Audit Committees – Their Evolving Role In the Financial Reporting Process

Highlights from CAQ Symposium Breakout Discussions

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At the CAQ Symposium, research academics and senior practice leaders joined together in small group discussions to further explore one of the four major topic areas addressed by the morning's panel on audit committee effectiveness. The questions posed to the breakout group members were designed to drive a dialogue about the factors that are key to a given audit committee role, the areas of potential improvement, and potential impediments to those improvements. The discussions also touched upon academic research on audit committee-related issues. Two separate breakout groups addressed each topic area.

Below is a brief summary of the highlights of each of the four breakout group topics. The opinions expressed by attendees during these discussions do not necessarily reflect the views of the CAQ or its member firms.

I. Audit Committee Oversight of the Financial Reporting Process

The primary responsibility of any audit committee is the oversight of the financial reporting process. Two breakout groups deliberated on what they thought were the most important areas of the oversight of financial reporting by audit committees. Between the two groups, they identified what they deemed to be the most important fields on which audit committees should focus: management integrity; management incentives; accounting estimates and judgments, and the oversight of internal control over financial reporting (ICFR).

The breakout groups believed managerial integrity starts with the establishment of trust between the audit committee and management. There was a consensus that an ethical tone-at-the-top is fundamental to ensuring management integrity. Audit committees should have established procedures to address questions that might arise with respect to management's integrity. Integrity of management, however, is hard to gauge without first understanding management incentives. Audit committees must understand and discuss the incentives that the board has set for management, and be vigilant in its examination of how those incentives might influence management's decisions.

High quality financial reporting has been linked to how audit committees deal with accounting estimates and judgments, and the oversight of the company's ICFR. It was suggested that effective audit committees routinely ask two key questions about management's use of estimates and/or valuations: how did management get to the number they decided on? And how did the auditors get comfortable with the number? Another key source of information for the audit committee is the auditor's evaluation of the company's accounting policies and estimates. Asking questions about the accounting policies can provide the audit committee with key information, and can serve as a catalyst for meaningful discussions with management and the auditor.

It was also suggested that the audit committee should have a good understanding of the company's ICFR – querying management about its assessment of the effectiveness of controls, and discussing with management, and the auditor, the results of the auditor's evaluation of management's assessment.

There was a strong consensus that effective audit committees tend to have the following characteristics: they have a keen understanding of internal and external risks facing the company; and they have a strong grasp of what goes into the financials and ask the right questions of the auditors and management.

<u>Potential improvements in the oversight process.</u> Breakout group members were asked to identify ways that the audit committee oversight process might be improved. There seemed to be agreement that more standards are likely not the answer. Rather, a more robust line of communication between the audit committee, management, the external auditor and investors would be the most beneficial. Audit committees, management and the external auditor should discuss how they fulfill their roles to uphold the public's trust.

Several ideas were mentioned for ways that audit committees might improve their oversight of the financial reporting process. One suggestion was to have the audit committee shift its focus to the grey and subjective areas of accounting policies, to devote more time to understanding current accounting practices, and to try to understand and provide guidance in those key areas where adjustments are made to management's estimates. Another suggestion was to have the audit committee be more proactive in setting its meeting agendas. Increasing the responsibilities and accountability of the audit committee could lead to better overall performance.

<u>Academic research on audit committees.</u> The extant research on audit committees tends to focus on the relationship between audit committee characteristics and observable outcome measures, such as earnings management. There is very little known about the process that audit committees undertake in the execution of their responsibilities, which makes meaningful research difficult. Another challenge to meaningful research is that some of the metrics used (e.g., number of audit committee meetings) is not overly useful, since so much audit committee-auditor communications goes on outside of the formal meetings.

Case studies and behavioral research studies could provide value, but there are impediments to conducting such research. Audit committee members are often difficult to reach for the purposes of research. Another major impediment to research on audit committee effectiveness are the potential liability issues. Fostering discussions of the benefits of the research verses the risk of legal exposures may increase the likelihood of future access.

II. Audit Committee Management of the External Auditor

Audit committees were given the responsibility for hiring, overseeing, and, if necessary, terminating the external auditor under the Sarbanes-Oxley Act of 2002. The breakout groups were asked to outline what they believed to be the key factors in the audit committee's annual evaluation of the external auditor, as well as key factors in the selection of a new auditor.

<u>Annual evaluation factors.</u> Quality and frequency of the discussions between the audit committee and the auditor (many of these interactions happen outside of the formal audit committee meetings) were considered detrimental to the evaluation process. An effective audit engagement partner keeps the audit committee chair informed of issues as they arise during the course of the audit, and does not wait until the formal meetings – audit committee chairs prefer to avoid surprises at those meetings. The breakout group members identified certain events that might lead to a negative evaluation of the auditor: cost overruns, going concern opinion and material weakness opinions in the ICFR.

It was suggested that the more experienced, better informed audit committee members are in the best position to assess auditors during the evaluation process. Audit committees should engage in dialogue with the auditors to set their expectations of the audit, and both parties should agree on the technical aspects of the audit at the outset. Audit committee members should be familiar with current accounting practices so they are more adept at evaluating auditors. The use of a standardized evaluation tool, such as the one recently developed collaboratively by the CAQ and other organizations should help audit committee with their evaluations of the auditor.

