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AUDIT COMMITTEE INSTITUTE

Global Boardroom Insights 2

Audit quality and communications with shareholders and others

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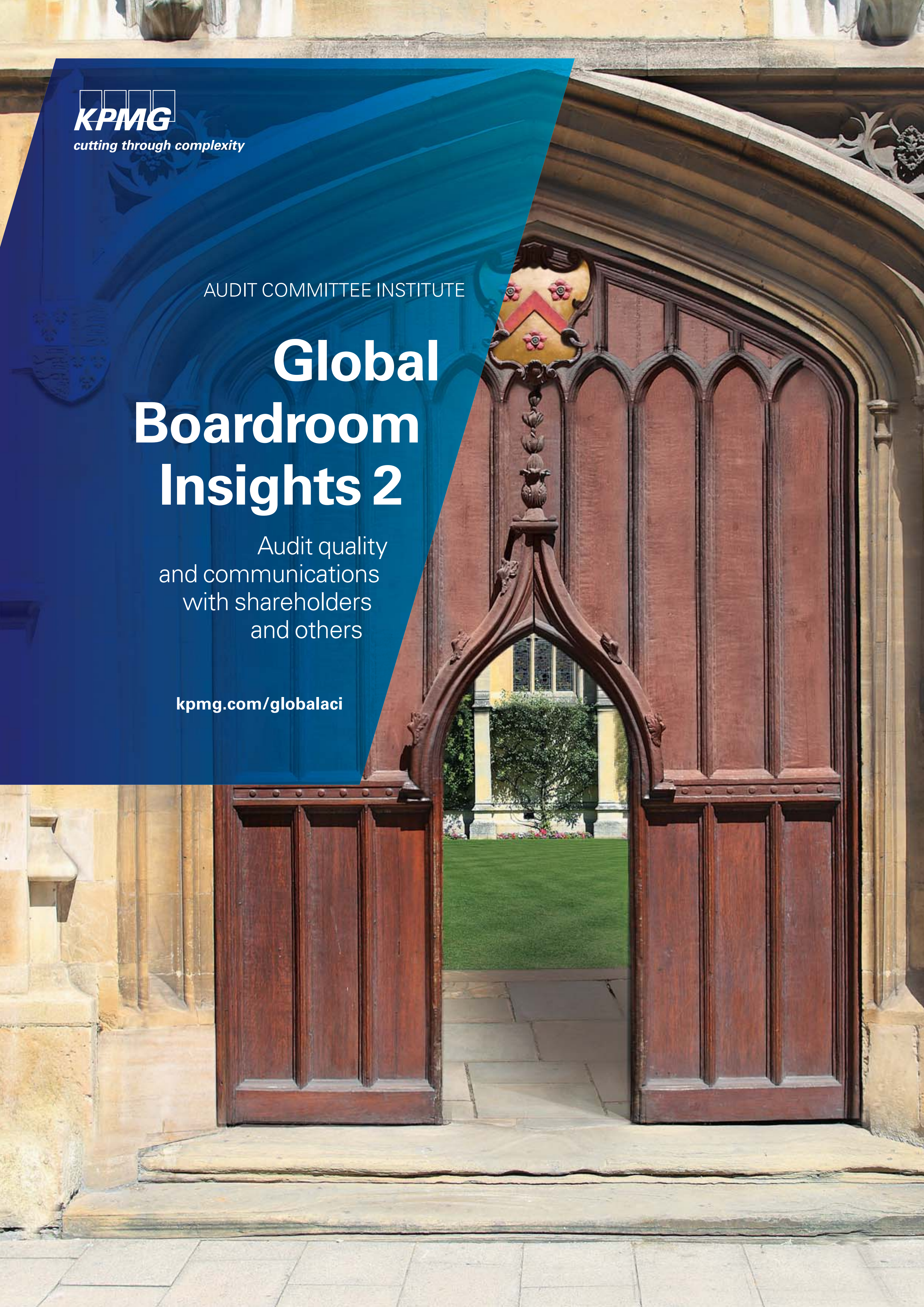

About

KPMG's Audit Committee Institutes

Sponsored by more than 30 member firms around the world, KPMG's Audit Committee Institutes (ACIs) provide audit committee and board members with practical insights, resources, and peer exchange opportunities focused on strengthening oversight of financial reporting and audit quality, and the array of challenges facing boards and businesses today – from risk management and emerging technologies to strategy and global compliance.

To learn more about ACI programs at resources, contact us at:

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Foreword

In the last edition of *Global Boardroom Insights*, one of our contributors noted the difficulties audit committees have in measuring audit quality - a major component of audit effectiveness. This is particularly true if one differentiates between 'audit service' (such as a no surprises environment, good communications and the chemistry between the audit committee and the audit partner) and the quality of the audit itself.

In this issue of *Global Boardroom Insights*, we explore the practical aspects of assessing audit quality in more detail, together with the relationship between the assessment of audit quality and any decision to tender the audit. Concerns around audit quality can differ widely by country, but the insights we've collected from seasoned audit committee chairs should be of interest in all regions.

Audit quality, and how the audit committee ensures the effectiveness of the audit, can also be a key concern for the investor community (and other stakeholders) – and in many parts of the world there is currently a healthy debate over the information available to investors around the audit process and the work of the audit committee in discharging its duties. International (IAASB), European (European Commission) and several national regulators have ongoing initiatives in train designed to help provide investors with the necessary hooks on which to start a meaningful dialogue with a company about audit issues.

