standards. In current international standards, audit committees represent one way in which 'those charged with governance' may be organised.

Although current UK and prospective 'clarified' international standards contain extensive guidance on communication between auditors and audit committees, there is nothing specific which would affect the substance of how an audit should be carried out, for example where an audit committee is particularly strong or weak. US auditing standards do contain such material but only in respect of the auditors' work in connection with Section 404 of the Sarbanes-Oxley Act on internal control over financial reporting.

Arguments for change

It is perhaps surprising that financial statement auditing standards have not evolved to place greater emphasis on the practical importance for audit quality of strong audit committees that have good relationships with audit teams or to specify the impact of audit committees and audit committee quality on the auditor's work. This is especially so since standards constitute one of the benchmarks against which audits are inspected by regulators. It could be argued that a disconnect between audits as portrayed in auditing standards and the reality of high quality audits could pose a threat both to audit quality and the credibility of auditing standards.

The principal potential practical benefits of making auditors' interaction with audit committees an explicit part of the audit process of assessing and responding to risks as set out in auditing standards is that it would:

- raise quality by narrowing the current gap between, on the one hand, best practice in the conduct of audits (where working with audit committees is central to what auditors do) and, on the other, the regulatory enforcement of auditing standards (where audit committees and governance considerations are not central); and
- raise perceived quality by enhancing confidence in auditing standards because they acknowledge the importance of audit committees and make it clear how audit committees affect the nature and extent of the work of auditors.

Arguments against change

There is no evidence of practical problems caused by the current treatment of audit committees in auditing standards. Moreover, reasons for not changing current auditing standards can be traced back to issues discussed in the earlier *Fundamentals* programme of the *Audit Quality Forum*, in particular the papers *Principles-based auditing standards* and *Making global auditing standards local.*

The main reason why there is little emphasis on governance matters in auditing standards is that there is a strongly-held view that auditing standards should be 'governance-neutral'. This means that they can be applied across different types of entity with different governance arrangements. Although this is most obviously necessary in international auditing standards which need to be applicable across countries, it is also desirable in national auditing standards if they are to apply across different sectors of the economy.

Auditing standards of wide-ranging applicability are thought to be in the public interest because they enhance consistent understanding of audits by users of audited financial statements and auditors and so increase the benefits of audits and eliminate the costs of multiple standards. Such thinking lies behind the phrase 'an audit is an audit'.

According to such arguments, because audit committees may not be appropriate, let alone required, across all the different entities to which auditing standards need to be applied, those standards should be largely silent on the subject. The alternative approach would effectively create different auditing standards for entities with audit committees and raise a presumption that audits performed using those standards are of higher quality.

Moreover, it can be argued that the increasing importance of audit committees for audit quality is not really an issue for auditing standards. There is a risk that if auditing standards reflected audit committees more thoroughly, then they would be seen as exceeding their legitimate role by imposing governance requirements on audited entities.

It should also be clear that there are many drivers of audit quality, such as the culture within an audit firm and the skills and personal qualities of audit partners that cannot readily be codified in auditing standards. Trying to shoehorn all the drivers of audit quality into auditing standards could be damaging to audit quality if it put pressure on audit firms and those who inspect their work to focus more on matters of form and 'box-ticking' rather than on issues of substance.

Discussion of whether auditing standards should more fully reflect the importance of audit committees and their relationship with audit teams raises a more general question. Audit quality depends crucially upon the behaviours and personal qualities of the people involved in the audit process and how they interact. There are limits to our ability to capture such matters in auditing standards that are designed to be applied widely and enforced objectively.

The IAASB Clarity Project

An additional practical matter means that any proposal for a major change in how auditing standards deal with audit committees would probably encounter considerable opposition. The International Standards on Auditing (ISAs) of the International Auditing and Assurance Standards Board (IAASB) are already undergoing a period of considerable change as a result of the Clarity Project. This is designed to clarify the precise requirements of every ISA and the status of every word they contain. The 'clarity drafting conventions' aim to improve the overall readability and understandability of ISAs by:

- setting an overall objective for each ISA;
- presenting requirements and application guidance in separate sections; and
- using the word 'shall' to identify requirements that are expected to be applicable in virtually all engagements.

The implementation of clarified ISAs means that a protracted period of significant change lies ahead for auditors, audited entities and audit regulators. Against this background, it is unrealistic to think that further major changes to auditing standards will occur in the short to medium term.