The breakout groups were asked to delve into key factors that audit committees should consider during the auditor selection process. Ideally, the audit committee should look for an audit firm that has the requisite industry expertise. However, there was a sense that audit committees tend to select the auditor with the lowest bid, unless they have a good understanding of why there is a disparity in the bids. Oftentimes, management will make recommendations to the audit committee on firm selection; in those instances the audit committee should independently determine if that recommendation is in the best interest of the company.

<u>Academic research.</u> The extant research adds little value to the nature of the relationship between audit committee and auditors because the available data do not provide variables that allow researchers to adequately measure that relationship.

Case studies and behavioral research could provide insight into the audit committee-auditor relationship. Using a case study method, researchers could develop a model that describes the leading practices of effective audit committees. Behavioral studies would allow researchers to examine audit committee decision making processes. However, obtaining access to audit committees is a major challenge for academic researchers. Two primary reasons were cited for the lack of access: fear of increased liability for the audit committee, and the amount of time that would be required of already very busy people. The audit committees would have to be convinced of the value that would be derived from the research.

III. Audit Committee Effectiveness: Experience, Training and Resources

What makes an audit committee effective? Breakout group discussants noted that research on audit committee effectiveness tends to focus on observable input factors: experience/background of the audit committee members, the length of time that an audit committee member has served on the committee, and the number of meetings held. The outcome measures used are earnings management, material weakness opinions, and other metrics used to quantify the quality of financial reports.

Audit committee characteristics that lead to effectiveness should be strongly associated with high quality financial reporting. However, those variables are not readily captured in available databases. Among the factors believed to be important was the audit committee's deep knowledge of the accounting issues specific to the company's industry. This would allow them to ask probing questions about the financials of both management and the auditor. Some discussants suggested that companies with proactive and engaged audit committee members produce higher quality reports. An effective audit committee chair has frequent discussions with the audit partner throughout the course of the audit. The nature and frequency of these communications are not captured in publicly available databases, and thus, do not figure in to the analysis of audit committee effectiveness.

The breakout groups looked at the impact of section 407 of the Sarbanes-Oxley Act of 2002 (SOX), the designation of an audit committee member financial expert. Agreement on what exactly the direct impact of SOX has been in this arena was mixed. Some members believed that the designation of a financial expert provides credibility. Members suggested that audit committees are now more diligent and provide oversight on a different level than they did prior to enactment of SOX. Other group members, countered, that SOX is a contributor, but not the primary driver in the improvement of audit committees.

<u>Academic research on audit committee effectiveness.</u> Regardless of the driving forces in improving audit committees, researchers have been able to study audit committee experience, training, and other measure for effectiveness. According to the breakout groups, extant research shows that the effectiveness of the audit committee is dependent on the composition of the board of directors. As for the committee itself, breakout group member cited research that shows that audit committee chairs with strong accounting backgrounds are more strongly associated with effectiveness. Breakout group members stated that it had been found that a higher number of audit committee meetings is a good proxy for audit committee effectiveness. However, it is unclear how that finding might be altered if it were possible to include information about the informal communications between the auditor and the audit committee chair.

Breakout group members were only able to reference a limited number of studies on what makes up an effective audit committee. Members felt that this limitation was due, in part, to use of archival data in audit committee research, which has minimal explanatory power. For research to be part of the current dialogue participants believed researchers need to understand interactions. Breakout members thought that the single greatest contributor to the limited pool of research was a lack of publicly available data and the fact that companies are not inclined to grant researchers access to the audit committee's internal workings.

IV. Best Practices for Audit Committee Communications with Shareholders

The desire for greater transparency has sparked a debate over expanded audit committee reporting. In this vein, breakout groups addressed what information the audit committees should provide to shareholders on their oversight of the external auditor. The breakout groups believed that audit committees should provide a macro view of audit committee processes, policies and evaluation tools, providing shareholders with the steps they have taken to ensure a high level of financial reporting quality. However, there was agreement that management should be responsible for more substantive information on facts such as significant judgments and estimates.

Breakout group attendees had trepidations about the degree of information the audit committee should share outside of the proxy statements, and there was no consensus about the best mechanism for providing those additional disclosures. It was suggested that it would be helpful to have a better understanding of who the target audience is for the additional audit committee communications. This would help determine the best form for that communication. Some suggested using current vehicles of communication: the audit committees could provide the information at the annual shareholders meeting; or provide the information to the stock exchanges and then have it disseminated to shareholders or interested parties. Another suggestion was using social media as an outlet for relaying information from the audit committee.

The breakout groups considered what impediments currently hinder audit committees from sharing information with shareholders. There was agreement between participants that the fear of legal liability prevents audit committees from disclosing information beyond the minimum requirements. The lack of an agreed upon framework or set of principles for qualitative disclosures was also cited as an obstacle in communicating with shareholder. It was also suggested that shareholders may lack the accounting expertise and understanding of the audit process to evaluate the effectiveness of the audit committee in carrying out its oversight role in the financial reporting process.

<u>Academic research on audit committee communications.</u> Unfortunately, there is little to no research concerning the leading practices of audit committee communication. Attendees felt that the literature would benefit from more case studies and qualitative analyses of methods used by audit committees to communicate with shareholders.