European Commission proposals regarding the statutory audit of public interest entities include requirements for the auditor's report to address the level of materiality applied to perform the audit and to identify key areas of risk of material misstatement of the financial statements including critical accounting estimates or areas of measurement uncertainty. Similarly, the IAASB have proposed changes to the auditor's report to include a new 'auditor commentary' section designed to give the auditor an opportunity to highlight matters arising from the audit "that are in the auditor's judgment likely to be most important to users' understanding of the audited financial statements or the audit." And in the UK, for example, compliance with the revised Corporate Governance Code now requires disclosure in the annual report of the significant issues considered by the audit committee in relation to the financial statements and how those issues were addressed, together with a description of how the audit committee assessed the effectiveness of the external audit process.

This issue of *Global Boardroom Insights* does not seek to summarise or necessarily comment upon the various regulatory initiatives, but it does explore, from the audit committee perspective, whether shareholders (and other users of financial statements) receive enough information about how auditors and audit committees discharge their responsibilities and the best mechanism for communicating with shareholders.

We hope you find this global interview series to be another valuable resource from KPMG's ACI, which was founded more than a decade ago – and now spans more than 30 countries worldwide – to support audit committees and boards with practical insights, resources, and peer-exchange opportunities focused on strengthening financial reporting integrity, risk oversight, and governance.

Our sincere thanks to the directors who shared their time and insights with us – Ann Godbehere, Nancy Hopkins, Aloysius Tse, John Harrison and Blythe J McGarvie.

Timothy Copnell
Audit Committee Institute
KPMG in the U.K.

Anthony Crampton
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A View from the UK

Ann Godbehere is a Canadian and British citizen with more than 25 years' experience in the financial services industry. She spent ten years at Swiss Re, a global reinsurer, latterly as chief financial officer from 2003 until 2007 and was interim chief financial officer and executive director of Northern Rock bank after its nationalisation.

Ann is now a non-executive director and chairman of the audit committees at Rio Tinto Plc, Prudential Plc and Atrium Underwriting Group Limited; a non-executive director and member of the audit committees at British American Tobacco Plc and UBS AG; and a non-executive director at Arden Holdings Limited.

ACI: *To what extent should audit committees be reviewing 'audit quality' (i.e., the effectiveness of the audit process)? To what extent does 'audit quality' differ from 'audit service' (i.e., the timeliness and quality of communications)? How do you objectively measure 'audit quality'? Should such an assessment be made every year or only when the audit is put out to tender?*

Ann Godbehere: I believe audit committees must consider audit quality. Without considering the effectiveness of the audit I don't know on what basis an audit committee can make its recommendation to the board with regards to reappointment of the auditor or tendering of the audit.

To ensure the audit continues to deliver value for money and to help absorb part of the annual expense inflation in fees the auditors need to deliver efficiency and effectiveness improvements. They can't do this without feedback from both management and the audit committee.

An audit is about much more than just timeliness and quality of communication. It is about understanding the business and the commercial pressures of that business, the culture of the firm and how its people are responding to delivering on targets. All of this helps the auditors to determine the risks in the business and define their risk map for the business which won't necessarily match the risk map that management define for the business although the two should not be a million miles apart.

Assuming the auditors are conducting a risk-based audit their risk map will help inform both them and the audit committee regarding the scope of the audit.

When evaluating audit quality many companies conduct an annual review of their auditors. This typically is conducted internally and may be led by internal audit, the company secretariat or finance. The review might encompass the views of the audit committee, executive committee members and the finance team. The areas covered might include the quality of the audit team, the audit process and communication.

Under 'audit team' you might consider areas such as the quality of lead partner, transition planning for senior members of the team including the lead partner rotation, continuity of the team, sector knowledge and any specialist knowledge within the team.

'Quality of process' typically includes planning, working with internal audit and being in a position to place reliance on the work of internal audit, management of the audit especially internal escalation processes for large global audits, issues resolution including timeliness of resolution and coordination during the audit across auditor disciplines.

'Communication' includes clarity of written and verbal communication with the audit committee, communication with the committee chair between formal meetings and transparency in dealing with material areas of debate on accounting judgements.

In addition to this formal process the audit chair is generally in a good position to judge audit quality. Often audit chairs are chairs or members of audit committees for more than one company and therefore can benchmark auditor performance from a variety of interactions. Audit chairs also typically have greater interaction with the auditors with regular discussions and meetings in addition to the formal audit committee meetings.

ACI: *What is the relationship between the assessment of audit quality/service and any decision to tender the audit?*

Ann Godbehere: If the determination of the audit committee is that the auditors are no longer effective - whether this is due to a loss of independence, concerns

