

## Dialogue with Ralf Bose and Alain Deckers on Audit Committee Realities

The Audit Regulation and Audit Directive (ARD), which came into effect in 2016, expanded the role and mandatory responsibilities of European audit committees.<sup>1</sup> The ARD provided limitations on the types and amount of nonaudit services that audit firms can provide to audit clients. In view of these conditions, Tapestry Networks published *Audit Committee Realities: Insights from Europe's leading boards*. The report provides stakeholders with a comprehensive inside look at the practices of the audit committees and audit chairs of some of Europe's largest listed companies.

On 14-15 November 2019, members of the European Audit Committee Leadership Network (EACLN) met in Paris to discuss the report. Two guests joined them:

- **Ralf Bose**, chief executive director of Germany's Auditor Oversight Body. Mr. Bose also serves as chair of the Committee of European Auditing Oversight Bodies (CEAOB), which is the framework for cooperation between national audit regulators in the European Union.
- **Alain Deckers**, head of unit, corporate reporting, audit and credit rating Agencies at the Directorate-General for Financial Stability, Financial Services and Capital Markets Union of the European Commission. He heads a team responsible for corporate reporting, including both financial and nonfinancial reporting, audit, and credit rating agencies. Mr. Deckers joined the European Commission in 1997 and has held positions of increasing responsibility throughout his 20-year career there.

*For longer biographies of the guests, see Appendix 1 on page 8. For a list of meeting participants, see Appendix 2 on page 9. For a list of discussion questions for audit committees, see Appendix 3 on page 10.*

### Executive summary

Mr. Bose and Mr. Deckers shared their perspectives on two areas addressed in the report:

- **Audit quality: its market influences and measurements** (page 2)

Audit chairs and other stakeholders agreed that audit quality is paramount. They noted that overall quality can be hard to define and is influenced by a range of factors. The profitability of auditing, along with the culture and incentive structures at audit firms, is one driver of audit quality. Notwithstanding the ARD's restrictions on nonaudit services, audit chairs remain confident that nonaudit services do not necessarily in any case compromise auditor independence or audit quality. Audit chairs and regulators acknowledged that sharing information, in particular information about audit inspections, might help both sides come to

a more common understanding on the factors that contribute to a quality audit. Nevertheless, inspection results are only one indicator for audit quality.

- **Audit technology: the benefits and challenges of a redefined audit** (page 5)

Audit technology is transforming how audits are planned, managed, and conducted. Along with the finance function, audits are becoming digitalized. Data analytics dramatically expands the scope of auditable information by providing insights on effectively all of the auditable information, which provides a comprehensive view of errors and exceptions. These larger data sets need to be maintained and utilized effectively to avoid inefficiency and inaccuracy.

## Audit quality: its market influences and measurements

Maintaining and improving high audit quality is a shared goal for audit committee chairs, policymakers, and regulators. Members and their guests discussed audit fees and audit-firm profitability, nonaudit services, and audit quality indicators.

### The nuanced relationship between fees and quality

One hallmark of the ARD is a requirement—implemented in different ways across different European member states—of audit tendering and mandatory firm rotation. Members and guests discussed the potential that a more competitive marketplace could lead to reduced fees, which, in turn, could put pressure on audit quality. Some audit chairs believe that there should be less focus on reducing audit fees in the tender process. One member said, *“There’s a real habit of many audit chairs wanting to push fees down. It should be the opposite: ensure that the fee is commensurate with the services provided.”* Another member agreed: *“In the past, we pressed auditors to lower fees. Now we need high standards and quality and that means paying an adequate price.”* The member went on to clarify the position: *“I stress that we’re not responsible for audit-firm profitability. We are responsible for meeting the highest quality standard.”*

