INFORMATION SHEET 196

Audit quality: The role of directors and audit committees

This information sheet provides guidance to assist directors and audit committees in their role in ensuring the quality of the external audit of a financial report. It explains:

- why audit quality is important
- the responsibilities of the auditor
- the roles of directors and audit committees
- the responsibilities of directors for auditor independence
- who should manage the appointment of auditors
- what matters should be considered in setting audit fees, and
- what directors and audit committees can do to promote audit quality.

This information sheet is relevant to audit committee members and to directors, whether or not they are members of a company's audit committee.

Why is audit quality important?

Auditors have a critical role in ensuring that Australian investors can be confident and informed in making their investment decisions. High-quality audits support the quality of financial reports and enable investors to rely on the auditor's independent assessment of financial reports.

Audit quality concerns matters that contribute to the likelihood of the auditor achieving the fundamental objective of obtaining reasonable assurance that the financial report as a whole is free of material misstatement, and that the auditor ensures any deficiencies detected are addressed or communicated through the audit report.

This view is consistent with the objective of the audit, as outlined in the auditing standards: see paragraph 11 of Auditing Standard ASA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with Australian auditing standards*, and is consistent with the Financial Reporting Council (FRC) definition of audit quality.

> Note: See the FRC submission on the International Auditing and Assurance Standards Board (IAASB) consultation paper, *A framework for audit quality*, May 2013, at http://www.frc.gov.au/reports/submissions/FRC_IAASB_A_Framework_for_Audit_Quality.pdf.

Audit quality can be influenced by a range of factors, including:

- an audit firm culture focused on audit quality and professional scepticism
- a culture of consultation
- an understanding of the business and the risks affecting the financial report

Information sheets provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

- the internal and external experience and expertise applied in audits (including recruitment and training, the use of experts, and specialist industry knowledge)
- the supervision and review of audit engagements (including audit firm quality reviews)
- audit firm quality controls, and
- the accountability of engagement partners and others in the firm for audit quality (e.g. through impacts on remuneration for poor internal quality review findings).

What are the responsibilities of the auditor?

Under the *Corporations Act 2001* (Corporations Act), the auditor is required to:

- form an opinion about whether the financial report complies with the accounting standards and gives a true and fair view, as well as about certain other matters (s307) and report to members (s309)
- conduct their audit in accordance with the auditing standards (s307A)
- meet independence requirements (including professional standards) and give the directors an auditor's independence declaration (s307C), and
- report certain suspected contraventions of the Corporations Act to ASIC (s311).

What are the roles of directors and audit committees?

An audit committee is a committee of the board of directors that focuses on issues relevant to the integrity of the company's financial reporting. The ASX Listing Rules require certain listed entities to have audit committees. Other companies may choose to have an audit committee.

While the existence of an audit committee does not alter the need for directors to take responsibility for financial reports, audit committees can play an important role in the financial reporting process and in supporting and promoting audit quality.

The auditor gives an independent opinion that follows after the directors' opinion on a financial report. A company must have its own systems, processes and controls, as well as appropriate resources, to produce high-quality financial reports. Directors must not rely on the auditor in forming their own opinion on the financial report, as this would undermine the objective of an audit in providing independent assurance to members on the financial report. See also Information Sheet 183 *Directors and financial reporting* (INFO 183).

Audit committees should consider raising any audit quality concerns that are not satisfactorily resolved with the auditor with the board of directors. Directors and audit committees may seek advice where appropriate, and may raise concerns with ASIC if needed.

What are the responsibilities of directors for auditor independence?

The independence of the auditor is important in promoting market confidence in the auditor's report on the financial report. Actual and perceived independence from directors and company management, as well as the objectivity of the auditor, underpins audit quality.

The directors' role in ensuring the independence of the auditor is illustrated by requirements in the Corporations Act for the directors' report to include:

- the auditor's independence declaration, and
- for a listed company, a statement about whether the provision of non-audit services by the auditor during a financial year is compatible with the general standard of auditor independence in the Corporations Act, and whether that statement is consistent with the advice of the audit committee (s300(11B–11E)).

