FAR PRACTICE NOTE:

AUDIT COMMITTEE INVOLVEMENT AND AUDIT QUALITY

FAR Project 2018B03 Vanstraelen

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Executive summary

The audit committee is a key feature of contemporary corporate governance. Despite ever-tightening regulation concerning its independence and expertise, it still is unclear why some audit committees underperform, and how this impacts the effectiveness of the external audit. We argue that, next to having the appropriate skills, audit committee involvement in the audit process is crucial for its effectiveness. Communication, trust, and support between the audit committee and the external auditor, as well as the power and leadership of the audit committee are key features which may affect how the audit committee deals with disagreements between management and the auditor, and to what extent it will critically challenge both parties. However, these "soft" dimensions are understudied, and more insight is valuable for practitioners, academics, as well as regulators on what triggers audit committee involvement, and how this feeds back into the audit process. We aim to demonstrate that an active, involved audit committee is able to create synergies with the external auditor, which can streamline the audit process and enhance audit quality.

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Introduction

Following recent governance reforms, audit committees have become of crucial importance for audit quality. However, the understanding about how audit committees influence audit quality is still incomplete. We posit that external auditors and audit committees can influence the quality of an audit on their own, but also – and in our opinion, critically – through interaction with each other. The latter means that external auditors modify their actions in response to the actions by audit committee members, and vice versa. Audit quality then is the product of the various actors involved (external auditors, audit committee members and management). Skilled auditors may by themselves positively affect audit quality. However, having trust, support, and good information flows from the audit committee can increase audit quality even more. Although this may seem obvious to audit practitioners, systematic empirical evidence on such interdependencies is still very limited, mostly due to data limitations. To improve our understanding of the working of audit committees and its impact on audit quality, our FAR research project will provide empirical evidence on these issues using proprietary data from Public Interest Companies (PIEs) in the Netherlands. As some recent preliminary findings of the Committee Future Accountancy show, this is a timely topic of study (Ottow et al. 2019).

The aim of this practice note is twofold. The first goal is to discuss what we already know from existing research about audit committees and their impact on audit quality. The second aim of the note is to discuss important issues which are un(der)addressed by prior research, and which are the focus of this FAR research project on audit committee involvement. The ultimate objective is to inform practitioners on the critical factors which shape audit committee effectiveness, and how these factors may translate into the external audit process. The explicit focus is not just on formal attributes, but rather on informal processes and the "soft" components of the audit process. This note should thus be relevant not only to external audit partners interacting with audit committees, but also to audit committee chairs and members themselves. Moreover, management, regulators and other stakeholders may benefit from a better understanding of how audit committees are involved in the audit process.

Short background on audit committees in the Netherlands

As a result of European legislation (European Commission, 2006), PIEs in the Netherlands must establish an audit committee. However, unlike in the US there is in Europe still variation in the proportion of independent members (Poretti et al. 2018). In 2014, the European legislation was amended and now requires that at least half of the members on the audit committee must be independent (Poretti et al. 2018). Well before audit committees were mandated for PIEs, many Dutch listed companies already established audit committees on a voluntary basis following best practice provisions of the Dutch corporate governance code. Although most listed companies have a two-tier board structure, with a management board consisting of executive directors and a supervisory board consisting of non-executive directors, already in 1997 the first Dutch corporate governance committee recommended listed companies in the Netherlands to establish an audit committees (Maassen 1998). Recently, the interim report of the Committee Future Accountancy stressed again the importance of audit committees in relation to audit quality (Ottow et al. 2019). Only a few empirical studies have examined the relationship between audit committees and audit quality in a continental European setting. Some notable exceptions are Hooghiemstra et al. (2008) and Tros (2015) in the Netherlands, Koch et al. (2012) in Germany, Piot and Janin (2007), Compernolle & Richard (2018) and Compernolle (2018) in France, and Poretti et al. (2018) who studied 15 European countries.