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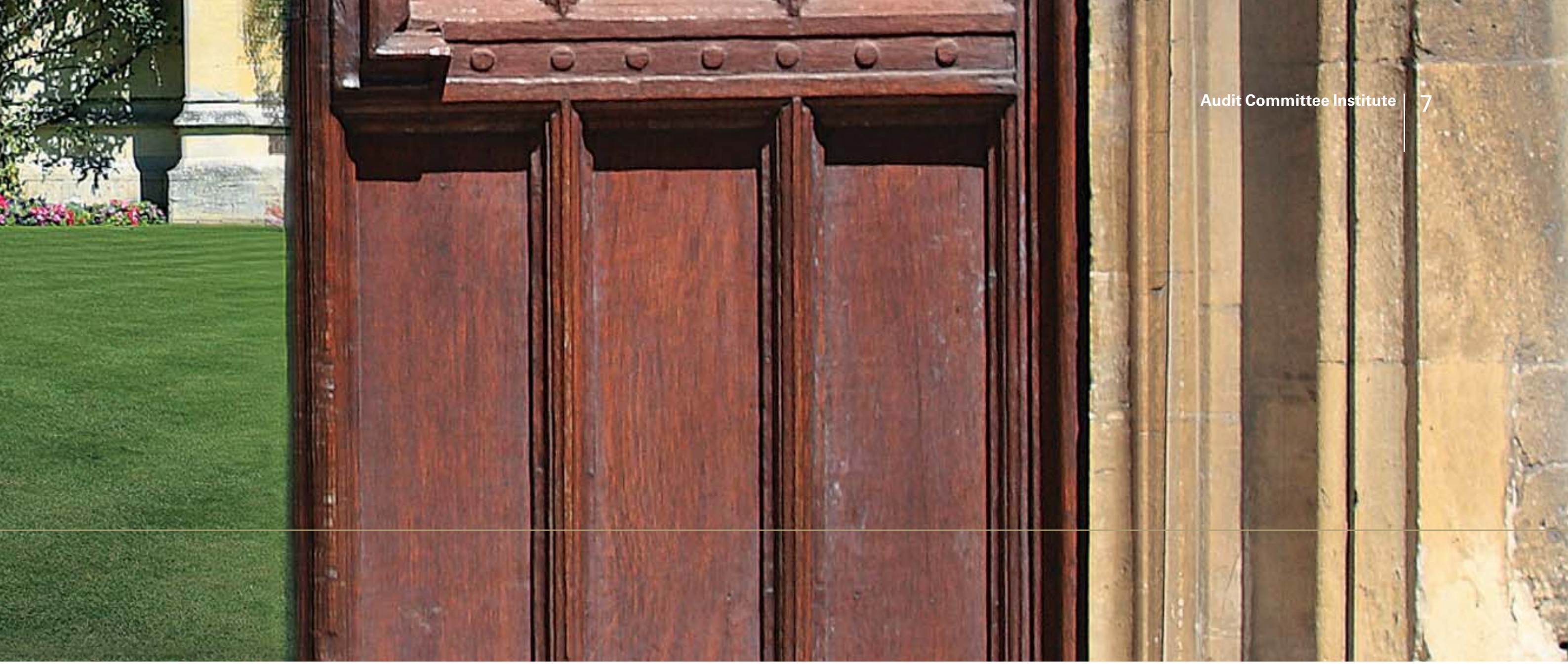

over audit quality, a material control failing where the audit committee believes the auditors should have been able to identify the failing earlier – then the audit should be put out to tender at the earliest possible opportunity.

Beyond this you get into the on-going debate as to the merits of tendering audits on a regular basis and whether there should be mandatory audit firm rotation. My own views are as follows.

- I support mandatory lead partner and other senior members of the audit team rotating off the audit every five years.
- I support a strong auditor independence policy over-seen by the audit committee. This policy should address what non-audit services the auditor can and can't perform, set out that all fees for non-audit services to be approved by audit committee and ideally that non-audit services over a certain value be tendered unless the auditors have a unique ability to deliver those specific services better than another firm. The policy should also address other matters including hiring of current and former members of the audit firm.
- I support audit tendering on a periodic basis and don't have a problem with this being every 10 years as long as there is some flex in this – as we have with the 'comply or explain' framework in the UK and some other countries. A reason for possibly not meeting a precise 10 year timetable could be a change in the CFO in the scheduled year of change or a major organisational change or acquisition or a major accounting standard change like IFRS Phase II - accounting for insurance contracts. These to me would all be good reasons to defer and explain why you have deferred an audit tender. Having embraced periodic audit tendering I would hope that a company with good reason for deferring would not need to defer the audit tender exercise more than two years beyond the initial date.
- I do not support mandatory audit firm rotation. Especially for large, global companies the audit committee and the board need to be satisfied that the auditor is able to deliver an effective audit and be able to invest in their own global footprint to match the company and its business as it develops. If a full audit tender is conducted and the assessment is unbiased and the audit committee and the board still reach the decision that the incumbent auditor is the best firm to deliver the audit then I would fully support that decision. If you think about it, quite often an incumbent auditor has invested a great deal in developing their own internal specialist knowledge of a sector or area of expertise so it may not be surprising that they remain in the best position to deliver the highest quality audit to that client. As long as the audit committee is 100% satisfied as to the robustness of the audit, the challenge, the independence and the quality it should then be able to make a recommendation based on its best judgement of which audit firm can deliver the best audit service to the board and ultimately for the shareholders.

ACI: *What are the key attributes of good auditor/audit committee communications? What do audit committees really want to see (and when)? How can the auditor demonstrate/communicate their professional scepticism in a constructive way? What needs to improve?*

Ann Godbehere: In addition to some of the points discussed above, the auditor needs to address matters of relevance. This is a combination of materiality and risk. A relevant issue may be material in size terms but of low risk while another matter may be a smaller order of magnitude but of much higher risk and may have other relevant considerations such as a reputational dimension that contribute to its relevance.

There should be some chemistry between the auditor and the audit committee. This includes mutual respect and trust and the ability to have tough discussions when necessary. Therefore the two-way communication between the audit committee and the auditor is fundamental as both sides need to be able to both listen to and hear the messages that the other is giving.

The audit committee needs to know what the key areas of debate were between the management and the auditors and how these were resolved. Having some of the 'colour' on these debates helps the audit committee understand the relationship between the auditor and management. Also the audit committee itself may want to engage in some of this debate to be satisfied with the final judgements that have been reached.

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It's also helpful for the auditor to inform the committee how other companies may be handling a similar issue. Feedback on areas of judgement and whether the auditor views the judgements as more or less prudent than the company's peers are also useful data points for the audit committee to consider. Auditors can also discuss with the committee how others are dealing with new areas of disclosure and what they believe to be best practice or the direction of travel.

Clearly the audit should be approached on a 'no surprises' basis. An opportunity to help ensure this is for the auditors to address emerging risks. This may be company specific matters that have been identified during the audit which have not resulted in any immediate audit findings but could result in future findings or it could be emerging risks within the external environment that the auditor feels the audit committee may benefit from early consideration of the possible impacts.

