CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

June 25, 2018

Mr. Jonathan Bravo
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid, Spain

Re: Public Comment on IOSCO Consultation Report on Good Practices for Audit Committees in Supporting Audit Quality

Dear Mr. Bravo:

The Center for Audit Quality (CAQ) welcomes the opportunity to comment on the International Organization of Securities Commissions (IOSCO) Consultation Report on Good Practices for Audit Committees in Supporting Audit Quality (the Consultation Report).

The CAQ is an autonomous, nonpartisan public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates for policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

In this letter, we offer for IOSCO's consideration our views regarding certain topics outlined in the Consultation Report. This letter represents the perspectives of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member. Our views are organized into the following sections:

I. General Views on the Consultation Report
II. Possible Good Practices for Audit Committees in Supporting Audit Quality
III. Audit Committee Reporting

I. General Views on the Consultation Report

The CAQ shares IOSCO's view that the quality of financial reports, supported by an independent external audit, is key to confident and informed investors and markets. Audit committees play an essential role in protecting the interests of investors by broadly overseeing a company's financial reporting process. We appreciate the effort by IOSCO to highlight and bolster the important role of audit committees in supporting audit quality. As we have shared previously with the Securities and Exchange Commission (SEC),[1] our comments are guided by certain core beliefs that serve as the foundation for our views. These core beliefs are:

- High quality audits are critical to capital markets because they give the public enhanced confidence in the credibility and reliability of audited financial statements; and
- A strong, independent audit committee promotes audit quality and accurate and transparent financial reporting by management, by fostering an independent audit environment aligned with investor interests and protection from undue management influence.

In addition to their fiduciary duties as members of the Board of Directors, in the United States audit committees also have been delegated special responsibilities with respect to the audit and the financial reporting process, which were strengthened by the Sarbanes-Oxley Act of 2002 (SOX)[2] and related SEC[3] and stock market rules.[4] For instance, public company audit committees have statutory responsibilities to appoint, compensate, and oversee the external auditor. Many of the good practices proposed in the Consultation Report are consistent with these requirements.

II. Possible Good Practices for Audit Committees in Supporting Audit Quality

a. How can Audit Committees Support Audit Quality (Section 3.1)

The CAQ has done extensive work on how audit committees can support audit quality, including consideration of objective criteria related to audit quality, which are commonly referred to as Audit Quality Indicators (AQIs).[5] We believe that a robust, two-way discussion of AQIs between an engagement team and the audit committee provides information that could enhance the understanding of the audit process and drive actions that could increase audit quality on the engagement. Context and dialogue are especially important when providing engagement-level AQIs because without them the information is insufficient for decision-making or comparative purposes.

The development of objective criteria to assess audit quality is an on-going process, and there is still work to be done in establishing metrics and criteria, as well as demonstrating their correlation to

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[1] See CAQ Comment Letter on the SEC's Concept Release related to *Possible Revisions to Audit Committee Disclosures* (September 8, 2015).

[2] Sarbanes-Oxley Act of 2002 §301.

[3] Rule 10A-3, 17 C.F.R. §240.10A-3, under the Securities Exchange Act of 1934, which was adopted in accordance with section 301 of the Sarbanes-Oxley Act.

[4] NYSE Listed Company Manual §303A.07; NASDAQ Marketplace Rule 4350(d)(3).

[5] The CAQ *Audit Quality Indicators: The Journey and Path Ahead* (January 2016) publication is available at https://www.thecaq.org/audit-quality-indicators-journey-and-path-ahead. The CAQ *Approach to Audit Quality Indicators* (April 2014) publication is available at https://www.thecaq.org/caq-approach-audit-quality-indicators.

audit quality outcomes. We believe the identification and evaluation of AQIs should be a voluntary, flexible, market-driven process that will require continuous assessment to best meet the needs of the users. More research and testing is still needed to determine which indicators could be viewed as having a relationship to audit quality and their usefulness. The auditing profession, audit committees, and regulators continue to assess various potential quantitative AQIs, and more experience and empirical evidence are needed to understand and evaluate how potential AQIs, or changes in AQIs over time, correlate with audit quality outcomes. We support continued pursuit of this effort.