Suggestions for further action

While rejecting any presumption that auditing standards should be fundamentally changed to reflect the growing importance of audit committees, *Forum* participants should remain alert to other possibilities, for example, to:

- explain the impact of audit committee quality on the nature, timing and extent of audit work to address risks of fraud and error in the context of auditing standards on risk assessment;
- explain the practical implications of auditing standards on communications for dialogue between auditors and audit committees and between audit committees and other interested parties;
- promote understanding of how audit committees improve the quality of audited financial statements by strengthening the entity's control environment, enhancing communication around the audit process, and monitoring the quality of the auditors' work and independence, all of which make it less likely that such statements are materially misstated;
- support IAASB standards with additional material on their application in the context of different national, sectoral or entity governance regimes, for example by providing examples of how auditors and audit committees can work together to enhance the quality of audited financial information; and
- demonstrate how to adhere to the principle that 'an audit is an audit' without imposing unnecessary costs by showing how the functions assigned to audit committees can be discharged through alternative governance arrangements.

These points are in line with observations made at the *Forum* debate that:

- from an auditing standard setter's perspective, directors, including audit committee members, have important roles to play in the whole audit process in all countries; and
- it is challenging for international auditing standard setters to deal with governance issues and there is an important potential role for national standard setters to produce guidance and other material to help ensure that auditors' relationships with directors are set out and promoted at the right level.

Evaluation of audit committees by auditors

Key points

Persuasive arguments against the policy option of having auditors evaluate the effectiveness of audit committees (or directors generally) in supporting high quality financial reporting are that:

- audit committee performance would increasingly become the subject of a box-ticking compliance exercise;
- there is a significant risk of unintended consequences for the quality of audited financial information; and
- there is as yet no clear evidence from US experience of the value of such assessments.

Nevertheless, it is suggested that audit practitioners, regulators and standard setters should respond in other ways to public expectations that they comment on whether and how audit committee and other governance activities are contributing to the quality of audited financial statements. In addition, in certain areas of audit committee effectiveness, such as the evaluation of the quality of auditors and communication with investors, other groupings and non-audit regulators may need to take the lead in producing guidance.

Given the acknowledged importance of audit committees in supporting high quality audited financial statements, it is worth considering whether auditors should evaluate whether audit committees are effective in that role.

Framing the policy option

In practice, implementation of such a proposal would be affected by views on the matters discussed in the two preceding sections, that is the circumstances in which audit committees should be required and the extent to which auditors' interactions with audit committees (rather than a broader group of those charged with governance) should be explicit in auditing standards. Therefore, in order to focus on the specific issue raised by this policy option, this section sets aside these questions and simply considers whether auditors of an entity's financial statements should be required to evaluate whether directors (ie, those charged with governance of an entity) are effective in supporting high quality financial reporting.

In the September 2007 *Forum* debate, there was some discussion of the possibility of auditing standards referring to a core principle by which directors have responsibility for the quality of financial reporting and interaction with auditors. Auditing standards could require auditors to evaluate whether directors were committed to discharging such a responsibility and state that failure would act as a trigger to put auditors on their guard and impact the nature, timing and extent of the auditors' work.

Were such an approach to be followed, ISAs might address issues such as:

- the risks to an entity of having ineffective governance over financial reporting;
- how assessments of the effectiveness of audit committees or alternative arrangements should be reflected in audit procedures;
- circumstances in which inadequacies might ultimately lead to a qualified audit opinion or the auditor's withdrawal from an engagement; and
- how and when auditors should communicate concerns about the effectiveness of audit committees or alternative arrangements to directors and others.

The pros and cons of change

The policy option of requiring auditors to perform an evaluation might be supported on the grounds that:

- it is important for auditors to assess the commitment of directors to high quality financial reporting and systematically reflect that assessment in the audit work that they subsequently perform and so it seems quite legitimate to codify expectations that such an assessment is performed;
- the assessment that is called for probably already represents good practice, even if it is not required by auditing standards, because it reflects the importance of governance considerations to the modern audit;
- it might help to sustain confidence in audit quality if auditing standards acknowledged the importance of audit committees or other governance arrangements and made it clear what auditors are expected to do when such arrangements are absent or ineffective, for example because an audit committee is denied information or fails to take action in response to auditor concerns;
- there are few mechanisms to help improve practice and performance among poorly governed companies and to ensure that corporate governance is effective in improving the quality of audited financial information and that there is more than token compliance with corporate governance requirements; and
- it might provide a basis for greater global convergence of auditing standards in the face of the difference that currently exists between the financial statement audit supported by ISAs and the integrated audit of financial statements and internal controls over financial reporting supported by US PCAOB Auditing Standards.