Empirical research on audit committee involvement and audit quality

Most of the prior literature on audit committees has studied the relationship between specific audit committee characteristics on the one hand and financial reporting and audit outputs on the other hand. These studies generally rely on publicly available, archival data, and examine the necessary conditions for audit committee effectiveness – which generally boils down to achieving high financial reporting quality(e.g., Abbott and Parker 2000; Carcello and Neal 2000; Klein 2002; Abbott et al. 2003; Abbott et al. 2004; Bédard et al. 2004; Chen and Zhou 2007; Carcello et al. 2009; Cohen et al. 2014). These studies typically expect that large, independent audit committees, with a high meeting frequency and financial/industry expertise, are associated with a better financial reporting process. The latter is then measured by the quality of earnings, the occurrence of restatements, qualified audit reports, audit fees and the employment of higher quality auditors (DeZoort et al. 2002; Turley and Zaman 2004; Bédard and Gendron 2010). For a sample of Dutch listed firms, Hooghiemstra et al. (2008) find that the presence of an AC is negatively associated with earnings management. Poretti et al. (2018) report for a sample of European companies from 15 countries that the proportion of independent members on the AC is positively associated with earnings credibility (as measured by the market reaction to earnings announcements), but that this association only holds in countries with weak institutions. This finding supports the idea that independent ACs can substitute for weak institutions.

However, the findings are not always in line with expectations. Research shows that audit committees can still underperform despite having all necessary qualifications to adequately safeguard financial reporting quality. Only a limited number of studies have addressed the "black box" of audit committee processes and its oversight of the external audit. An important exception is Gendron et al. (2004), who conducted a field study in Canadian public corporations, examining audit committee meetings. They find that a key aspect of the work carried out by audit committee members is to ask challenging questions and to assess the responses provided by managers and auditors. Through dialogue and interactions, audit committees will over time develop a level of confidence and trust in both parties involved. Audit committee financial expertise is a necessary condition for an audit committee to be able to ask the right questions, but it may not be suffcient for safeguarding financial reporting quality. Mutual trust between the auditor and the audit committee and their underlying relationship are key, but this trust is only built up over the course of the working relationship with the audit firm (Rummell et al. 2018). These informal interactions are the basis of the audit committee's impact on the audit process and its power vis-à-vis the auditor and management (Turley and Zaman 2007).

Next to the independence and expertise, research has shown that companies where audit committee chairs or financial experts are too busy have a lower financial reporting quality (Tanyi and Smith 2015). Moreover, a high status of the audit committee compared to management can help deter earnings management (Badolato et al. 2014).

Beasley et al. (2009) provide insights into audit committee practices using responses from 42 public companies in the US. Overall, audit committee members rely heavily on the external auditor in executing their oversight over financial reporting quality. At the same time, the committees also provides meaningful oversight on the external auditor himself. The authors stress the importance of frequent and meaningful interactions between the audit committee and the external auditor, and say this is critical for effective audit committee oversight. Audit practitioners confirm this. Cohen et al. (2010) interviewed US auditors and find that auditors believe that audit committees have become more active and diligent in the last decade, following the implementation of the Sarbanes-Oxley Act. Most auditors believe that audit committees are much more active with respect to overseeing audit risk assessments and related audit planning decisions. However, only half of the auditors perceived that audit committees play an important role in resolving auditor disputes with management, despite having adequate expertise and authority. This seems to be indicative of an expectation gap between the auditor and the audit committee, in which audit committees take on a more active role, while the audit process does not necessarily fully benefit from the viewpoint of the auditor.

From the auditor's perspective, management, and not the audit committee, is still the dominant party in accounting disputes and auditor appointment and dismissal decisions (Beasley et al. 2009; Fiolleau et al. 2013). Fiolleau et al. (2013) show that in some situations, the audit committee's involvement in the auditor selection decision is limited, and merely serves as a monitor for management's selection decision. Also in the Netherlands, Tros (2015) observes that management has a large role in the selection process. While responsibilities are shared among the CFO and the AC, the process is often led by the CFO, potentially lowering (perceived) independence. For example, powerful CFOs still heavily affect or even control audit fee negotiations (Beck and Mauldin 2014). Along the same lines, Lisic et al. (2016) find that CEO power can reduce audit committee effectiveness, via appointing management-friendly directors, installing weaker internal control systems, or providing only limited information to the audit committee. These findings are in sharp contrast with the idea of an active audit committee who takes the lead in the financial reporting and auditing processes. CEOs should not be involved in the director selection process, as the chosen directors may then have an allegiance or informal ties to management, casting doubts on any notion of audit committee independence (Carcello et al. 2011). Social ties between the audit committee and the CEO are indeed associated with lower-quality oversight by the audit committee (Bruynseels and Cardinaels 2014). However, social ties between the audit committee and the auditor are equally detrimental, as these ties prevent the audit committee from critically challenging the auditor (He et al. 2017).

