ecoDa / ECIIA Workshop
on the implementation of the Audit Committee reform by audit committees
19 September 2018, Brussels

SUMMARY REPORT

This workshop gathered 22 audit committee members from different EU member states. It was co-organized by the European Confederation of Directors Association (ecoDa), and the European Confederation of Institutes of Internal Auditing (ECIIA).

The reasoning behind this workshop was twofold:

1) the EU Audit Reform requires more training and information, and would need to be well targeted to the primary objective and not create additional responsibility or an expectation gap for audit committees, and

2) other stakeholders in the EU audit reform - primarily the CEAOB and the EU commission - needed more contact with audit committees to better understand their role.

The explicit purpose of this workshop was to determine whether the audit reform, as far as audit committees are concerned, is effective and progressing towards its goal, and whether there are some unexpected drawbacks.

The new regulations and directives recognise the crucial and very unique role of the Audit Committees as the overarching body to direct and supervise the Enterprise Risk Management of the company. This enforces their responsibility, in an environment of growing complexity and of more demanding results.

The two panels address the question of audit quality:

- panel 1 was from the perspective of fostering the right conditions for audit quality i.e. selecting a competent audit firm (selection, reappointment), making sure that the auditors are not biased in their judgment from non-audit services (independence) or excessive familiarity (rotation);

- panel 2 was about the quality of the audit itself - the "carefully designed and well executed audit".

The focus was clearly on the relationships between audit committees and auditors and did not not cover the full range of audit committees' roles and responsibilities.

Given that Internal Audit plays more and more its role of independent business partner, collaborating with Risk management, Internal control, Regulatory compliance, External audit, and communicating to both the General Management and to the Audit Committee, the organisers included the perceptive of Internal Auditors. Without Internal audit, Audit committee may indeed lack of eyes and ears to understand what is happening. Internal audit guarantees Audit committee efficient supervision over the internal control system. There are 5 imperatives for meeting this expectation of Audit committee:

1. IA is **strong** (independence of IA supported by dual reporting to both the CEO and the Audit committee chairman, IA has adequate resources and "courage audible")
2. IA is **complete** (it covers all key risks/business areas)
3. IA is **professional** (it provides high quality, up-to-date and objective information, quality is ensured international standards, individual and collective certification)
4. IA is **proactive** (it coordinates its activities with other assurance and risk functions, is able to act quickly)
5. IA makes **things happen** (corrective actions monitoring, ensuring positive changes)

INTRODUCTORY REMARKS FROM THE EUROPEAN COMMISSION (DG FISMA)

The European Commission made some introductory remarks reminding the EU Audit legal framework and the enhanced role for ACs. The EU legislators have allowed Member States to adopt different discretions on some aspects of the new rules (e.g. definition of a PIE, duration of maximum audit engagement and rotation period, list of prohibited non-audit services).

As required by Regulation No 537/2014, the Commission published in September 2017 a joint report based on the national market monitoring reports prepared by the national competent authorities and the European Competition Network. This report includes elements related to market concentration and ACs' performance.

On market concentration, the report made the following conclusions:

- Diverse EU audit market in size and structure;
- Market remains relatively concentrated, particularly in turnover;
- Big Four consolidated market share > 80% in 15 out of 21 MS;
- Highest EU-wide market concentration of the Big Four in Banking and insurance undertakings.

If no major risks were identified, three frequent issues were identified as main findings:

- Deficiencies in the internal quality control systems;
- Failure to document some aspects of audit engagement;

Lack of sufficient audit evidence.

Regarding ACs' performance, the past report was based on insufficient information on AC's activities (How do ACs perform their new roles and responsibilities?). The report concluded that the Commission could have a role to play in promoting this dialogue and in engaging with ACs directly to better understand their experience in implementing the audit reform. There was a large discrepancy in terms of information quality. The CEAOB tries to understand the challenges of collecting information in each country. The fact that the definition of PIEs goes beyond listed companies makes it even more difficult. To prepare the next report, the CEAOB is about to launch through the National Competent Authorities (NCA) a questionnaire to audit committee chairs in order to get more insights on the way they are applying the new audit reforms. The data provided will help national competent authorities to analyze what is going on in their market.