ACI: *Does 'company reporting' in its widest sense (i.e., beyond the financial statements) receive the audit attention it deserves? Are all the appropriate elements of corporate performance sufficiently transparent to shareholders and the other users of annual reports?*

Ann Godbehere: While the board and management must be held accountable by shareholders for the stewardship of the business, I don't agree that the way to tackle this is by trying to add to the scope of an audit. An audit has a specific role to play and that is ultimately to opine on the integrity of the financial information. To go beyond this I believe dilutes the clear responsibility of the entire board for conveying the correct balance of information to shareholders and other stakeholders of the strategy, risks and performance of the business.

Outside of the financial services sector (which often have separate risk committees), audit committees usually have a responsibility for risk governance as well as audit matters. Clearly risk appetite is the responsibility of the entire board and is tied to the strategy and business model but overseeing risk governance frameworks and processes and helping the board to think about the risks in the business is often part of the audit committee's remit. However this does not lead to changing the audit scope. This should be addressed instead with sound 'second line defence' processes and an effective internal audit function.

With the changes in the UK Corporate Governance Code regarding fair, balanced and understandable annual reports this is very much on the minds of audit committee chairs. How do you reduce clutter and guide the reader of annual reports to understand what is truly important in considering the performance of a business? How do you ensure that the risks that shareholders' capital is exposed to are clearly articulated so that shareholders can make their own judgement as to whether they are appropriately compensated for such risk? How do you report meaningfully on the company's record on governance and sustainability matters? I believe these are the questions that should be debated rather than whether the audit scope should be expanded to incorporate the front half of the annual report and accounts.

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However I think we are all struggling to think about how to tackle this question of 'understandable'. No one actually sets out to write an annual report which is unintelligible and 'understandability' is going to be judged by the reader (and in hindsight). However I do believe we have the opportunity to rethink how the business is described and potentially link more clearly how the risks relate to performance and how the strategy translates into performance.

ACI: *Do shareholders (and other users of financial statements) receive enough information about how auditors and audit committees discharge their responsibilities including: the significant issues considered in relation to the financial statements, and how such issues were addressed; and how the effectiveness of the external audit process was assessed?*

Ann Godbehere: This at least in part is a question of what does a reader of the annual report and accounts want to read about and focus on. I think one should start by asking did any of the recent company weaknesses and in some cases failures that were exposed during and post the global financial crisis stem from audit failings. I do not believe that they did. I feel we are losing sight of the real issues. The companies that got into trouble had failures in one or more of strategy/business model, governance or risk management or they were exposed to financial markets or had liquidity challenges.

These are all areas that management and the board should be held accountable for but providing more information about how the audit was conducted would not address any of this and has the potential to add more clutter to the reporting.

As discussed earlier, I think a clear articulation of the links between strategy, risk and performance would be of more benefit to shareholders and other users of annual reports. This might include a description of the major areas of judgement considered by the audit committee.
For instance, if we think back to 2008 many audit committees were struggling with the appropriate valuations for Level 3 investments (i.e., securities that were less liquid with no observable readily traded market). This could have been an area where audit committees provided some description of how they satisfied themselves over which securities were bucketed into Level 3 and how the valuations were arrived at.

Some thought also needs to be given to any disclosure around how the audit committee assessed the effectiveness of the external audit process as I wouldn't want to see this evolve into some over-long analysis. Adding clutter to the annual report must be avoided and the focus should always be on what is relevant. This possibly could be a short description of how the audit committee has determined the effectiveness and independence of the auditor with perhaps a limited number of KPIs covering the annual review of the audit effectiveness as described earlier.

ACI: *If more is required, then what is the best mechanism for communicating with shareholders?*

Ann Godbehere: Beyond what has already been discussed, I don't think more is required. As you can tell from my comments I am concerned about adding unnecessary or less relevant material to the existing reporting requirements.

One possible approach to dealing with transparency in these areas is for the board to consider holding a governance meeting at which institutional investors would have the opportunity to meet non-executive board members and learn in greater detail how the audit committee and other committees fulfil their remits. I have been involved in a couple of these and they have worked well. The chairman of the board and the chairs of the board committees meet with institutional investors and also potentially proxy advisors in a meeting of 20 to 30 people. This is not an annual event but rather on a two to three year cycle. The feedback from attendees to the meetings I have been involved in has been very good. It serves the dual purpose of giving the attendees the opportunity to meet more non-execs than just the chairman and to understand in more detail - both from the formal presentations as well as the Q&A session – how the committees work and what their priorities are. This gives the investors the opportunity to judge for themselves how effective the committees appear to be working. ❖

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A View from Canada

Nancy Hopkins, Q.C., is a partner with the law firm McDougall Gauley LLP, and is on the board of Cameco Corporation where she chairs the nominating, governance & risk committee and is a member of the audit committee; the board of Growthworks Canadian Fund Inc. and Growthworks Opportunity Fund Inc., where she chairs the audit committee; and the board of the Canada Pension Plan Investment Board where she chairs the governance committee.

Nancy has also been involved for many years with the chartered accounting profession, most recently serving as a director of the Canadian Institute of Chartered Accountants (CICA). During that time she served on the Public Interest and Integrity Committee of the CICA for the development of the new Independence Rules for the chartered accounting profession.

ACI: *To what extent should audit committees be reviewing audit quality, for example the effectiveness of the audit process?*

Nancy Hopkins: If one is looking at the audit process overall then of course one of the main things for the audit committee is to make sure that the auditors are in fact bringing scepticism to the table – that is that they are not necessarily agreeing with everything that management has to say; that they are looking at things independently and that they actually have the capacity to do that; that they do it in a timely way, and that to the extent that the issues need to get raised to a higher level within the organisation they are raised to that higher level.

To my mind audit quality reviews are not discrete periodic events, but something that audit committee members should be assessing on an ongoing basis. Good audit committees do this and you see it, from time to time, when the audit committee says we are not really satisfied with the answer we got from that individual from the auditors, we want to hear more, we want to probe deeper on this. So, I do believe it is an ongoing assessment and best made when issues are in front of a person, in front of a committee. If you don't do it on a regular basis then issues that might have come up tend to get lost and you assess audit quality only when something occurs that causes you to realise that this isn't 'business as usual'.