We also note that qualitative AQIs – for instance, people/team, leadership abilities, communication, articulation of decision making processes, etc. – have been recurring inputs to audit quality that audit committees have highlighted in their discussions with the CAQ. These are of course harder to measure, but an equally important part of the discussion that should not be overlooked.

b. Recommending the Appointment of an Auditor (Section 3.3)

We also support the proposal in Section 3.3 that the audit committee should "ideally manage the process of developing a recommendation on selecting, appointing and replacing auditors and the process of determining their remuneration."

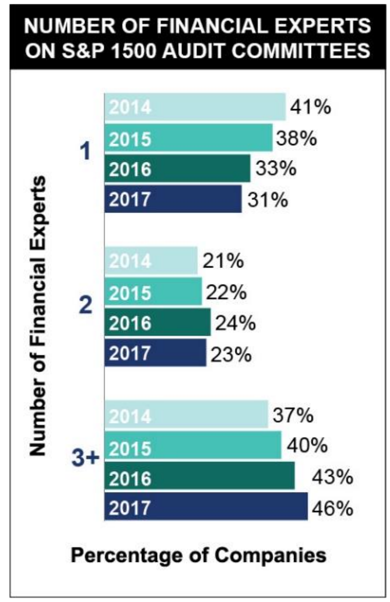
As mentioned above, in the United States, SOX strengthened audit quality in many ways, including requiring the audit committee to appoint the auditor, be directly responsible for auditor compensation, and pre-approve non-audit services provided to the audited entity by the auditor. Additionally, the auditor reports directly to the audit committee, rather than to management. As part of the appointment process, we believe the audit committee should evaluate audit quality. Assessing auditors against objective criteria with regard to audit quality, as described in good practices 15 and 16 in Section 3.3 could help promote and enhance their dialogue and focus on audit quality.

c. Facilitating the Audit Process (Section 3.6)

We agree with the proposed good practices in Section 3.6 that suggest audit committees "can have a key role in ensuring the quality of financial information produced by management," and "should assist the board by reviewing significant financial reporting issues and judgements made in connection with the preparation of the company's financial statements." While management has the primary responsibility for preparing an SEC issuer's financial statements and disclosures, the audit committee has an important role to play in facilitating the audit process. The audit committee's responsibilities include the oversight of management's internal controls over financial reporting and management's process for preparing the financial statements. In addition, SOX Section 301 requires the audit committee to oversee the independent auditor's work and be directly responsible for the auditor's appointment and compensation.

The Consultation Report also notes that, "while directors are not expected to be accounting experts, they should seek explanation and advice supporting the accounting treatments chosen and, where appropriate, challenge the accounting estimates and treatments applied in the financial report." We agree that all audit committee members need not be accounting experts, but believe that to effectively carry out its responsibilities, the audit committee should have sufficient expertise.[6]

Since 2014, the CAQ and Audit Analytics have been tracking the number of Audit Committee Financial Experts (ACFEs)[7] on Standard & Poor's (S&P) 1500 companies' audit committees. We have seen a consistent trend whereby S&P1500 companies are adding multiple ACFEs to their audit committees. While we are unaware of any data that can definitively correlate an increase in the number of audit committee financial experts on an audit committee to enhanced audit quality, we think this trend toward additional expertise on audit committees suggests that the committees are taking seriously the need to have members with appropriate expertise and experience.



***Source**: Center for Audit Quality and Audit Analytics analysis of 2017 S&P Composite 1500 proxy statements (filed July 1, 2016 through June 30, 2017)*

d. Assessing Auditor Independence (Section 3.7)

Section 3.7 states, in part, that the audit committee should assess auditor independence and that "independence of the auditor (both in fact and appearance) is important for promoting market confidence in the auditor's report on the financial report." We agree and think that certain SEC and Public Company Accounting Oversight Board (PCAOB) requirements in the United States address independence and, in doing so, support audit quality. These rules, noted below, have strengthened the responsibilities of audit committees and promote an important two-way dialogue between the audit committee and the auditor.
SOX mandates that audit committees be directly responsible for the oversight of the engagement of the company's independent auditor. In accordance with SEC independence rules, the audit committee:[8]

- must follow certain pre-approval requirements;
- should be informed about the services expected to be provided by the audit firm to understand whether the audit firm's independence will be impaired; and
- should consider whether company policies and procedures require that all audit and non-audit services are brought before the committee for pre-approval.