DEBATE:

The panellists agreed that the oligopolistic situation encountered by the big 4 is not unusual in other sectors. As long as the situation is well managed, it does not cause any efficiencies but it generates on the contrary a sound competition. The role of ACs is to challenge this oligopolistic approach and to make sure that the audit quality risk is measured and mitigated. Change of partners, renewal of mandates, provision of non-audit services allow the audit committees to compare and benchmark the audit firms. What really matters is to eliminate “the bad apples”. It is also important not to let audit firms compete only on price.

It is true that the big 4 have the biggest capacities. The new audit reform imposes new requirements that will not make it easy in certain countries or for international companies to find other suppliers than the big 4 to cover all the legal entities.

PANEL 1: ON MONITORING OF AUDIT SELECTION, ROTATION, AND INDEPENDENCE

Panel 1 started with some explanations on the composition and the role of the CEAOB. The CEAOB is competent for adopting opinions and non binding guidelines. The CEAOB is not responsible for supervising the EU auditor oversight bodies and is not a “EU Super regulator” for audit oversight.

The overall strategic objective of the CEAOB is to consistently support audit quality and consequently keep and increase confidence and trust of investors and the broader public in financial reporting in the European Union.

Its mission consists in:

- Enhancing investor confidence by improving audit quality;
- Promoting common understanding and consistent application of audit reform directive

Its main tasks include:

- Providing overarching structure to support national competent authorities in their cooperation (making sure that the national competent authorities have a common understanding in every remits that they have);
- Facilitating the exchange of information, expertise and best practices for the implementation of audit reform directive and to provide advices to the European Commission for technical assistance);
- Promoting common understanding of inspections methodologies, international standards framework and enforcement processes;
- Intensification of dialogue with stakeholders about audit quality;

- Enhancing dialogue with audit networks.

All decisions at the CEAOB are taken by consensus.

The areas of consideration by Audit Regulators are:

- culture, value, tone at the top;
- independence;
- growth and profitability in advisory vs audit;
- power and strength of global networks;
- root cause analysis and quality improvement;
- measuring/monitoring audit quality;
- digital analytical, audit and audit management tools;
- standard setting and standard setting processes.

The objectives of the questionnaire to be sent to ACs' chairs is not to review the regulation but to follow up the trends and make sure that the objectives of the audit reform have been met.

DEBATE:

Panel 1 discussed independence, rotation and selection or reappointment of the external auditors, which are all conditions that should lead to a better environment for the conduct of an audit.

Some preliminary comments were made to launch the debate on how to foster the right conditions for audit quality. The panelists agreed that the AC's role is increasing and their remit is expanding.

The large number of control functions reporting direct to AC makes things even more complicated given that they all have different opinions and use often a different vocabulary. ACs expect a high quality work from the external auditors and the other functions. ACs' members have to demonstrate independence and courage (combining the human quality and the value of people).

The panelists addressed different questions.

Q1: Year 2 of the implementation of the audit reform, what are the difficulties encountered with respect to the new requirements (mandatory rotation, appointment of auditors and non-audit services preapproval)?

Article 17 of the Regulation requires that all PIEs in the EU must rotate their auditor after a maximum period of 10 years, with a member state option to extend this period once for a further ten years on the basis of a tender or 14 years in the case of a joint audit.

With regard to groups which have subsidiaries in various EU member states, each EU PIE in the group will have to comply with the MFR rules applicable to the member state in which it is based, however there is no requirement for non-PIE entities in the group to rotate their audit firm. Above mentioned different rules for auditor rotation in EU member states might cause practical problems in multinational group as there could be more auditors within the Group (eg. problems in auditing of consolidated financial statements).

This situation is even more complex when companies (being large companies or mid-caps) are not allowed by law to align the mandates and to change auditor when their mandate has not expired yet.

And this is not even counting the fact that other regulatory bodies like supervision of banks, insurance, stock market have extra requirements.

Nevertheless, it is recommended to appointment the auditors one year in advance to allow them to get familiar with the company.