Of course, issues don't come up at every meeting – but whenever something does come up that is out of the ordinary, auditors have an opportunity to demonstrate that they have assessed the facts, challenged management's assumptions and ensured they concur with management's accounting analysis. They have a chance to demonstrate to the audit committee that they truly are independent, that they are objective and that they are bringing the required expertise.

ACI: *So not just setting it up on a timetable but rather as they come up, and address as needed.*

Nancy Hopkins: That's right. Management has a different opportunity to assess quality but from an audit committee perspective I think you have to do it on an ongoing basis as the issues arrive.

This can tend towards subjective assessments but I believe you can be objective about the process. It's not an impression that the audit committee think the auditors are good – it is based on the auditor's response to a particular set of facts and circumstances as opposed to "did I like those guys over the past five years" when you are thinking about putting the auditor out to tender.

ACI: *To what extent does audit quality (the effectiveness of the audit process) differ from audit service (the timeliness and quality of the communications)? Do you see a difference between the two?*

Nancy Hopkins: There is some overlap but yes I do believe that they are different issues. You can have people who are absolutely responsive and who come back to you with an answer promptly and work late in to the night to get your issues looked at but if they don't do that with people who understand the issues and who have the background, knowledge and experience necessary to address them properly you may have great kindliness of service but you don't have the quality in the resulting audit that the audit committee and the shareholders want.

ACI: *What is the relationship between the assessment of audit quality/service and any decision to tender the audit?*

Nancy Hopkins: I think that audit quality/service and the audit tender process are somewhat separate issues – or they should be in a properly managed audit committee context – and I would be both surprised and disappointed if a decision to tender had to do with poor audit quality.

If an audit committee has concerns about audit quality they should address it right away rather than wait for the audit tender process to begin. The committee should be going back to the individual in the audit firm who heads up the client relationship (not the lead audit engagement partner because that person's probably most responsible for the quality of the audit) with any concerns about the quality of the audit service, or the engagement partner's experience or their ability to appropriately challenge management, or whatever the issue is. I would be very disappointed if any quality/service concerns couldn't be addressed through the course of the audit engagement by going through such a

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process. Ultimately, a tender process takes a considerable period of time and you need an auditor to carry out high quality work throughout that period – and that is quite difficult to do if you have a bad relationship with the auditor or concerns about the quality of the audit.

ACI: *What are the key attributes of a good auditor/ audit committee communications and what do audit committees really want to see and when?*

Nancy Hopkins: The key attributes are trust and open communication. I remember being at a conference once and one of the panellists was asked to describe an ideal *in camera* session with the external auditor and the response was 'short'. I fundamentally disagree with that because the *in camera* session between the audit committee and the auditor is one of the few opportunities to build some kind of relationship between the members of the audit committee and the external auditor.

Now, the chair of the audit committee and the lead engagement partner should have other communications outside the meeting but for most of the audit committee members, the *in camera* session is going to be one of the few opportunities for them to interact directly with the external auditors. So, I think it is actually appropriate to have some discussion about things that you wouldn't necessarily have to address *in camera* as this can facilitate the lines of communication between the external auditor and the committee. It's trite but true that you don't get the best crisis communications if the only time you communicate is in a crisis. You need to have good communications in place prior to the crisis in order that you can actually communicate effectively and have the necessary degree of trust and confidence when the crisis happens. So, a key attribute to good communications is the practice of communication itself - even if it's not dealing with fundamental issues. It's important for management to know that this is part of the process and the fact that an audit committee is spending a bit of time with the external auditors doesn't necessarily mean that there are terrible issues going on. The committee just wants to spend a bit of time with the external auditor. They can be nice folks!

ACI: *Can the auditor demonstrate and communicate professional scepticism in a constructive way?*

Nancy Hopkins: Well I have seen some very good communications but ultimately this comes down to the lead engagement partner, and to some extent, the concurring partner and their ability to communicate in an effective and timely manner with the audit committee. Perhaps it is in the general session of the committee after management has raised an issue and the auditors are invited to provide their thoughts on it that they say "we looked at this issue carefully and there are a couple of different approaches we have seen companies take", or "we believe that managements approach in this circumstance provides a fair result for your financial statements because" or even that "this is the most appropriate way in our view given the circumstances". The auditor demonstrates that they have heard management's recommendations and they give the audit committee a flavour of the conversations that went on, the other approaches that were talked about and then their assessment of why the result is an appropriate result. Laying out the process they followed is very helpful.

The other thing that is really helpful is how the auditor responds when invited to comment on a particular issue arising during a meeting. I have seen incredibly thoughtful analytical responses, not just "yes this approach is fine" but a more detailed response that gives the audit committee the assurance that the auditors have the capacity and the depth to understand the issues, that they have thought about them, they have talked with management about them and they are prepared to talk to the audit committee about them.

ACI: *Do auditor / audit committee communications, adequately address risk, audit materiality and audit scope? Are these matters sufficiently transparent to shareholders and the users of financial statements?*

Nancy Hopkins: Well the auditor and the audit committee better be properly addressing audit risk, materiality and scope - that's one of the fundamental obligations addressed both when looking at the audit plan and later when issues arise. You will occasionally encounter a circumstance where the auditor will come back and say "because of the deficiency of internal controls in this part of the organisation we had to expand the audit work that we do in order to provide us with sufficient assurance and so forth". And that also gives the audit committee assurance that these issues are addressed properly. The more difficult question is whether such issues are sufficiently transparent to shareholders and other users of financial statements. Audit committees tend to be quite inward looking, we focus on the audit, we focus on the financial statements, we focus on the accounting policies chosen by management and how we present various transactions. When it comes to the communications with shareholders and other users of the financial statements, we tend to leave that to the people who write the external communications. So we believe that we follow the rules, we make sure that our financial statements and the notes

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are explanatory and readable but, in my experience, we don't get in to a lot of detail with what do we say in our Management Discussion and Analysis (MD&A) or annual information form or any of those other public disclosure documents.