In accordance with PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* the auditor must:

[6] SOX Section 407 requires an issuer to disclose whether at least one financial expert is on the committee. A company that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert. If the committee has a financial expert, the company must disclose the expert's name.
[7] As defined by SEC Release No. 33-8177A.
[8] See the SEC Office of the Chief Accountant website on *Audit Committees and Auditor Independence* at https://www.sec.gov/info/accountants/audit042707.htm.

- prior to accepting an initial engagement and at least annually thereafter, describe, in writing, to the audit committee all relationships between the audit firm and the company that may reasonably be thought to bear on the audit firm's independence;
- discuss potential effects of the relationships described on independence; and
- at least annually affirm to the audit committee, in writing, its independence.

e. Communicating with the Auditor (Section 3.8)

Section 3.8 suggests that an audit committee "should establish a direct line of communication between the audit committee and the auditor…Open, timely and meaningful communication between the auditor and the audit committee is important in fulfilling the responsibilities of both the auditor and audit committee." We concur that open, timely, and meaningful communication between the audit committee and the auditor is important in fulfilling the responsibilities of both the auditor and audit committee. Two-way communication between the auditor and the audit committee members helps the auditor to obtain information that is relevant to the audit and assists the audit committee and directors in overseeing the financial reporting process.[9]

In the United States, PCAOB Auditing Standard 1301, *Communications with Audit Committees*, (AS 1301) requires communication between the auditor and the audit committee related to overall audit strategy, timing of the audit, and significant risks.[10] We believe that the requirements of AS 1301 support audit quality.

For instance, AS 1301 requires, among other things, the auditor to communicate to the audit committee qualitative aspects of significant accounting policies and practices, assessment of critical accounting policies and practices, conclusions regarding critical accounting estimates, the auditor's understanding of the business purpose (or lack thereof) of significant unusual transactions, the results of the auditor's evaluation of the presentation of the financial statements and the related disclosures, and other matters related to new accounting pronouncements and alternative accounting treatments.[11]

As part of this dialogue, it is appropriate for the audit committee to seek explanations related to accounting policies, significant estimates, complex transactions, and other questions arising from their review of financial reports. The audit committee should gain comfort that concerns or risks highlighted by the auditor have been considered and addressed.

AS 1301.23 also states the auditor should communicate to the audit committee any significant difficulties encountered during the audit (e.g., significant delays by management, the unavailability of company personnel or unwillingness to provide information needed). We believe the requirements of AS 1301 are important to audit quality and the audit committee is responsible for resolving such difficulties.

[9] The Consultation Report, page 23.
[10] AS 1301.09.
[11] AS 1301.13.

f. Assessing Audit Quality (Section 3.9)

The CAQ believes that audit committees should evaluate the external auditor's performance at least annually and make an informed recommendation to the board whether to retain the external auditor. We concur with the Consultation Report's suggested good practices around evaluation of the auditor's performance and concur that evaluations promote "market confidence in the issuer's financial reports."

Further, providing constructive feedback to the external auditor may improve audit quality and enhance the relationship between the audit committee and the external auditor. The evaluation should encompass an assessment of the qualifications and performance of the external auditor; the quality and candor of the external auditor's communications with the audit committee and the company; and the external auditor's independence, objectivity, and professional skepticism. The CAQ in partnership with the Audit Committee Collaboration has published the *External Auditor Assessment Tool*, which is designed to assist audit committees in such an evaluation.

III. Audit Committee Reporting (Section 4.1)

We support the current disclosure requirements in the United States for audit committees. Beyond existing requirements, we support a market-driven, voluntary disclosure approach that allows audit committees to take into consideration evolving expectations of stakeholders, while communicating material information that is most relevant to their businesses and investors. In the United States, we are encouraged to see a positive growing trend of voluntary, enhanced audit committee disclosure in proxy statements since we started tracking such disclosures.[12] For example, in 2017 37% of S&P 500 companies disclosed audit committee considerations in appointing the external auditor (up from 13% in 2014); 38% disclosed the criteria considered when evaluating the audit firm was (up from 8% in 2014); and 31% disclosed an explanation for a change in fees paid to the external auditor (up from 28% in 2014).

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The CAQ appreciates the opportunity to comment on the Consultation Report and would be pleased to discuss our comments or answer any questions that IOSCO may have regarding the views expressed in this letter.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

[12] See the *2017 Audit Committee Transparency Barometer*, an annual report issued by the CAQ and Audit Analytics.

cc:

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