



More vital than ever

Carol Der Garry and **Weng Yee Ng** review the role of audit committees in overseeing the quality of audit in the UK

The role of audit committees in ensuring audit quality is increasingly important during the Covid-19 crisis, as companies face disruptions and uncertainty, and financial strain and risks increase as directors' duties are impacted by changes implemented by regulators.

The current pandemic has also brought a number of challenges to external auditors in executing their routine annual statutory audits, such as limited accessibility to information and audit evidence and the need to conduct audit procedures remotely. However, stakeholders and regulators continue to focus on the role of audit committees in preventing and mitigating the risk of financial and accounting misstatements.

Carol Der Garry
Partner, FRA

Weng Yee Ng
Director, FRA

Background

Audit committees have a distinct role calling for them to act independently from a corporation's executives and to protect the interest of shareholders, in particular on internal control and financial reporting. The audit committees' key responsibilities in relation to external auditors include:

- assessing the integrity of the company's financial statements, including reviewing significant financial reporting judgments contained in them;
- oversight over the external audit tender process, appointment, remuneration, terms of engagement, independence and objectivity;
- reviewing effectiveness of the external audit process;
- ensuring appropriate policy and prior approval for external auditor's provision of non-audit services; and
- reporting to the board on how these responsibilities have been discharged.

In response to continued emphasis in the UK concerning audit quality and the importance of the audit quality oversight role of the audit committee, a number of authorities in the UK have commissioned studies and issued guidance to address this concern. These include practice aids, guidance documents, reports, studies and independent reviews issued, or commissioned, by the Financial Reporting Council (FRC), the Competition and Markets Authority (CMA), the Parliamentary Committee on Business,

Energy and Industrial Strategy, and the Institute of Chartered Secretaries and Administrators to name a few.

Also of relevance to UK foreign private issuers, in December 2019, the US Securities and Exchange Commission's statement reminded audit committees of their responsibilities for oversight of financial reporting, internal control and the external, independent audit process.

While these reports and guidance were commissioned by different agencies, common key themes mentioned are the effectiveness of audit committees in overseeing auditors and in ensuring the quality of the audit.

Impact of Covid-19

Amidst this emphasis, the Covid-19 environment and changing UK government laws have increased risks for directors, and in some instances, blurred lines on directors' duties. For example, the government has instituted a temporary suspension of wrongful trading, thereby reducing the threat of personal liability for directors for wrongful trading for the period of the Covid-19 pandemic. However, given changes to insolvency legislation, wrongful trading provisions have not been entirely suspended, and it is not entirely clear whether any circumstances remain in which a court could order contributions for wrongful trading.

Therefore, in some cases, the changing requirements create nuanced situations and audit committees will need to be cautious and vigilant as they exercise their duties.

Considerations for audit committees

Whilst the various guidance suggests best practices and points of reference to members of audit committees on how to implement those requirements, below are some practical considerations and challenges that audit committees should consider.

Audit committee and auditor interaction

The audit committee must determine the appropriate level and timing of interaction with the external auditors and the nature of questions to ask. Audit committees should be ready to challenge their auditors when information with which they are provided is not clear. And consideration should be given as to how the audit committee can corroborate information provided by the external auditors.

Audit firm's internal quality control procedures

In order to ensure the audit is being run effectively, audit committees should seek to understand the quality controls, such as training, technical support and "tone at the top" that the external audit firm has in place. Quality control procedures, or a lack thereof, might not always be obvious.

One aspect that the FRC's December

2019 Audit Quality Practice Aid for Audit Committees ("Practice Aid") addresses is that audit committees should discuss audit quality inspection reports issued by the FRC's Audit Quality Review team and remedial actions taken, in order to ensure that the audit committees fully understand the potential implications for the quality of their audits.

Auditor independence, conflicts of interest and potential bias

Arguments around "cultural fit," "chemistry" and "personal relationship" have been raised regarding companies' relationships with their statutory auditors. However, these concerns – as well as concerns around auditor independence, conflicts of interest and potential bias – continue to persist and have been noted in independent reviews commissioned by the UK government and CMA (see bit.ly/2D7N48s).

The audit committee should be able to explain how it has assessed characteristics such as the auditor's mindset and firm culture, and the auditor must demonstrate to the audit committee that they exercised professional scepticism and made appropriate challenges of management. Audit committees should probe the audit firm's culture, independence, conflicts of interest and potential bias.

Involvement of experts/specialists and consultations

Some of the FRC's recommended best practices for audit committees require specific skill sets and knowledge to execute; however, audit committee members will not always have the required skills or knowledge. The audit committee should assess whether to obtain support, either internally within the company or externally through advisors, taking into consideration availability of budgets. Support and consultation may be required in assessing the appropriate accounting treatment and disclosure requirements for complex, judgemental and technical areas, such as deferred taxation, pension calculations, valuations, impairments and going concern.

Audit Quality Indicators

In a May 2020 FRC publication, the FRC provided information about a number of case studies of Audit Quality Indicators (AQIs), as well as information about the most useful indicators of both poor and good audit quality within the UK. The study found that if AQIs are used properly, they can be a vital tool in helping audit firms to detect audits at risk of not meeting necessary standards for audit committees to hold audit firms accountable (see bit.ly/2ZDStMh).

The FRC's Practice Aid recommended that audit committees should discuss with the auditor the AQIs used by their firm, and the results of the firm's own monitoring processes for the audit business.



Author bio

Carol Der Garry has 35 years of professional experience as a certified public accountant in forensic investigations, auditing and accounting.



Author bio

Weng Yee Ng holds more than 16 years of experience in audit and forensic accounting, with expertise in compliance reviews, internal investigations and litigation support.

AUDIT COMMITTEES

Documentation and evidence

The UK Corporate Governance Code requires the audit committee to report to the board on how it has discharged its responsibilities, including how it assessed the independence and effectiveness of the external audit process.

When companies fail or businesses struggle, the level of stakeholder and regulatory scrutiny tends to increase, and the question about whether audit committees have appropriately discharged their responsibilities inevitably arises. This contributes to the importance of audit committees evidencing their reviews and assessments through proper documentation – not only to demonstrate to the stakeholders that they have carried out their responsibilities diligently, but also to protect and defend themselves in the event they are challenged.

The FRC's Practice Aid does not provide detailed guidance as to how the review and assessment should be documented, the level of granularity or detail, or who takes the lead in preparing the documentation; the audit committee may wish to take advice in this area.

What should audit committees do?

First, audit committees should review current practices and perform a gap assessment; i.e. ascertain what is required versus what is currently performed, which will highlight areas and procedures requiring further action by the



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audit committees. The audit committee should then evaluate the gaps identified and ascertain where external support or consultation may be required.

Next, audit committees should have in-depth discussions with the company's external audit team to assess the quality and effectiveness of the audit and ensure that adequate contemporaneous documentation is prepared to evidence the discussions and conclusions reached. If unsure, audit committees can refer to the guidance and practice aid issued by regulators and government agencies, and seek professional advice, as needed.

Conclusion

Even without the Covid-19 pandemic, the roles and responsibilities of audit committees, in particular with respect to ensuring the quality of the audit, have been in the limelight. The strain Covid-19 has on businesses creates even greater pressure to meet financial expectations. This can lead to a heightened risk of potential fraud and accounting misstatements. And changing UK government laws may increase risks for directors by blurring lines on directors' duties. These situations will naturally lead to greater emphasis on audit committees to demonstrate that they have duly discharged their responsibilities, in particular by evidencing transparent contemporaneous considerations, to ensure robustness of audit quality. ●



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