ACI: *That gets left up to the financial side and the investor relations team?*

Nancy Hopkins: The investor relations team do the draft and the audit committee look at it and say "yes, that's right, you haven't made any gross errors in any of these descriptions and, so we are fine".

ACI: *Do shareholders (and other users of financial statements) receive enough information about how auditors and audit committees discharge their responsibilities including: the significant issues considered in relation to the financial statements, and how such issues were addressed; and how the effectiveness of the external audit process was assessed?*

Nancy Hopkins: There are two questions here – both of which might be better posed to others. One is, what does the user group think about the current situation and the other is what degree of information is it appropriate for the user group to have? One of the difficulties we face is the amount of material we put out – just the sheer volume. And of course IFRS has made the issue worse. Our basic required disclosure is even longer now than it was before - and we know that when you make it longer you reduce the chances of people reading the whole thing. So, the

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questions that need to be answered is what are the most important things for shareholders and users to have and how do we get that information to them in an effective way?

Do shareholders and other users want information on how the audit committee discharges its duties and the choices made? Then there is the issue around how we communicate on these issues. We have these hugely lengthily communication documents that we try to make readable, that we try to put in plain language, that we try to capture current information – all without being repetitive. Are there other mechanisms we can use, other ways to leverage technology to get information that is more optional in to the hand of people that want to see it? I think those are the questions that companies need to address. I am not sure they are just questions for audit committees; this truly is more the investor relation people who need to look at this.

ACI: *Do you feel that more disclosure is required in the annual report or is what we currently have sufficient for shareholders' needs?*

Nancy Hopkins: Well, as I say I think I would rather hear about that from shareholders and other users. Do they think that the disclosure is sufficient and then hear from them what they would like to see or what they find irrelevant. That's another really good question - is there material in the annual report that doesn't fulfil any useful purpose? ❖

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Two views from China/Hong Kong

Mr Aloysius Tse is an Independent Non-Executive Director of China Telecom Corporation Limited (secondary listing on NYSE), Wing Hang Bank Limited, CNOOC Limited (secondary listing on NYSE), Linmark Group Limited, SJM Holdings Limited, Sinofert Holdings Limited, and from 2004 to 2010, - all companies listed on the Hong Kong Stock Exchange. He is also an Independent Non-Executive Director of CCB International (Holdings) Limited and a member of the International Advisory Council of the People's Municipal Government of Wuhan.

John Harrison is an Independent Non-Executive Director of Hong Kong Exchanges and Clearing Limited, The London Metals Exchange Limited, BW Group Limited and AIA Group Limited. He is also a member of the Asian Advisory Committee of AustralianSuper Pty Ltd and a council member, standing committee member and honorary treasurer of The Hong Kong University of Science and Technology.

ACI: *To what extent should audit committees be reviewing 'audit quality'? To what extent does 'audit quality' differ from 'audit service' (ie the timeliness and quality of communications)? How do you objectively measure 'audit quality'?*

Aloysius Tse: In my opinion, an audit committee should constantly be assessing audit quality. Generally, when I assess audit quality, I start by considering the adequacy of the audit plan including the experience of the engagement team, followed by the quality of the audit findings and service deliverables.

I believe that in reviewing audit quality, it is important to consider how well the auditor understands the business, and the depth of insight that they can offer. Familiarity with accounting and reporting standards is a must, but what is important is the auditor's ability to consider the quality of accounting treatment and the various options available to the business. From a service point of view, I can assure you that audit committees appreciate auditors who are forward looking and can provide guidance on what's coming around the corner.

We ask management their opinion about the auditors. We ask if they have any problems or concerns regarding the auditors. We also ask about how proactive the auditors are.

External Audit has evolved from an annual and half-yearly certification activity to becoming a year-round process. This is where audit service comes in. It is expected that auditors have proactive relationships with the audit committee and management, and that they come equipped with business solutions.

When considering audit service, I consider the overall delivery, taking into consideration how well the auditor identifies and approaches issues, whether they have brought sufficient challenge and whether private meetings with auditors are useful.

John Harrison: Audit quality assessment is a key role of the audit committee. The audit committee must assess the quality of the audit firm's people, their knowledge of the business and the environment in which business is conducted, communications, interaction and processes, not just at head office, but at all material locations. It is also important to take management's views into account, as they interact with the auditors on a day to day basis. Whilst there is usually an annual formal assessment, this is an ongoing process and responsibility.

Audit service is linked to audit quality. Factors that contribute to audit service include the timeliness and quality of communications, whether the auditor provides input when requested, ensuring consistency of the team, that there is a proper process in place for audit partner rotation, and whether the auditor is prepared to spend time and effort with the business.

An audit partner can provide comfort to the audit committee by communicating proactively before the audit committee meeting and in doing so, raise issues and share knowledge and points of view. I was recently invited to spend a day with an audit team in my role as audit committee chairman. I attended an audit planning workshop where I was introduced to key members of the audit team, subject matter specialists and discussed the strategic planning of the audit in detail. This kind of activity reinforces my impression of both audit quality and audit service.

Conversely, an audit committee becomes concerned when communication is poor, the auditor's understanding of the business is lacking, and there is insufficient engagement, poor interaction and poor relationships.

ACI: *What is the relationship between the assessment of audit quality/service and any decision to tender the audit? Is anything else important?*

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John Harrison: There are many different reasons why an audit may be put out to tender. Issues with audit quality and audit service could certainly be a trigger, but other triggers may include a material acquisition that has created a conflict or alignment issue, or perhaps the level of non-audit fees is too high and a decision may be made that the firm in question is too valuable as a subject matter expert.

