

## Audit Quality and Financial Reporting

# What is the Role of the Audit Committee?

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IN THE WAKE OF THE FINANCIAL CRISIS OF 2007-2009 and the failure of a number of global corporate entities, investors, analysts and regulators continue to wonder exactly what happened, what could have prevented it, and what measures can be taken to ensure it doesn't happen again. With companies collapsing on the heels of financial reports that sounded no alarm bells for current or potential investors, it's understandable that the quality of financial reporting is coming under scrutiny. Investors' ability to read and understand financial statements, and then make informed, balanced decisions based on the company's current condition and position, is more important than ever. Seen as critical to rebuilding confidence, increasing transparency and ensuring future market stability, this issue is attracting greater attention in Canada and around the world.

### Audit Quality and the Audit Process

While there are numerous discussions and activities underway around accounting standards, judgments, estimates and other technical reporting components, audit committees may find it valuable to consider the connection between audit quality and the quality of financial reporting. If sound and relevant financial reporting is one of the direct results of a quality audit – and I believe that it is – then the immediate questions to ask may be: what does “audit quality” mean? Will current audit reform proposals improve it? And how can the audit committee help the process?

It starts with considering what “audit quality” really involves. In this regard, I see the audit not as a compartmentalized event, but as part of a process. In addition to providing assurance that quarterly and annual financial reports are fair, not misleading, and aligned with a company's stated accounting policies, the audit also influences the quality of other financial information prepared by the company.

Stakeholders too often see the audit as a relatively discrete event when, in fact, the processes and controls that ensure the broader integrity of the audit comprise much more than the audit opinion itself. These processes and controls range from the company's collection and recording of financial information to the actual audit, through to the issuance of the financial report. As a result, the quality of financial reporting – so critical to investor confidence and transparency – is directly dependent on the quality of the audit. The value of an expert, independent opinion on a company's financial statements simply can't be underestimated. And the simple knowledge that the audit is coming, combined with the requirements and internal controls that exist around it, exerts a preventative, quality-control



pressure on financial statement preparation – even before the audit takes place.

The true value of the audit, in terms of the market, lies not in the opinion itself but in the work that goes into it – the sequence of steps and procedures that drive quality before, during and after the actual audit. It's important for audit committees to understand the nature and scope of that work. One way to become more effectively involved is for boards (usually through the audit committee) and management to build strong auditor relationships, just as the auditor can help the process by establishing objective, productive, reciprocal relationships. When it comes to assessing audit quality, the nature of those relationships is key. Is there true candour? Was access to information unrestricted and as broad as possible? Is independence and objectivity insisted upon and maintained? The better defined the relationships, the better the chance that the process will yield the most accurate, uncompromised results.

Understanding the full audit continuum – getting insight into the overall process – is an important part of the audit committee's role in pursuing quality. But how is that quality ultimately defined? Regulators are now putting their minds to that question.

One simple measure can be found in the number of restatements companies are required to make. Post-Sarbanes-Oxley, the number of restatements in the U.S. rose radically, then decreased from 2007 to 2009, and rose slightly again in 2010. This would seem to indicate that audit quality has improved considerably as a result of the "SOx era" reforms, including auditor oversight and inspection, enhanced auditor independence rules, and additional focus on internal controls. Companies also responded by delivering better, more accurate financial statements, and restatements have levelled off. Regulators, however, spurred by the financial crisis and the concerns of users of financial statements, remain dissatisfied, and have developed a reform agenda that auditors and audit committees need to carefully consider.

### Proposals and Problems

Although the audit profession holds that the financial crisis was more the product of business and market issues than audit practices, there is always room for improvement, and I believe all audit firms embrace

opportunities for improvement. Audit is currently undergoing a broad reassessment on a global scale, which includes self-assessment by audit firms and proposals for significant change from bodies such as the European Commission (EC) and the U.S. Public Company Accounting Oversight Board (PCAOB).