Nevertheless, the counter-arguments against the policy option appear more persuasive:

- it is not clear that auditors are well placed to assess all aspects of an audit committee's effectiveness, for example the committee's assessment of the quality of the audit and the auditors' delivery of consistent quality on an international basis and its handling of thorny governance issues such as communications with the board and investors;
- there is a significant risk that a new requirement could turn current best practice into a box-ticking compliance exercise with an inherent tendency to reach positive conclusions;
- potential perverse unintended consequences are that audit committees would become complacent and reliant on auditors' assessment of their effectiveness and that auditors would place too much reliance on high-level assessments of audit committee effectiveness and neglect problems with other aspects of governance and lower-level controls;
- the assessment of audit committee effectiveness could become a source of conflict and tension between auditors and audit committees that creates barriers to achieving the shared goal of high quality financial reporting;
- implementing this policy option would introduce a new mandate for auditors beyond expressing an opinion on the financial statements for which there appears to be little pressure;
- such a new mandate would be analogous to Section 404 of the Sarbanes-Oxley Act on internal control over financial reporting, which as the appendix to this paper explains has resulted in an implicit requirement for auditors to assess the effectiveness of audit committees; and
- there is no clear evidence of the value of US assessments of audit committee effectiveness with statistics compiled by Audit Analytics in January 2008 from SEC filings for the period 2004 to 2007 showing that only 20 out of a total of 1,362 reported material weaknesses related to audit committees.

Suggestions for further action

Nevertheless, auditors should be prepared to respond to public expectations that they comment on whether audit committee and other governance activities are contributing to the quality of audited financial statements by:

- privately feeding back their views on company-specific audit committee communications, processes and performance directly to audit committees and boards and promoting dialogue on these issues; and
- contributing their experience of effective audit committee and governance practices to wider public discussion and public policy initiatives to promote high quality financial reporting.

Audit firms have shown great willingness to engage in the development of audit committee best practices and in this area there is a fortunate coincidence of their own self-interest and the public interest. It should, however, also be recognised that in certain areas of audit committee effectiveness, auditors' ability to give authoritative help may be limited, as may the ability of audit regulators and standard setters.

Other groupings and non-audit regulators might help here by providing more guidance for directors in areas highlighted by the *Forum* debate and survey as needing further clarity. Some of them are already the subject of separate consultations by bodies with the relevant authority and they include:

- audit committee processes for appointing auditors;
- audit committee responsibilities;
- the audit committee's evaluation of the quality of auditors; and
- the usefulness of additional reporting and disclosure by audit committees to shareholders.

It is up to relevant representative groups, policymakers and regulators, including standard setters, to determine their priorities in providing assistance. For example: reporting on the process by which auditors are appointed has been covered separately in the UK as part of the FRC project on choice in the UK audit market; and in December 2007 the FRC issued *2007/08 Corporate Reports: Key Questions for Audit Committees* to help audit committees discharge their responsibilities in the face of deteriorating credit market conditions.

In addition, the FRC report *Promoting Audit Quality* identifies concerns about audit committees' reviews of the effectiveness of audits. There is a wide variety of views on this subject. For example, some people think that the FRC needs to put out additional guidance to help audit committees review audit effectiveness while others think that because many audit committee members have experience of more than one audit committee, they are well placed to exercise their own judgement.

Appendix: How auditing standards deal with audit committees

Auditing standards mainly refer to audit committees in two contexts:

- communication about the audit to people connected with the audited entity; and
- consideration of internal control as part of the planning of the audit, particularly when determining the impact of controls on risks of financial statement misstatement and the need for auditors to carry out substantive testing.