In my experience, the level of audit fees rarely prompts a tender, but may be used as an excuse. Fee issues can usually be resolved.

Quality and service factors that can prompt a tender could include perception issues regarding the quality of the firm. An audit firm that is frequently in the news for the wrong reasons does not inspire confidence. The quality of the firm's global reach is also important. Audit quality must be maintained in all key locations. A perceived weakness in the audit firm in a particular location could cause an issue.

Audit partner rotation should not be underestimated. The process of partner rotation is important, but so too is the character and qualifications of the individual put forward. The candidate must have suitable knowledge and chemistry to match the needs of the company. If this isn't achieved then a decision to tender may present itself as an attractive alternative.

Aloysius Tse: The decision to put an audit out to tender is not always in the hands of the board or audit committee. In the People's Republic of China, rules that mandate audit rotation often dictate the timing of a change in auditor. I have been involved in a number of these rotations and they can have the unfortunate consequence whereby the audit relationship is seen as having a finite shelf life. Some auditors view this as a disincentive to invest in the relationship. My recommendation is not to forget that audit is a service that is best delivered when the auditor has a deep understanding of the organisation.

In my experience, a decision to tender is initiated when the board is not happy with audit service or, if the auditor is at fault professionally. Fee is used as a sweetener; however there is often too much emphasis on fee competition. Firms put the chance of winning a tender just as much at risk by being the cheapest as by being the most expensive and I would recommend that it is easier to negotiate a fee down than up!

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ACI: *What are the key attributes of good auditor/audit committee communications? What do Audit committees really want to see (and when)?*

Aloysius Tse: An open, proactive dialogue between the audit committee chairman and the engagement partner is essential. I like to make a habit of having proper preparatory meetings before the audit committee meeting. The time gap between the audit committee and the board meeting can be short, which can create difficulties in dealing with surprises. This is particularly true if you are between interim and final results announcements.

Closed door meetings are good. If there are problems, or disagreements with management, then the audit committee chairman should be informed and this is a good forum for delivering the message.

When presenting a view, it is important for the auditor to clarify the implications of the matter and to speak plainly when necessary. Few issues are black and white. Alternative viewpoints, business common sense and pragmatism are greatly appreciated. In addition, audit committee's appreciate hearing about accounting trends and any potential impact on their companies in advance. Some auditors communicate too late which can leave an audit committee unprepared.

John Harrison: Open, honest, regular and proactive communications are essential. The auditor must be engaging, as per the example discussed above where the auditor invited me to their strategy workshop. Challenge is important; one does want the auditor to challenge management and provide alternative points of view, but it is important that the auditor and management resolve disputes well in advance of reporting deadlines.

Audit committees want to see those key attributes demonstrated with a view to timeliness. Most issues should be able to be resolved well in advance of reporting deadlines when there is time to explore options. This includes the relevant technical clearances.

There is a huge opportunity for auditors to be seen as a source of knowledge and best practice. In their role as a trusted advisor, providing alternative views, foreshadowing the impact of regulatory or financial reporting change and bringing best practice opportunities are very valuable.

ACI: *Do auditor/audit committee communications adequately address audit risk, audit materiality and audit scope?*

John Harrison: These are fundamental elements of auditor/audit committee communications. Early in the year the auditor should be bringing the audit plan to the audit committee for the audit committee to ensure that audit risk, audit materiality and audit scope are appropriate. These matters may not be directly transparent to the shareholders, but they should be covered in the audit committee report. The audit committee chairman attends the AGM and a shareholder has the ability to ask any questions or raise any concerns at that time.

Aloysius Tse: In general, I've found communications between the auditor and the audit committee on these matters to be sufficient. In my experience, shareholders in Hong Kong are more interested in reported results rather than the intricacy of audit risk, audit materiality and audit scope. However, analysts and institutional investors are keenly aware of business risks and if there is a history of internal control inadequacy, or write downs, these areas are usually questioned in future periods.

ACI: *Do shareholders (and other users of financial statements) receive enough information about how auditors and audit committees discharge their responsibilities?*

Aloysius Tse: In Hong Kong all annual reports have a corporate governance report which provides a sufficient framework for the company to provide information on audit committee activity, internal controls and risk management. That said, the quality of those disclosures varies between companies and, like other shareholder communication and indeed the annual general meeting (AGM), is largely dependent upon the tone from those responsible for corporate governance.

John Harrison: Shareholders receive sufficient information regarding how auditors and the audit committee discharge their responsibilities in the corporate governance report. Any further questions can be asked at the AGM. Having seen the 'Shareholder Spring' of last year, I would have thought that in the current environment, clarity over executive remuneration is more top of mind for shareholders than audit activity.

The substance of audit quality is what is most significant, not disclosure. Ultimately, the shareholders are responsible for appointing independent non-executive directors and the composition of the audit committee is vital for good corporate governance. It is important to note that the audit committee chairman is not and should not be a spokesman for the company, but he should act in the overall interests of the shareholders. ❖

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A View from the US

Blythe J. McGarvie serves on the boards of Accenture, LKQ Corp., and Viacom, and chairs the audit committees at LKQ and Viacom. Ms. McGarvie is currently a professor at Harvard Business School. She served as chief financial officer of a Fortune 500 company in the U.S. and a consumer goods company in France, and is the author of Shaking the Globe: Courageous Decision-Making in a Changing World (Wiley & Sons, 2009).

ACI: *In your experience, what does good auditor/audit committee communication look like? What are audit committees looking for from their external auditor – beyond, of course, a quality audit?*

Blythe J. McGarvie: A good auditor is a good listener and provides insights and overviews of what's going on topically – what's happening in the regulatory world, at the FASB, the SEC, internationally. Looking back, the best auditors have been the ones who were always prepared to talk about current issues and how they might impact the business – for example, the impact of the fiscal cliff and some of the things our company needed to be thinking about, from the auditor's perspective.