It is important for directors and audit committees to consider the independence of the auditor both in recommending the appointment of auditors and on an ongoing basis.

Who should manage the appointment of auditors?

The members of a public company appoint the auditor at an annual general meeting (AGM): s327B. The directors must appoint an auditor to fill a vacancy in the office of auditor, but the ongoing appointment of an auditor occurs at the next AGM: s327A and 327C.

Because it is generally not practical for members of larger listed companies to be involved in a detailed assessment of auditors and the determination of audit fees, the audit committee and directors can play an important role in recommending the appointment of an auditor.

It is possible that company management may have interests that are not fully aligned with the conduct of quality audits, and so may not be best placed to assess auditors and set audit fees. For example, incentives for management to achieve certain levels of financial performance may lead to setting low audit fees that could place undue pressure on audit quality.

While consideration should be given to any management concerns with audit quality, non-executive directors—who are focused on the need for audit quality and who have direct accountability and fiduciary responsibilities to the company—should ideally manage the process of appointing and replacing auditors and determine the remuneration of the auditors.

What matters should be considered in setting audit fees?

A company is required to pay the reasonable fees and expenses of an auditor: s331. The setting of audit fees is a commercial decision by companies and their auditors. The process should be managed by the directors (who should be responsible for setting the overall fee) and the audit committee. Directors and audit committees should ensure that audit fees are not set at a level that could lead to audit quality being compromised.

Many companies have been under pressure to reduce costs because of difficult economic circumstances or other factors. Audit fees have sometimes been affected in the pursuit of general cost reductions. However, audit fees are usually a small proportion of costs, and reductions generally do not have a significant impact on a company's profit.

In difficult economic conditions, auditors continue to be faced with more challenging judgements in areas such as assessing whether the company is a going concern, impairments of assets and fair values. This increases the time spent on an audit and might be expected to lead to increases rather than reductions in audit fees. Changes in the company's business, reporting requirements or the risks affecting financial reports may also warrant increases in fees.

If a company decides to seek tenders for audit services, the primary focus should be on audit quality rather than on reducing fees and saving costs. A quality audit supports the quality of financial reporting.

Some audit firms may offer discounted fees to maintain or increase revenues, contribute to fixed costs, occupy staff during downturns, maintain or build market share, or build a presence in a particular industry. In some cases, an auditor may not have understood the company's business, reporting requirements and the extent of audit work required.

While there may be instances where an effective but more efficient audit can be obtained, audit committees and directors should be aware of a risk of pressures in some audit firms to limit the impacts of low or reduced fees on margins. Inadequate fees can create a risk that audit quality is compromised and that auditors do not obtain sufficient and appropriate audit evidence to support their opinion. This should be of concern to directors and audit committees.

What can directors and audit committees do to promote audit quality?

In ensuring audit quality, directors and audit committees may consider certain good practice matters when:

- recommending the appointment of an auditor to members
- assessing potential and continuing auditors
- facilitating the audit process
- establishing ongoing communications with the auditor
- maintaining auditor independence
- assessing the quality of audits conducted.

The matters that may be considered are listed as questions under each area. They may also be included in some form in the audit committee's charter.

Recommending the appointment of an auditor

In recommending the appointment of an auditor to members, directors and audit committees may consider the following matters: see also 'Assessing potential and continuing auditors' for other matters that may be relevant.

Any audit tender or other selection process	✓ Is any audit tender or other selection process being conducted independently of company management (i.e. using a panel of non-executive directors)? ✓ Are the audit tender or selection criteria focused on audit quality? ✓ Is audit quality likely to be compromised by reduced audit fees that might result in the audit being inadequately resourced or insufficient work being performed? ✓ Have separate tender documents relating to audit quality and to fees been requested, and the document relating to quality been considered before reviewing the proposed fees? ✓ Does the process ensure that potential auditors are not asked for their views on contentious judgements or accounting treatments before their selection (also known as 'opinion shopping')?
Commitment to audit quality	✓ Has the auditor (including any incumbent auditor) demonstrated a commitment to audit quality and the culture within their firm? ✓ Has any information relevant to audit quality in the audit firm's annual audit transparency report been reviewed? ✓ Has the auditor been asked about how they are addressing any general overall findings reported publicly by ASIC from audit firm inspections or from the firm's own internal quality reviews?

