Effective audit committee oversight of the external auditor and audit

Introduction

In our Point of View series, we have emphasised the role of the audit committee as a central pillar of effective corporate governance and in the best position to provide effective oversight of the performance, independence and objectivity of the auditor and the quality of the audit. We believe that there are ways to build on their role and we support the introduction of a periodic comprehensive review of auditor performance and quality of the audit by the audit committee. A number of regulators have considered the need for such a review and this approach is being considered by Canadian Public Accountability Board (CPAB) and the Chartered Professional Accountants of Canada (CPAC) - it is a model we support (see Appendix 1).

PwC's proposal

We see a periodic comprehensive review as a logical evolution of the audit committee's responsibilities. It would be an appropriate and effective addition to the existing activities[1] of audit committees to oversee the performance of the auditor and quality of the audit. Some other proposals under consideration, which enforce mandatory change, would conversely undermine the role of the Board and audit committee by limiting their freedom to decide which audit firm best meets the needs of the company and its shareholders. These measures restrict the audit committee from effectively discharging its oversight responsibilities and its ability to enforce good governance which, in turn, disenfranchises shareholders.

A more in-depth and strategic periodic assessment

There are certain aspects of assessing auditor performance that may be impractical or too time-consuming for the audit committee to perform on an annual or more regular basis. However, a periodic comprehensive review, if undertaken at least every five years, would allow the audit committee to:

- Analyse changes over time which are not readily apparent from year to year, such as any impacts linked to tenure or cyclical events. This could include issues relating to:
    - **The auditor** - fee levels (including comparing those for the audit and non-audit services); changes in scope (particularly any additional non-audit services); audit team membership/expertise; inspection report findings and consequent actions; relationship with management; value/impact of 'insights'; demonstrations of objectivity and scepticism; and any breaches of independence and subsequent mitigating actions.
    - **Management** - responsiveness to previous issues and challenges from the auditor; attempts to mitigate any contractual obligations that restricted the audit committee's choice of auditors; response to significant issues affecting the financial statements.
- Consider future requirements over the medium to long term (including the suitability of the incumbent auditor to meet those needs and possible alternative approaches) and any changes to its policies and procedures to increase its own effectiveness.

Audit committees will need to establish appropriate and robust performance measurement criteria including key performance indicators to enable them to effectively quantify

[1] See Appendix 2 for details of 'good practice' activities of audit committees in the oversight of the performance of the auditor and the quality of the audit

performance and measure quality. They will also need to agree how they communicate the results of the review to shareholders and, as appropriate, to regulators and supervisors.

Regulators and supervisors could establish minimum requirements for the content and process of a review and for the form and transparency of reporting which could be integrated into relevant corporate governance guidance to audit committees or their equivalent.

Enhanced role of the audit committee

The benefits are that the audit committee would be able to:

- More clearly demonstrate the effectiveness and value of its oversight of the selection, independence, performance and quality of the audit and the auditor to shareholders and other stakeholders.
- Select or retain the audit firm it believes is most appropriate for the company, considering, for example, the continuity of audit services, the level of professional competency of the audit team, industry expertise and global access to audit resources.
- Develop greater knowledge and insight about the audit and the auditor.
- Give consideration to a broader range of approaches to meet their responsibilities including:
    - Requiring prior approval of the content and form of the review by shareholders.
    - The use of external reviewers to increase the independence of the process.
    - Inclusion of a 'self-review' by the incumbent auditor.
    - A comparative market review, for example, including discussions with other auditors or providers of required services for both current and future requirements.

In summary

The introduction of a periodic comprehensive review by the audit committee would further enhance the effectiveness of audit committee oversight of the performance of the auditor and the quality of the audit. We believe it is more appropriate and effective than other measures such as mandatory change, which undermine the ability of the audit committee to effectively govern the performance of the auditor and the quality of the audit. We believe this should be considered as part of a wider 'package' of changes which we have proposed in our previous Point of View papers, including:

- Ensuring strong, independent national regulators of the profession.
- Enhancing transparency about the audit and the auditors.
- Restricting those non-audit services that could impair an auditor's independence.

Appendix 1

The Enhancing Audit Quality Initiative (EAQ initiative)

The Canadian Public Accountability Board (CPAB) and the Chartered Professional Accountants of Canada (CPAC) collaborated to undertake the EAQ initiative[2] to '*examine how to enhance audit quality to remedy perceived problems and encourage participants in the financial reporting chain to comment on the remedies suggested*.' They concluded that the introduction of a comprehensive periodic review of the audit firm (on at least a five yearly basis) would place responsibility on the audit committee for considering any institutional familiarity threats resulting from long term audit tenure, and also allow a focus on other key issues including the application of auditor scepticism. They also concluded that, to improve transparency around the auditor evaluation and reappointment process, details of the review and findings should be included in the audit committee's public report.

The members of the EAQ initiative also indicated in their final report that the '*overriding benefit of a periodic comprehensive review of the audit firm accrues from the realisation that the review is conducted with the best interests of shareholders in mind instead of a requirement to follow a 'one size fits all' mandate that does not (or indeed cannot) take into account the particular circumstances of a corporation and its shareholders*'.