A good auditor understands what the CEO and his management team are most worried about – and has a perspective on that. Secondly, what's going on from an industry standpoint – what trends are they seeing? Thirdly, what are some of the important trends in other parts of the world – what's happening in our key markets around the world that we should be aware of? For example, in Europe there's a lot of focus on communicating with regulators because they don't seem to have a full understanding of how much work the audit committee chair and his or her committee members do.

ACI: *So above and beyond a quality audit, is the auditor bringing current information and insight to the audit committee?*

Blythe J. McGarvie: Yes – and it's not only about the big headline issues, but other things that may not have hit the Wall Street Journal yet. Maybe it's something the auditor is seeing in PCAOB reviews or through its interaction with other regulators. Or maybe it's something they're seeing in non-GAAP financials. I like to think of the external auditor as the hound dog that's sniffing out what's ahead so that the audit committee can do its homework and be prepared.

ACI: *How important are your informal communications and interactions with the external auditor?*

Blythe J. McGarvie: Informal communication is very important. For example, I'll call my lead partner to say, "Hey, we just made this large acquisition, where do you think the pitfalls are?" First of all, it's an opportunity to learn what he's concerned about, which might be very different from what management is concerned about because he may be looking at it through a financial lens, or a reputational lens, or an audit scope lens – or all three. Second, it gives him a chance to show his knowledge, because he's been involved.

I also try to ask open-ended questions, like "How do you think the new CEO is doing? How is this CEO different from the prior CEO?" I want to hear the auditor's views – and sometimes that means reading between the lines. If the auditor says the new CEO is "a bit more mercurial," that tells me a lot. I want to hear the good, the bad, and the ugly – and I'd rather hear it from my auditor than from the SEC.

ACI: *What are your expectations during executive sessions with the external auditor?*

Blythe J. McGarvie: Well, first of all, hopefully we've covered most issues in the formal audit committee meeting, but executive sessions are an opportunity to go deeper into a particular concern. For instance, it might be about a backlog they're seeing in a new IT rollout or some other process the company is working on. The auditor should have a good sense of the tone at the top, a sense of the talent and personnel – how the head of internal audit and the CFO are doing.

You can also get a sense of whether the auditor is working well with management. Does the auditor feel comfortable with the way things are going? No company is perfect, but you just want to make sure you're making progress towards your goals, and executive sessions can help you dig down a little and get a better sense of how things are progressing.

ACI: *Let's go back to an issue you raised earlier – whether regulators and investors are getting a full picture of what the audit committee does, including its interaction with the external auditor.*

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Blythe J. McGarvie: It's a good question. How proactive should you be in terms of communicating what the audit committee does? From our perspective as audit chairs, we're thinking, "Well of course we're doing everything we can, why do they still think audit committees should be doing more?"

I think a lot of people have no idea how much work is involved – how much time a good audit committee chair really spends not only on shaping the agenda, but getting one-on-one information from different sources, not just in a group environment.

ACI: *But at the same time, there's often a concern – by general counsel, for example – about saying too much.*

Blythe J. McGarvie: Well, I think we're in a transitional period. You don't want to over-communicate and make it sound like all the risks are on the audit committee. But it can be helpful to show that you've reviewed, you've discussed, and you've asked the right questions and probed. Don't be afraid to change the boilerplate report to reflect what you really did. For example, you might want to say, this year, on the 10-K, we spent more time on debt refinancing, acquisitions, and our audit process as we grew in this market or that market. You want to make sure what you're putting in your disclosure is something that would protect you from plaintiff's attorneys, but also helps explain to your shareholders and all the other stakeholders the extent of the audit committee's involvement. There's a balance.

It's understandable that people would want to keep the explanation of the audit committee's work relatively simple considering all the things that have to go into the 10-K. But there are companies that actually include a letter from the chairman or audit committee chair that talk about the board's or the audit committee's work, which is helpful as information and as an independent voice.

ACI: *We see more audit committees taking time for deep-dives on different issues. Do you look to the external auditor for support there?*

Blythe J. McGarvie: One thing I do as audit committee chairman is to rotate a review throughout the year and have a deep dive on critical accounting policies – a different one each meeting – to make sure we understand it. For example, inventory write-down for one of my companies is very important to understanding how we evaluate inventory evaluations and subsequent write-downs. How do we account for income taxes? What about pensions? Now, for a lot of companies, pensions aren't that big of a deal. They're well-funded, stock prices have jumped back and they're pretty healthy again – so, should that really be a critical accounting policy for us? These deep dives help you really learn about the company and it gives management and the auditor an opportunity to show their knowledge and how they approach accounting issues.

ACI: *Any thoughts on the audit committee's oversight of the audit – of audit quality?*

Blythe J. McGarvie: There's a balance that we want to keep in terms of managing audit fees. Making sure that you're getting a quality audit at a reasonable cost means you have to ask questions. How much technology is the auditor using in the audit plan? Does the auditor go with the head of internal audit to some foreign locations? Is there a way the auditor can double-up and use more of the internal audit group's work? I want to get a sense of whether the audit is well-coordinated, and that the quality is there as well.

ACI: *Final thoughts or words of wisdom on the audit committee/auditor relationship?*

Blythe J. McGarvie: A director who's been on boards for 20 years once said to me, "You know, one mistake I made was worrying too much about the pennies instead of thinking about the dollar impact. I should never have worried about flying to go see my audit partner or having him fly to me." Spending time with your auditor really helps you understand the auditor's perspective and concerns – which goes back to my very first point about being a good listener. What is the auditor hearing and seeing, and does he have insights to offer? ❖

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