Assessing potential and continuing auditors

When assessing potential auditors to recommend to members, and when reviewing and promoting the quality of ongoing audits (through review of the continuing auditor's plans for each reporting period), directors and audit committees may consider the following matters.

Resources devoted to the audit	✓ For a continuing auditor, has the auditor prepared a high-level plan for the audit for review by directors and the audit committee? ✓ Does the continuing auditor or potential auditor plan to adequately cover operations and risk areas? ✓ What level of resources will be devoted to the audit by the auditor? ✓ Has the auditor demonstrated a sufficient understanding of the business, operations and risk areas relevant to the financial report, and planned to respond appropriately to assessed risks? (In a tender process, sufficient access would normally be provided to management.) ✓ Do the auditor's engagement partner, review partner and audit team members have sufficient experience and expertise, given the size and complexity of the company and its operations (including relevant industry expertise, and valuation expertise appropriate for the types of assets, liabilities and exposures of the company)? ✓ Will the senior audit team members be sufficiently involved in the audit, particularly the engagement partner? ✓ Are the firm's arrangements for supervising and reviewing the audit, and internal firm quality reviews and controls, adequate?
Reliance on experts and other auditors	✓ Will the auditor directly engage their own firm or external experts to supplement the audit team's experience and expertise in specialist areas (e.g. for complex asset and financial instrument valuations, or using specialists such as geologists or actuaries, or information technology (IT) system experts) to obtain an independent view on the work of company management and any external specialists engaged by the company? ✓ Will the auditor review and rely on systems and controls in performing the audit, particularly where there are large numbers of systematically processed transactions, and are matters such as the auditor's system rotation plan, proposed reviews of IT controls adequate and appropriate? ✓ Will the auditor use the work of other auditors and coverage of components within a group (e.g. local or foreign branches, and subsidiaries) and how will they satisfy themselves on the work of other auditors? ✓ Will the auditor rely on internal auditors to perform external audit work? (External auditors may rely on internal audit as part of internal controls and to identify risks. However, independence is essential to investor and market confidence in the external audit, and internal auditors may not be seen as fully independent as they are employed by the company.)
Accountability	✓ Is there appropriate accountability for audit quality by the auditor's engagement partner, review partner, specialists and audit team members?

Facilitating the audit process

To facilitate the audit process, directors and audit committees may consider the following matters.

Supporting the audit	✓ Is audit quality likely to be compromised by reduced audit fees that might result in the audit being inadequately resourced or insufficient work being performed? ✓ Have financial reporting processes and audit processes been planned to ensure that an effective quality audit can be conducted within the financial reporting deadlines? ✓ Have any concerns or risks highlighted by the auditor, including concerns about systems, processes or policies that could materially affect future financial reports, been considered and addressed?
Company management and staff	✓ Is there appropriate accountability and incentives for company management and staff to focus on the quality of financial reporting, timely reporting and facilitation of the audit process? ✓ Has company management facilitated the audit by providing all information and explanations that may be relevant to the financial report and audit, and done so in a timely manner? ✓ Do company management and staff have a positive and helpful approach to the audit process?

Establishing ongoing communications with the auditor

The quality of communications between directors and audit committees and the auditor is important in supporting audit quality. This communication should include concerns and risks affecting processes supporting the information in the financial report, and how these concerns and risks are being addressed by directors and management and responded to in the audit.

Two-way communication between the auditor and directors helps the auditor to obtain information that is relevant to the audit and assists directors in overseeing the financial reporting process. In establishing ongoing communications with the auditor, directors and audit committees may consider the following matters.