This appendix analyses the treatment of audit committees in relation to an audit of financial statements under:

- current International Standards on Auditing (ISAs) as issued by the International Auditing and Assurance Standards Board (IAASB);
- ISAs with additional material for application in the UK and Ireland referred to as ISAs (UK and Ireland) and issued by the UK Auditing Practices Board (APB);
- ISAs as clarified as a result of the IAASB's Clarity Project (Clarified ISAs); and
- existing Statements on Auditing Standards (SASs) issued by the US Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA).

The appendix also analyses the treatment of audit committees in relation to an integrated audit of financial statements and internal control over financial reporting under the Auditing Standards (ASs) of the US Public Company Accounting Oversight Board (PCAOB).

In summary, only the PCAOB's standards require auditors, albeit implicity, to assess the effectiveness of audit committees and to take specific follow-up actions when they conclude that a committee is ineffective. Although they contain important references to audit committees, no other auditing standards either require an assessment of audit committee effectiveness or specify the impact of audit committees and audit committee quality on the auditor's work to assess and respond to risks.

International Standards on Auditing

ISAs contain basic principles and essential procedures identified in bold type (and referred to in this appendix as requirements) together with related guidance in the form of explanatory and other material. Auditors are expected to exercise professional judgement in applying ISAs and in exceptional circumstances may judge it necessary to depart from a bold-type requirement to achieve the objective of an audit engagement. In such cases they should be prepared to justify the departure.

ISA 260 is entitled *Communication of Audit Matters With Those Charged with Governance* and paragraph 2 sets out the basic requirement that the 'auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity'.

The term 'those charged with governance' is used throughout ISAs and refers to people entrusted with 'the supervision, control and direction of an entity'. They 'ordinarily are accountable for ensuring that the entity achieves its objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties.' They 'include management only when it performs such functions.' The term is used in the interests of making ISAs governance-neutral although a footnote to ISA 260 qualifies the opinion that there 'is no single model of good corporate governance' with the statement that 'a common principle is that the entity should have in place a governance structure which enables the board to exercise objective judgment on corporate affairs, including financial reporting.'

The use of the term 'those charged with governance' precludes ISAs from making any distinction between audited entities with and without audit committees (or equivalent governance arrangements) since both boards and audit committees are covered by the term. Although paragraph 6 of ISA 260 refers to the fact that 'there may be an audit committee that assists the board in its governance responsibilities with respect to financial reporting', this is purely in the context of helping the auditor to meet the requirement of paragraph 5 of ISA 260 to 'determine the relevant persons… with whom audit matters of governance interest are communicated.'

ISA 260 identifies the matters that the auditor needs to communicate, which must include uncorrected misstatements aggregated by the auditor. However, it also points out that the auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest. Under paragraph 11, matters to be communicated ordinarily include 'the general approach and overall scope of the audit' and 'material weaknesses in internal control, questions regarding management integrity, and fraud involving management' but there is no requirement, for example, to communicate the impact on the audit of the auditor's assessment of the board's ability to exercise objective judgement, because there is no requirement in other standards, notably ISA 315, to perform such an assessment.

In ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, audit committees are covered by references to those charged with governance. Paragraph 2 sets out the following bold-type requirement: 'The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.'

It is as part of this overriding requirement that paragraph 67 sets out the further bold-type requirement that 'the auditor should obtain an understanding of the control environment.' Paragraph 67 goes on to explain that 'the control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.' Further guidance in paragraph 69 states that 'in evaluating the design of the entity's control environment, the auditor considers… participation by those charged with governance – independence from management, their experience and stature, the extent of their involvement and scrutiny of activities, the information they receive, the degree to which difficult questions are raised and pursued with management and their interaction with internal and external auditors.'

Paragraphs 67 and 69 of ISA 315 refer to factors that will affect how well those charged with governance discharge their responsibilities for the financial statements. Moreover, paragraph 107 of ISA 315 identifies factors, such as concerns about the integrity of management and about the reliability of accounting records, that may raise doubts about the auditability of the financial statements and leave the auditor with no choice but to withdraw from an engagement. Yet, although auditors are expected to use their understanding of governance issues to inform their identification and assessment of specific risks of financial statement misstatement, there is no requirement to reach an assessment either of the overall control environment or of how those charged with governance, including audit committees, discharge their responsibilities for financial reporting.

