THE EVOLVING ROLE OF AUDIT COMMITTEES
CHALLENGES AND THE WAY FORWARD

How can audit committees best address pressing challenges in a shifting global policy environment? A series of panels yielded many insights on that question.

A global policy wave continues to sweep over audit committees.

Policymakers worldwide increasingly recognize the vital role that audit committees or their equivalents play in companies and markets. In some instances, this recognition has led either to the imposition of new requirements on audit committees, or proposals that could lead to new requirements. In other instances, audit committees are being affected by other measures, such as mandatory audit firm rotation and retendering.

From March 2013 to September 2015, the Center for Audit Quality (CAQ) and the International Corporate Governance Network (ICGN) co-hosted a series of panel discussions on the evolving role of the audit committee in this environment. The panels spanned the globe—Amsterdam, Boston, London, Madrid, Milan, New York, and Tokyo—with participants hailing from many backgrounds and communities (academia, auditing, investor, issuer, and regulatory).

Despite the variety in settings and participants, common themes and threads emerged. In addition to identifying key challenges, participants offered a distinct set of solutions and ideas for strengthening audit committees to the benefit of investors and the markets.
A glance at several regions shows the extent of policy changes taking place in the realm of audit committees.

- **European Union**: The EU adopted sweeping audit legislation that entered into force in June 2014 with most provisions taking effect June 2016. Among many other provisions, EU rules require the auditor’s work to be more closely supervised by audit committees—the auditor must submit a detailed report to the audit committee on key issues in connection with the outcome of the statutory audit, including, for example, possible significant deficiencies identified in the internal control system. Audit committees also take on new responsibilities, notably involving appointment and dismissal of the auditor.

- **United States**: A notable U.S. policy development deals with audit committee transparency, in particular a concept release from the U.S. Securities and Exchange Commission (SEC) on audit committee disclosure. At a 2015 CAQ/ICGN breakfast in Boston, a panelist from the investor community noted that U.S. companies increasingly are providing more information to investors voluntarily about how audit committees are discharging their roles and responsibilities. “Some companies have done a good job,” she said, but “some companies may need a little prodding.”

- **Brazil**: Policymaking has been active in Brazil. In 2011, for example, the Securities and Exchange Commission of Brazil introduced the Statutory Audit Committee, which, in terms of requirements, approximates audit committee structure in the United Kingdom or the United States. While audit committees in Brazil are gaining more authority, observed a panelist from Brazil, they continue to lack independence.

- **Japan**: As it has moved forward with a range of provisions intended to strengthen corporate governance, Japan has seen shifts between several different structures that fill the audit oversight role: Kansayaku boards, the so-called “3C” framework, and more U.S.-styled audit committees.

- **United Kingdom**: Change around audit committees has gathered momentum in the United Kingdom, thanks in part to efforts of the Financial Reporting Council (FRC) to regularly update the UK Governance Code. CAQ/ICGN panelists observed that UK audit committee reports now provide investors an ability to have “a meaningful conversation,” following the FRC’s adoption of expanded requirements on audit committee reporting in 2013.

### CHALLENGES FOR AUDIT COMMITTEES

In this shifting environment, marked by heightened regulatory requirements, panelists agreed on several major challenges.

- **Regulatory fragmentation**: Regulatory fragmentation can create gaps in investor protections, which is one reason why global harmonization is desirable. Yet, in the assessment of a panelist at the Milan breakfast, “we are not going to see a global regulatory approach” when it comes to auditing and audit committees. What’s more, as shown in countries like Brazil, simply importing governance structures from other
jurisdictions with a “cut-and-paste” mentality may not be feasible, given differing cultural and corporate norms.

- **Lackluster interaction between investors and audit committees:** Said one London participant: Audit committees should “tell [investors] what you’re doing, what keeps you up at night, what arguments you’re having.” But breakfast participants also observed that such engagement is rare, even in jurisdictions that have completed reforms aimed at encouraging it. Indeed, another London participant revealed that over nine years of chairing UK audit committees, he had received just two questions from investors.

- **Uncertainty regarding audit committee qualifications:** Audit committee composition is a key factor in enhancing the effectiveness of the audit process. Still, questions swirl around what the right composition is. How much financial expertise is necessary? Should other qualifications be required? How important is diversity?

- **Policy complexity and concerns about regulatory excess:** As audit committees’ responsibilities expand, regulatory burden and complexity can prove a challenge. For directors, a Madrid panelist pointed out, the amount of responsibility has become “enormous.” Consider that the SEC’s 2015 concept release on audit committee disclosure invited commenters to offer feedback on over 200 questions related to the audit committee’s oversight of the external auditor alone.

**KEYS TO PROGRESS**

In contemplating these stark challenges, the discussions yielded notable points of agreement on how to address them.

- **Enhancing transparency:** A critical part of overcoming pitfalls arising from regulatory fragmentation, particularly regarding audit committees, will be efforts to enhance transparency. In the audit context, this transparency can take place through more informative audit committee and auditor reports, and it needn’t necessarily be mandated. In the United States, for example, the *Audit Committee Transparency Barometer*—an annual publication of the CAQ and Audit Analytics—shows encouraging year-over-year trends with respect to voluntary, enhanced disclosure by U.S. companies around external auditor oversight. Such voluntary disclosure has the benefit of allowing audit committees to tailor their disclosures.

- **Effecting evolutionary (not revolutionary) change:** While challenges faced by audit committees may loom large, responses to them need not always be drastic, particularly given the reality that cut-and-paste or one-size-fits-all solutions tend not to work. This notion was explored at length at the 2014 Tokyo breakfast, where panelists described the gradual, measured steps taken in Japan recently towards rationalizing its sometimes disparate approaches to audit oversight.

- **Embracing assertive audit committees:** Panelists highlighted the need to elevate the stature and independence of audit committees. It was suggested that audit committees should be proactive, initiating investigations, challenging auditors and management, “walking the floor” to gather input directly from employees, and seeking out meetings with investors—not waiting for their call.
Striving for diversity of viewpoints: Even as participants grappled with how to strike the right balance on audit committee composition, a clear consensus emerged around the fundamental importance of diversity. They agreed that audit committees should have a variety of skillsets and experience to protect against herd-like thinking and to enhance the willingness to challenge assumptions.

Engaging in the policy process: Participating in the regulatory process can be daunting, especially given the dizzying complexity of some policy proposals. But, as was made clear at this series of panel discussions, policymakers need—and in many cases desire—input from all stakeholders, including boards, audit committees, and investors. These stakeholders should make their voices heard, whether through individual efforts or through trade bodies or policy organizations.

THE WAY FORWARD

There is one thing that panelists at this CAQ/ICGN series did not provide: an easy answer to the question of how to enhance the audit committee’s vital role. Why? Simply put, no easy answers exist, given the challenges of a complex and global policy environment. Yet while none are silver bullets, the steps identified above—enhancing transparency, effecting evolutionary change, embracing assertive audit committees, striving for diversity, and engaging on policy—will all serve to bolster audit quality and benefit investors.

ABOUT THE CAQ

The CAQ is an autonomous 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 requiring action and intervention, and advocates policies and standards that promote public company auditors’ objectivity, effectiveness, and responsiveness to dynamic market conditions.

ABOUT ICGN

An investor-led organisation of governance professionals, ICGN’s mission is to promote effective standards of corporate governance and investor stewardship to advance efficient markets and sustainable economies world-wide. Established in 1995 and present in over 50 countries, the ICGN membership includes global investors with assets under management in excess of US$26 trillion.