Starting with the premise that audit quality *was*, in fact, a major factor in the European economic crisis, the EC Green Paper on Audit Policy critically examines the role of the audit and the processes by which audits are conducted. On Nov. 30, 2011, EC commissioner Michel Barnier proposed new regulations on audit and governance. Canadian audit committees need to consider these proposals carefully and weigh in on the issues.

Proposals from the EC include:

- Mandatory audit firm rotation after six years, or nine years in the case where a company engages two auditors;
- Mandatory tendering through an "open and transparent tender procedure";
- Restricting firms that audit public-interest entities from performing non-audit services; and
- Requiring large audit firms to separate audit from non-audit activities.

For the PCAOB's part, its recent concept releases ask for input on a number of topics related to the auditor's reporting model, as well as independence and objectivity concepts, including auditor assurance on documents outside of the financial statements and mandatory audit firm rotation. PCAOB chairman James R. Doty, in an October 4, 2011 keynote address to the NACD Board Leadership Conference, said, "If we make changes, they will be focused on enhancing the relevance of the auditor's communication to investors."

Debate around improving the reporting model and investor transparency is welcomed by the audit profession. But I find myself compelled to question any proposals made with the assumption that the audit profession caused or should have prevented the financial crisis. Any changes should promote the integrity and efficiency of the capital markets, not impair public confidence in the audit profession. Many of the expected proposals, while they will

heavily affect audit firms, will not necessarily improve audit quality; in fact, some may weaken it.

I recognize I may have a bias because of my previous involvement with one of the Big 4 audit firms. However, I seriously question whether certain of the measures – particularly audit firm rotation – will improve audit quality. This will clearly result in duplication of effort by audit firms and incremental audit cost. I also question whether audit quality will be improved by further limiting advisory services that may be purchased from an audit firm, when that firm often may be the most qualified to provide the service. Requiring large firms to separate their audit activities from non-audit activities will also likely add cost and make it more difficult for firms to attract talent.

Canadian companies may be highly affected by these measures if they come to Canada. In a country with many small public companies, how difficult will it be to access alternative firms with necessary industry and technical expertise?

The most fundamental question is whether audit quality can be achieved with targeted improvements to current audit models, or whether change – perhaps sweeping – is required. While the proposed changes and proffered concepts are currently being discussed beyond our borders, it seems likely that Canadian regulators will give them due consideration. In the current economic climate, auditors, regulators and corporate management, as well as audit committees, must all re-examine their contributions to audit quality and consider whether the timing is right to introduce such broad, potentially disruptive initiatives.

### **Governance – What Should Audit Committees Be Doing?**

Like audit firms, audit committees face hard questions as their role is re-assessed. Could audit committees do more to ensure the accuracy and completeness of financial reports? What questions should they ask? Do they have the right information? What *can* audit committees do to help their companies improve financial reporting? Do these recommendations help improve audit quality and the relevance of financial reporting?

The regulators will continue to weigh in, but audit committees can take several steps to ensure their company is getting quality audits:

- Spend the time to understand the biggest challenges, from both management’s and the auditor’s perspectives, in reporting on the financial statements. For example, what is the magnitude of possible differences in reported financial amounts with respect to aggressive versus less aggressive estimates, or conservative versus less conservative?
- Determine if the auditor’s audit plan is in sync with the directors’ understanding of the business.
- Develop an open, candid relationship among the audit committee, management and the auditor. Foster an environment that ensures both management and the auditor feel comfortable having open discussions at audit committee meetings, even when their views may differ; ensure the auditor has access to all necessary information; and likewise expect an explanation if the quality of the audit is brought into question.
- Ask questions about the audit team. What skills do the senior members bring? Are they aligned with your corporate risk profile? What is the team’s overall level of industry knowledge and experience?
- Be aware of impending audit reform proposals. Consider possible impacts on your organization, and make your views known. And consider what would enhance your audit quality.

### **Audit Committees Can Play a Key Role in Audit Quality**

Your understanding and input are critical. You have the opportunity to consider what you want from a modern-day audit, and to help achieve it. This means undertaking an honest assessment of any proposals advocating fundamental changes to the audit process and embracing (or, where justified, questioning) their repercussions.

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