A last set of studies examines the broader contextual factors which may affect audit committee effectiveness. For example, Agoglia et al (2011) examine the reporting regime in which the audit committee operates, specifically whether reporting rules are clear or allow for a large amount of discretion. The authors find that audit committee strength reduces aggressive reporting in a rules-based regime, but not in a principles-based regime, as more discussion is possible in the latter. This suggests that discretion in account rules impedes the monitoring ability of the audit committee. Contessoto et al. (2014) find that the auditors view the diligence of audit committee members – and specifically the time they spend in preparing and executing audit committee oversight – as a key condition for audit committee effectiveness. Lastly, the audit committee chair's leadership is critical to an effective audit committee, and research documents different but not mutually exclusive styles of audit committee chairing: collaborative, administrative, and rational oversight. Different leadership styles are required depending on whether the audit committee discussions deal with the correct application of accounting rules, or managing conflicts between the auditor and management (Compernolle and Richard 2018).

Overall, prior literature suggests that while audit committees on average have become more diligent, current regulations still allow for a range of audit committee effectiveness, with on one end of the spectrum actively involved audit committees fulfilling their responsibilities in a substantive manner, and on the other end uninvolved audit committees with actions that are more ceremonial. Factors playing a crucial role in the effectiveness of audit committees are the relative power of management versus the audit committee, the existence of social ties, mutual trust between the auditor and the audit committee, leadership of the audit committee chair, and due diligence on behalf of the audit committee.

Research gap and the ongoing FAR research project

The practice note shows that there still are many issues that we do not know a lot about, and that a comprehensive picture of the conditions under which audit committee involvement improves audit quality is lacking. Moreover, an important shortcoming of the current literature is that the majority of studies have been conducted in the US-setting, mainly because of data constraints. This gives rise to concerns about the generalizability of the findings discussed above, and we urge practitioners to be cautious in relying on the conclusions of extant audit committee research until validation studies in other settings outside the US have been conducted.

Our FAR research project is original in the sense that it addresses both issues mentioned above: (1) examining the audit committee in an alternative setting; and (2) using a broad approach which takes into account audit committee involvement and its interactions with the external audit. In particular, we will perform a study to identify drivers of audit committee involvement, which go beyond the regulated functional characteristics (e.g., audit committee size, expertise, independence), but (also) target the "soft" dimensions of the audit committee such as leadership, cohesion among the audit committee members, and mutual trust between the audit committee and the auditor. These understudied characteristics likely affect all components of the audit, from input, via process to output. In effect, the objective of this study is to go beyond the "form", and focus on the "substance" of the characteristics of the audit committee that enables it to function effectively in providing oversight on the financial reporting process (Cohen, Krishnamoorthy, and Wright 2008). To achieve these objectives, we gratefully make use of the possibility offered by

FAR and the participating audit firms. The FAR allows us to establish contacts with audit committees as well as audit partners, which helps us go inside the 'black box' of the audit process and the clients' governance and control environments. This project is key to advance our understanding of how, and under what conditions, audit committee involvement affects the core input, process and output factors of audit quality, and to provide a meaningful contribution to the academic literature and practice. Our findings may shed light on an expectations gap between audit committees and audit partners, and highlight areas in which cooperation between both parties can be improved.

Conclusion

Most existing research on audit committees has focused on the relationship between specific audit committee characteristics, such as independence and expertise, and financial reporting and audit outputs. However, a key aspect of the work carried out by audit committee members is to ask challenging questions to management and the auditor, and assess their responses. As confidence and trust are built up (or not), these interactions between the various parties involved become central to the audit process. An important impact of audit committees thus comes through informal interactions between the audit committee and the auditor/management, which is the basis for the committee's authority in settling disputes between the auditor and management. Unfortunately, prior research suggests that audit committee involvement in resolving auditor disputes with management is still weak, and management continues to be the dominant party in auditor appointment and dismissal decisions. This casts doubts on the effectiveness of regulatory reforms such as the Sarbanes-Oxley Act, the Audit Directive, or stock exchange listing requirements, which aimed to strengthen the position of the audit committee in achieving a high financial reporting quality.

We aim to contribute to the regulatory debate by performing a study to identify the drivers of audit committee involvement, which go beyond the regulated functional characteristics (like audit committee size, expertise, independence), and focus on audit committee leadership and power, cohesion within the audit committee, and mutual trust between the audit committee and the auditor. We expect that the embeddedness of the audit committee in a wider network of governance actors, and the quality of its interactions with these actors, are central drivers of audit committee involvement and effectiveness.

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