As an already observed consequence of auditors' rotation, pressure on prices has now moved to non-audit services.

Q2 – How practices have changed regarding the new requirements - what do you do differently?

In general, expertise is stronger in ACs (more skills are required), and cooperation between Internal Audit and External Audit is more efficient.
Showing key audit matters increases transparency and generates a lot of discussions with external auditors on important matters. It also raises awareness of audit issues and the ACs get information about the audit process in a more structured way. The involvement of all audit committees structures also the deep dive in risks.

For non-audit services, the management has to be more at the front edge with auditors.

Q3- Overall, would you say that the communication on independence between the audit committee and the auditors has improved materially?

When considering the independence of an auditor, the audit committee has to take a broad view to capture any relationships or services that could be viewed as impairing independence.

The culture of 'box ticking' or 'mere compliance' are a matter of great concern and requires deeper analysis. AC have to go beyond procedural compliance. Independence has to be approached through the competence, the expertise and the alignment with the organisation interests.

In certain countries like Italy, independence is not a new topic; the assessment of AC performance on independence of the firm is part of the yearly general assessment of the AC. The Audit Committee (Collegio Sindacale) is in charge for a three years period, while auditors for PIEs and listed companies are appointed for a nine year period.

According to some panellists, public procurement rules raised problems by preventing AC to present two auditors in the selection process and by putting too much emphasis on price criteria.

For the panellists, audit firms should first prove their independence, the AC should then figure out whether the auditor has expertise and experience under the circumstances of the future audit. The fees should be decided at a latest stage.

Q4- Do you believe that auditors' independence has been substantially improved by the new rules (in proportion to, or greater than, the additional effort)?

Audit rotation forces audit firms to compete and provide the best partners fit for each company/sector. Financial performance criteria are now completed with a more general performance criteria. A large international French Group has changed both audit firms at the same time to stimulate both executives and auditors.

As a consequence of the audit reform, it is becoming more and more difficult to attract AC members. Board members are more eager to join the strategic committee or the governance committee rather than AC. Remuneration of AC members have to increase in order to make the position still attractive. The continuing education board members is a key success factor not to be neglected.

The freedom of speech has to be enhanced within AC. It is important to organize formal non-executive sessions with and without the auditor.

Concerning the presence of shareholders, it is recommended to have them sitting in AC as long as they are in minority and remain independent. This practice can facilitate discussions at the general meeting. It makes even more sense in controlled companies.

The panellists agreed that media attention should be raised on those topics.

Q- Do you believe that the objectives of the audit reform regarding deconcentration of the audit market will be reached?

All panellists agreed that the objective of deconcentration will not be reached by the audit reform. In some countries, the number of audit firms available for PIEs is decreasing in different countries (e.g. in Slovenia: 16 firms for 71 PIEs in the past and now 13 firms for 68 PIEs). Certain audit firms refrain from taking over new PIEs for audit services.

Some PIEs have difficulties in defining selection criteria to ensure quality work without being discriminatory.

Panel 1 was closed by a short presentation from Audit Analytics which made a brief overview of their audit benchmark services. As the selection or reappointment process of auditors has been impacted by the Reform, it was useful to have this presentation as a source of information, independent of how the assessment is conducted (internally or externally). More specifically, none of the four institutions - EU Commission, CEAOB, ecoDa or the ECIIA - endorsed the proposed services which were presented only as background and to stimulate the dialogue.

PANEL 2: MONITORING OF AUDIT QUALITY (QUALITATIVE AND QUANTITATIVE)

As part of the EU audit reform, the audit committee is now also responsible for:

- Explaining to the board of directors how the audit contributed to the integrity of the financial statements;
- Monitoring the audits and in particular the performance of the audit (in other words, monitoring how the audit actually takes place and its quality).

The PCAOB stated in 2015, - more than 10 years after the Sarbanes-Oxley law (2001) which considerably increased the scope and involvement of audit committees regarding monitoring of the relationship of the external auditors, pretty much in the same way as the EU Reform has done two years ago- :

> *"The manner in which the audit is conducted lies primarily under the surface, and the strengths and weaknesses of the process are opaque. The sole observable output of the audit*

is a standardized report that cannot be used to distinguish auditors from one another. Since this is so, it is difficult to evaluate the elements of audit quality […] or to understand how it might be strengthened; it is also hard to recognize and reward audit quality when it is present.