The EAQ initiative members concluded that there were significant additional benefits, particularly reinforcing the role of the audit committee as the most appropriate people to act in the best interests of the shareholders, and improving its skills and knowledge.

Comprehensive review of the external auditor model (CREA)

The EAQ initiative developed a model involving a CREA at least once every five years resulting in a recommendation to shareholders to retain or replace the incumbent audit firm[3]. It also stipulated that the responsibilities for '*determining the scope, timing and plan for the CREA could not be delegated to, or influenced by, either management or the external auditor'*. However, management may assist in providing information needed, and the audit firm may assist in providing a self-assessment and information on firm quality control processes, procedures to deal with auditor independence issues and auditor judgement and scepticism.

The CREA should assess the on-going effectiveness of the professional relationship between the audit firm and the company, focussing on the external audit team's independence and any impairment of objectivity or effectiveness in conducting the audit. The plan for the review should be developed by the chair of the audit committee in discussions with a senior partner at the incumbent audit firm who is not involved in the audit or in providing other professional services, and then approved by the audit committee.

A CREA would include the identification, review and evaluation (less frequently than annually) of whether or not the:

- Safeguards put in place by the incumbent auditor against independence threats are sufficient and comprehensive.
- Quality and transparency of audit firm communications are timely, clear, concise and relevant and that any suggestions for improvements or changes are constructive.
- Exercise of professional scepticism includes looking at contrary evidence, the reliability of evidence, the appropriateness and accuracy of management responses to queries, and considering potential fraud, the need for additional procedures, and the willingness of the auditor to challenge management assumptions.

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[2] Copies of the initiatives reports are available at: http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item74564.pdf and http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item71922.pdf
[3] This would not (except in the year of the periodic review itself) replace the annual recommendation to shareholders on the appointment of the auditor

- Evaluation of the results of the annual assessments of the audit firm including the audit firm's responsiveness to previous suggestions for improvements (including those of external regulator quality reviews) and whether their internal processes for assessing and monitoring quality were appropriate and sufficient.

- Quality of the engagement team is sufficient and appropriate - including the continuity of appropriate industry, sector and technical expertise (including new areas of activity by the client and changes in regulation or professional standards) and whether it has exercised sufficient objectivity to mitigate any independence and familiarity threats.

- Audit committee has the required and necessary resources and expertise needed to effectively undertake the CREA and that any changes, for example in composition or training that are required, are appropriately addressed.

The CREA would assess and evaluate these factors including how the incumbent audit firm has applied them to the audit, any additional entity-specific issues that have arisen, and how the incumbent auditor responded to these. The process for undertaking the review and its findings and conclusions would be detailed in the audit committee's public report.

It suggests that an appropriate next step could be the development of an 'audit committee toolkit' to set out how an audit committee should carry out the comprehensive periodic review, including requirements for reporting on the process and its outcomes to shareholders.

Appendix 2

‘Good Practice’ activities of an effective audit committee

The oversight role, responsibilities and principle activities of the audit committee **regarding audit quality and the performance, independence and appointment of the auditor** is likely to include the following activities on a regular (preferably annual) basis:

1. **Governance** - including:
    a. Setting the tone at the top with a focus on shareholder needs.
    b. Development of the committee charter covering policies on selection, appointment and remit of the auditor including the scope of services and any approvals needed.
    c. Oversight of the effectiveness of the company’s:
        i. Risk management and internal controls programmes[4].
        ii. Internal audit.
        iii. Compliance with relevant laws and regulation.
    d. Oversight and review of the external auditor’s independence and objectivity including:
        i. Demonstration of professional scepticism including challenges to management with their outcomes.
        ii. Review of annual independence confirmations and processes for monitoring compliance with independence and ethical standards.
        iii. Assessment of safeguards covering the provision of non-audit services and compliance with the company’s policies in this regard.

2. **Quality of the audit** - covering review and assessment of the:
    a. Soundness of the audit strategy (including approach and scope) and implementation arrangements (including project management), any deviation from this plan, and, as appropriate, the effectiveness of international coordination.
    b. Identification and implementation of technical developments and up-dates.
    c. Comprehensiveness and clarity of the audit findings, including views on the robustness of the company’s going concern assessment, outcome and disclosure.
    d. Robustness and appropriateness of the audit firm’s internal quality control procedures.
    e. Inspection reports by audit regulators and subsequent actions to address issues.
    f. Integrity, level of judgement, attitude, knowledge and experience of the audit team and clarity of their roles and responsibilities.
    g. Provision of perceptive, practical and effective recommendations and observations that add value to the business and which were timely.
    h. Auditor’s demonstration of their understanding of the risks and issues important to the company which could impact the audit.
    i. Auditor’s effectiveness in assessing the quality and transparency of financial reporting by management.

[4] This responsibility may be covered by a separate Risk Committee of the Board and therefore would not full within the remit of the audit committee

3. **Communication -** assessment of the effectiveness of communications between the auditor and management, and with the audit committee.
4. **Expertise and knowledge -** ensuring committee members have sufficient expertise and knowledge of the audit process and statutory requirements to effectively review and assess the performance of the auditor.

It should be acknowledged that adoption of these 'good practice' approaches should take account of the size and complexity of the company and that the frequency of undertaking them may vary as a result but as a minimum they should be performed as part of the PCR.