ISAs (UK and Ireland)

Auditing standards applicable in the UK and Ireland contain the complete text of the ISAs issued by the IAASB plus additional 'grey text' containing material that is specific to the UK and Ireland. ISAs (UK and Ireland) explain that those charged with governance include the executive and non-executive directors of a company and the members of an audit committee. The extensive additional text in ISA 260 (UK and Ireland) clearly acknowledges the important role of audit committees in modern UK audit practice because it retains most of the UK and Ireland Statement of Auditing Standards that preceded the APB's decision to adopt ISAs in 2005. However, most of this additional text is included in guidance in the form of explanatory and other material rather than in basic principles and essential procedures identified in bold type.

The UK and Ireland version of ISA 260 requires auditors to communicate audit planning information and certain findings from the audit, including views about the qualitative aspects of the entity's accounting practices and financial reporting and material weaknesses in internal control. Additional grey text in ISA 260 (UK and Ireland) in relation to the responsibilities of audit committees includes the following:

- paragraph 7-3 notes that communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance;
- paragraph 7-5 states that 'as part of obtaining an understanding of the control environment, the auditor obtains an understanding of how the audit committee operates, including the particular remit given to the committee by the entity's board and its role in relation to governance matters such as reviewing the identification, evaluation and management of business risks'; and
- paragraph 11-3 notes that the audit committee 'is usually responsible for oversight of the relationship between the auditor and the entity and of the conduct of the audit process.'

However, there is no reference to auditors assessing the quality of the audit committee function and dealing with any related shortcomings either in ISA 260 (UK and Ireland) or in ISA 315 (UK and Ireland) which contains no substantive additional grey text.

The impact of the IAASB Clarity Project

It is in the nature of the Clarity Project that it is meant to clarify ISAs rather than change them. However, as well as being redrafted in line with the clarity drafting conventions, ISA 260 has also been fully revised and now picks up much of the grey text in ISA 260 (UK and Ireland).

The revised and redrafted ISA 260 is effective for periods beginning on or after 15 December 2009. It contains useful clarifications of the objectives of the auditor in the context of this standard which according to paragraph 5 are to:

- communicate the responsibilities of the auditor;
- obtain information relevant to the audit;
- provide timely observations to those charged with governance relevant to their responsibility to oversee the financial reporting process; and
- promote effective two-way communication between auditors and those charged with governance.

Paragraph 8 of the clarified ISA 260 requires the auditor to determine whether communication to the governing body is also needed when the auditor communicates with a subgroup of those charged with governance, for example an audit committee. Paragraphs A9 to A11 of the application material go on to describe the role of audit committees in rather more detail than the current ISA 260. For example, paragraph A11 states that 'audit committees (or similar subgroups with different names) exist in many jurisdictions' and it echoes ISA 260 (UK and Ireland) in stating that 'communication with the audit committee… has become a key element in the auditor's communication with those charged with governance.'

Paragraph 12 of the revised and redrafted ISA 260 also requires the auditor to communicate 'other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.' Moreover, the application material in paragraph A1 states that effective two-way communication is 'important in assisting… those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.' Nevertheless, there is no reference to what the auditor does if in the auditor's judgement these oversight responsibilities are not being discharged appropriately.

The redrafted version of ISA 315 represents a radical restructuring of the original standard to make it easier to understand but it has not been revised and so there are no changes of substance relevant to this paper.

US Auditing Standards

In 2003, when the PCAOB started its work on auditing standards for companies with securities registered under US securities legislation, it decided to adopt on an interim basis the existing SASs issued by the ASB. These included two standards of particular relevance to audit committees. SAS No. 61, *Communications with Audit Committees* (SAS 61) is concerned with communications about the audit to people connected with the audited entity. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (SAS 55) relates to the consideration of internal control as part of the planning of the audit and, in particular, determining the impact of controls on risks of financial statement misstatement and on the need for auditors to carry out substantive testing.

The PCAOB's main priority in its early years was to develop standards relating to the work of auditors on statements about the effectiveness of internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act. Because the audit of internal control is not to be performed under a separate engagement from the financial statement audit but as part of an integrated audit, these standards are also relevant to the matters discussed in this paper.

In March 2004, the PCAOB issued Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS 2). In May 2007, the PCAOB issued Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 5) to replace AS 2 for years ending on or after 15 November 2007. This was done to address the concern that the costs and effort of applying AS 2 were widely seen as 'greater than necessary to conduct an effective audit of internal control over financial reporting.'