For these reasons, audits currently may fall within the class of what economists call "credence goods." That is, the quality and impact of the auditor's services may be difficult or in some cases impossible to ascertain accurately. The auditor is usually in the best position to determine the scope of the service required; the client has limited ability to make a similar judgment, and the outcome of the service – the quality of the audit – is either unobservable or can only be observed at significant cost to the audited company or others."

The audit reform is intended to enroll audit committees to help put a greater pressure and scrutiny on auditor's work, in a contemporaneous manner, in a context where:

- Auditors are independent and responsible for developing their own audit approach;
- There need to be a fine balance struck between challenge / discussion, and over influence;
- Audit regulators are responsible for the monitoring of audit quality;
- And Audit committees have certainly a role to play, in the (by essence) limited time and interactions they have with the external auditor (and we need to make the most of it).

Panel 1 started with some information related to the questionnaire that will be launched by the national competent authorities.

The questionnaire is created as a tool for communication between AC and national competent authorities. It will help NCAs that don't have the remit to engage with ACs or those which have just been set up. The questionnaire will include a set of common questions that would facilitate the aggregation of the answers. All questions integrate space for comments. The questionnaire will be sent in the coming months.

There is some limited guidance at the end of the questionnaire, covering for example what reference period to use, but other guidance was developed to assist Audit Committee chairs in the completion of the questionnaires. Given the various requirements across member states this was made available to NCAs who can tailor it appropriately to each member state.

It would be the NCAs' prerogative when to specify the deadline for submission, as long as the collated data is submitted before our internal CEAOB deadline (Q2 of 2019).
It will be also up to each NAC to define a sample of PIEs. The data provided to the European Commission will be treated anonymously but each NAC can make a public disclosure of their national report.

DEBATE:

The panellists agreed that the board should endorse the responses made by ACs.

Q1: How would you define audit quality, have your views/practices regarding audit quality changed with the audit reform?

IOSCO in their June consultation report has defined audit quality as relating to matters that affect the auditor's ability to [achieve an audit fundamental objectives and ensure that any material misstament detected are addressed or communicated], which is very broad.

Audit quality is a given, there is no ex ante audit quality. An audit has high quality when it meets its objective and detect material discrepancies in the financial statements.

In some countries, there are some sets of quality indicators. The involvement of partners is an interesting indicator but it depends on the business and on the complexity of activities.

There is no leverage to use the inspection results to understand the mechanism of incentives. Transparency reports can provide good quality control systems (partner compensation, training of staff) and should be used more often to launch a debate on audit quality.

The AC must assess the evidence and the courage of the external auditors. The review of the "adjusted" differences can be interesting to test the quality of the auditors. Tension between external auditor and the management does not as such really help to increase audit quality.

Q2: Audit committees are often at the crossroad between management and the auditors. Have you experienced situations where there was a perceived general lack of quality? What did/would you do? How do you assess your impact on audit quality?

The panellists identified some good practices:

- Have a preparation meeting with external audit, management and all stakeholders and make sure the process is understood and well implemented;
- Insist to have a clear audit presentation at each board with an executive summary and key points and attention;
- Have separate meetings with the external auditors during the whole audit process and before each AC. Make sure they understand the processes of the organisation, its chart (and changes), the different projects, the outsourced activities, etc.;
- Obtain a draft of the F/S or other well in advance to review if and ask questions (It is important to receive the documents in advance to review them and challenge them before the AC);
- Challenge the composition of the audit team (experience, resources);
- Ask Management or other stakeholders (internal audit, control functions) what they think about the audit quality / performance. Make a survey towards the Management about the staff, quality of the exchanges, etc.;
- It is important to understand CAATs, audit methodologies, analyticals as an AC member.
- AC should review the scope of the audit, the audit techniques and the level of materiality.