Addressing any risk areas or areas of concern	✓ Is the auditor informed in a timely manner of any risk areas or areas of concern that are relevant to the financial report and audit? ✓ Are timely comments from the auditor sought on any concerns with accounting treatments, accounting estimates, accounting records, and financial reporting systems and processes so that any concerns may be properly considered and addressed? ✓ Does the auditor provide written reports on key issues and concerns? ✓ Do directors and the audit committee challenge the auditor, including on professional scepticism applied in judgement areas such as accounting estimates and accounting policies?
Ensuring access to directors and audit committee	✓ Is the auditor invited to attend all audit committee meetings, except where the audit committee is discussing the auditor's performance? ✓ Is there an open dialogue between the auditor and directors and the audit committee on matters affecting the financial report, the audit and audit quality? ✓ Does the auditor meet with the directors and the audit committee, without company management present and without any minutes of the discussions being shared with management? ✓ Does the auditor have open access to the audit committee chair without company management present, outside of the formal audit committee meetings?

Maintaining auditor independence

To maintain auditor independence and objectivity, directors and audit committees may consider the following matters.

Policies and processes	✓ Is there a set policy on the independence of the auditor?
Independence and objectivity	✓ Have any non-audit services been reviewed and approved before the auditor is engaged to perform these services, ensuring that such services do not compromise the auditor's independence? ✓ Have audit team members avoided becoming too close to company management, which can affect independence and objectivity? ✓ Have the directors and audit committee members formed their own views on complex accounting policy choices or estimates, including seeking independent third-party advice, rather than relying on the views of the auditor? ✓ Have any other matters that may affect the independence and objectivity of the auditor been considered? ✓ Has the auditor explained the basis for their independence declaration?

Assessing the quality of audits conducted

Directors and audit committees are well-placed to evaluate the performance of an auditor and can help to ensure that members are provided with a valuable independent audit opinion on the financial reports. This promotes market confidence in the company's financial reports.

In assessing the quality of an audit that has been conducted, directors and audit committees may consider the following matters.

Quality and standards	✓ Has the auditor demonstrated a commitment to audit quality, the culture within their firm and the application of high ethical standards?
The audit process	✓ Has the auditor demonstrated a sufficient understanding of the business, operations and risk areas relevant to the financial report, and have they responded appropriately to assessed risks? ✓ Has the auditor exhibited sufficient professional scepticism in challenging, rather than rationalising, estimates and accounting policy choices (e.g. complex or subjective asset valuations, including cases where the reported net assets exceed the market capitalisation of the company)? ✓ Has the auditor addressed risks or concerns identified by the directors and audit committee?
Communication of issues	✓ Has the auditor raised key issues affecting the financial report, and done so in a timely manner? ✓ Has the auditor raised relevant and useful comments in their management letters?
Other information	✓ Has information relevant to audit quality in an audit firm's annual audit transparency report been reviewed? ✓ Has any other information on audit quality been reviewed (e.g. internal company staff observations or assessments of audit quality)? ✓ Are there any actions that may be undertaken by the auditor to improve audit quality, and is there reporting back on progress for such actions against predetermined measures and timetables?

Findings from ASIC's audit inspections and surveillances	✓ If the company's audit was selected for review by ASIC (or other regulators), have the review's scope and results been considered by the directors and audit committee? ✓ Have any overall findings from ASIC's inspections or surveillances been addressed (even if not directly related to the company's audit)? ✓ If the auditor indicated these findings were not significant (e.g. mere documentation matters), have the directors and audit committee challenged this, given that we do not report insignificant findings?

Where can I get more information?

- For copies of auditing standards, go to http://www.auasb.gov.au/Pronouncements/Australian-Auditing-Standards.aspx.
- Download a copy of Information Sheet 183 *Directors and financial reporting* (INFO 183) at www.asic.gov.au/infosheets.
- Contact ASIC on 1300 300 630.

Important notice

Please note that this information sheet is a summary giving you the basic information you need. It does not cover the whole of the relevant law and is not a substitute for professional advice.

You should also note that, because this information sheet avoids legal language wherever possible, there may be some generalisations about the application of the law. Some provisions of the law referred to have exceptions or important qualifications. In most cases, your particular circumstances need to be taken into account when determining how the law applies to you.