The need for development of new auditing standards to increase the effectiveness of auditor communications with audit committees and boards has been acknowledged by the PCAOB which has hosted discussions on the topic and commissioned a study of relevant academic research by Jeffrey Cohen, Lisa Milici Gaynor, Ganesh Krishnamoorthy and Arnold M Wright.

The ASB continues to set auditing standards for private companies in the US that are not registered with the Securities and Exchange Commission (SEC). The ASB is planning to adopt the IAASB's clarity drafting conventions and looking to align SASs with ISAs. SAS 61 on communications is one of the first standards that is expected to be issued by the ASB in line with the IAASB's clarity drafting conventions.

ASB Statements on Auditing Standards

SAS 61 requires auditors to communicate specific matters to the audit committee (or another body responsible for oversight of the financial reporting process) for all audits of entities that have established an audit committee or an equivalent body. This standard reflects specific features of US corporate governance arrangements, in particular the fact that management are responsible for financial statements and in this activity are subject to the oversight of the board, or its audit committee. This contrasts with, for example, the UK system where the board, which generally includes management, is responsible for the financial statements and the audit committee is a committee of the board that helps it to discharge this responsibility.

While SAS 61 requires certain communications, it states that these are incidental to the audit and are not required to occur before the auditor's report on the financial statements is issued. The principal matters required to be communicated to an audit committee include:

- the auditor's responsibilities;
- significant accounting policies;
- management judgements and accounting estimates
- audit adjustments;
- the auditor's judgement about the quality, not just the acceptability, of the entity's accounting principles;
- disagreements with management; and
- difficulties encountered in performing the audit.

Although the list of requirements is extensive and demanding, the standard is written for a governance regime in which the audit committee's responsibility relates to the oversight of the preparation of financial statements, not the preparation of the financial statements themselves.

SAS 55 makes it clear that the quality of a company's system of internal control is central to the conduct of an audit and also states that 'the auditor's understanding of internal control may sometimes raise doubts about the auditability of an entity's financial statements.' However, the standard is silent on the subject of audit committees, principally because it is framed in a US governance context where management are responsible for the preparation of financial statements. Consequently, an audit committee of board members is not actually part of the system of internal control although, when discussing the control environment, the standard does note that 'an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities.'

PCAOB Auditing Standards

AS 5 makes extensive references to audit committees. It should be pointed out that footnote 8 to AS 5 states that if no audit committee exists, all references to the audit committee apply to the entire board of directors. However, this footnote is not relevant to issuers listed on the NYSE or NASDAQ because they are required to have an audit committee. As in the analysis of references to audit committees in financial statement auditing standards, it is possible to distinguish between two contexts: the audit committee as a body to whom the results of the engagement are communicated; and the audit committee as an element of the system of internal control to be considered when planning the engagement.

In relation to communication:

- paragraph 78 requires the auditor to communicate, in writing, all material weaknesses to the audit committee prior to issuance of the auditor's report;
- paragraph 80 requires all significant deficiencies to be communicated in writing to the audit committee;
- paragraph 81 requires the auditor to inform the audit committee when lesser deficiencies are reported to management; and
- if the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, then paragraph 79 requires the auditor to report to the board as a whole.

Communication feeds through into planning because paragraph 9 requires auditors to evaluate the importance of control deficiencies previously communicated to the audit committee when planning the audit of internal control over financial reporting. Moreover, AS 5 implicitly obliges auditors to assess the effectiveness of audit committees and to act on the results in a way that is not currently required by international, UK or US financial statement auditing standards.

The reason for this is that paragraph 22 of AS 5 requires the auditor to test those entity-level controls that monitor other controls and that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. Although there is no explicit requirement in this context to test the work of the audit committee, according to paragraph 24, the audit committee is an example of an entity-level control and detailed oversight by the audit committee is described as a useful entity-level control over management override in smaller companies.

Paragraph 25 goes on to state that the auditor must evaluate the control environment because of its importance to effective internal control over financial reporting and as part of this should assess 'whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control'. Paragraph 69 picks up on this assessment by stating that 'indicators of material weaknesses in internal control over financial reporting include… ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.'

Under paragraph 90 of AS 5, 'if there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.' Consequently, under the ASs of the PCAOB there is an implicit requirement for the auditor to assess the effectiveness of the audit committee and where it is found to be ineffective, the auditor must issue an adverse audit report.

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