Q3: Understanding the business and aligning risk assessment between external auditors, internal auditors and the audit committee is a starting point for audit quality. What is your experience and how do you rate the cost/benefit balance (proportion of the audit effort on risk areas)?

The panellists identified some good practices:

- The management of the risks is key and sometimes a Risk Committee has to be set up as a stand-alone committee;
- The risk control self assessment is a good tool for both the external and the internal auditors to build the audit plan for some sectors (financial services).The audit plan must be based on a risk approach;
- It is good to know how much time is spent by the external auditor on high risk areas;

- During the kick off meeting with the external auditor, it is good to share concerns (from risk map, controls made by IC , internal audit plan and vice versa).
- It is important to control how IT risks are taken into consideration in the audit.

Q4: What other factors would materially impact audit quality (auditing standards, definition of materiality, use of technology in the audit, etc)?

The external auditors usually are under pressure to reduce their audit fees when competing with each other, and also receiving a pressure from their clients to reduce further the audit fees. The reducing fees may negatively impact the audit quality and compliance with the International Standards on Auditing. Audit Committee (AC) can review the audit hours budget as split between partners/senior and other staff to assess whether the total and experienced staff number of hours is properly planned. The big size hourly budget does not necessarily ensure the quality of the audit, and the small size hourly budget must be a red flag for AC.
AC's must be timely and quality engaged in discussing significant judgmental areas with management and external auditors. The current regulation requires AC's of listed entities to mandatory review significant related party transactions and in addition AC's need to lead discussions with management and external auditors to understand and assess the proper accounting and disclosure treatment of significant unusual events, transactions and balances.

NCA's audit results should be addressed by AC's during the selection process of external auditors and in assessing the quality of completed relevant external audit after the results of NCA's audits become available.

AC should discuss with external auditors during the planning and final stages of the audit the materiality applied to perform. The AC should receive information about how materiality has been assessed and should challenge and discuss it twice a year (planning and final).

The big 4 audit firms have regular cycles of enhancing their audit and other services related technology with the big 4 clients benefiting (via higher audit coverage, higher quality recommendations, etc.) from more sophisticated technology engagement during the audits. Smaller audit firms have lesser resources to complete the significant technology updates. The investments in technology by external auditors should be on the agenda of the discussion with the AC. The AC should question: to what extend do they leverage data analytics, what is the percentage of the population tested, what are the techniques for sampling, what tools do they use? It is also interesting to discuss how EA will recruit the right people in the future.

Q5: Inspections have driven stricter interpretations of auditing standards, with a correlative increase in audit procedures and an impact in the sophistication of finance departments (in particular for smaller listed companies). Do you believe the new requirements will actually increase audit quality overall and eliminate large audit failures? Other consequences, if any?

A systematic trend has developed more and more prescriptive procedures. This has led to a corresponding impact on the sophistication of finance departments and increased audit fees. We have reached a point where it could become unproductive, in the sense that for example, smaller PIE are encountering real difficulties in recruiting people deemed sufficiently qualified by external auditors, or been subject to disproportionate increase in audit fees, which could have a repulsive effect for smaller companies to go for a listing and turn to private equity instead.

In addition, audit is often performed by junior people who don't know about the business, are not able to identify the risks, and have a box ticking approach. A lot of time is spent on internal documents of the firm beacuse of the scare of controls. As a matter of fact, a lot of mid-caps companies prefer to leave the quotation. They don't see the benefits of paying twice or three times more for the same audit exercise. Even some auditors are recommending to SMEs not to go listed. In Poland, it is even worse; when a company leaves the market, it is the whole sector that follows.

Furthermore, it happens that some companies set up another AC to discuss only the figures.

Another point of concern is related to the fact that discussion on figures don't happen anymore at board's level. Boards rely on ACS to discuss those matters. There is a risk that financial decisions are not taking any longer in a collegial manner.

Regulations must be proportionate. Over regulations kill businesses.

CONCLUSIONS

All panellists were thanked for their active participation as well as the European Commission for bringing a clear perspective on the main objective of the Audit Reform and the PCAOB for the information on the questionnaire. All participants were invited to promote it in their various countries.



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