The audit tender is a logical juncture at which an audit committee can examine audit team and scope to ensure quality. Members said that in most cases, a higher-priced proposal is not a direct indicator of a higher-quality audit. But they also said that a bid that is priced substantially lower than others could be a sign of trouble. If it appears that a bid is inadequately priced, the audit committee can factor the discrepancy into its evaluation. *“We had a mechanism to prevent dumping,”* a member recalled of a recent tender. *“A low fee did win the tender, and it was borderline, but we had to make sure it was a profitable fee.”* Mr. Bose agreed that low bids should raise flags but acknowledged that many factors could affect price in ways that are not always apparent: *“It must not be dumping. It must be a fair fee. But that depends (amongst others) on cost structure of the audit and the audit firm (traditionally audit hours times hourly rate). It might depend on the efficiency of the audit based on information technology used by the audit firm. And, the fee calculation will probably be impacted in the future in by different factors like costs for cloud services, storage space, computing capacity and other IT related costs.”* Not all audit chairs grapple with the relationship between fees and quality. One

member said, *“In my case, we haven’t always necessarily avoided the lowest fees. I think many people are over-concerned about this issue.”*

Mr. Bose said audit firms can do their part to alleviate the tension between fee competition and audit quality through culture including independence and incentive system. He looks for audit-firm cultures which incentivize audit quality—for example, firms that reward audit partners more for quality and not for more nonaudit work. *“It may sound like a no-brainer, but it’s about tone at the top of the audit firm,”* Mr. Bose said. He posed questions about incentives that can draw out the culture of an audit firm: *“Does management support quality audit work? What kind of significance and importance does the audit have within a firm where the audit practice is only 25-30% of the whole business? How are partners compensated and promoted? Is an audit partner always thinking about quality or how to make money?”* Telling answers to these questions, he said, include remuneration decisions that are driven by audit quality, such as larger bonuses for quality audits and lower bonuses for negative ones. Amongst others, these elements of independence in mind should not be underestimated.

### **Nonaudit services and their connection to auditor independence and audit quality**

The impact of nonaudit services on audit quality is a fixture in the audit reform debate. Mr. Bose raised questions about whether audit firms’ advisory businesses threaten auditor independence, and therefore audit quality. The ARD limits the percentage of fees an audit firm can collect from a client for nonaudit services, requires approval by the audit committee of any nonaudit service, and precludes firms from providing certain nonaudit services to audit clients.<sup>2</sup>

Mr. Bose wondered whether, irrespective the legal provisions of the ARD how to ensure auditors independence of client’s management. Can a firm provide an independent audit if it earns substantial fees from providing advisory services to that client? The ARD mandates that the total fees for certain nonaudit services “shall be limited to no more than 70% of the average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity.”<sup>3</sup> *“This also includes aspects of independence in mind and, in addition, independence in appearance. Regardless the many legal provisions for independence an audit committee chair should always also consider the public perception when, amongst others, agreeing on additional consulting work,”* Mr. Bose said.

Members reported that their audit committees are cognizant of this perception and work to ensure both compliance and true independence. Members said they strictly adhere to this requirement, as well as any more stringent limitations on advisory services. One said, *“As a global company, you have to assume you follow the toughest rule. Independence is a mindset.”* Another member said that, in the tender process, *“We had to make sure they had a profit only from the audit, not nonaudit.”*

Some members do not view this is a major concern in the current marketplace. One said, *“The ARD has totally killed that issue. With the limitations on nonaudit services, manufacturing opportunity from the audit engagement is nonexistent.”* Another member said, *“I believe the discussion of nonaudit services has gone too far. I have been an audit chair for many years.”*

*Nonaudit fees have been no more than 10% of what the firms receive for audit services in that time.”*

Nonetheless, members said that the burden of ARD compliance has risen to absurd levels for some audit committees. One said, *“I think it would be useful to alleviate the system a little. We recently considered a nonaudit purchase costing a few hundred Euros. The company drafted a report on it, sent it to the audit committee, and we had to review it. It was not for prohibited nonaudit services, but it couldn’t be pre-approved, so we had to formally approve it. In almost every audit committee meeting, in fact, we have to approve a few thousand Euros of nonaudit services. I can’t see these fees challenging auditor independence.”*

### **Audit committees would benefit from more guidance on the definition of audit quality**

Audit committees, regulators, policymakers, and other stakeholders have yet to reach a consensus on what constitutes a quality audit. Although there is currently no common basis of a widely used set of quantitative and qualitative audit quality indicators (AQIs), audit firms are understanding and managing their businesses very well and should know what the influencing parameters are, Mr. Bose said (*“you cannot manage what you cannot measure”*). Members and guests discussed the path to a more common set of audit objectives.

There was a consensus among audit chairs, regulators, and the audit profession that those stakeholders should share a common set of AQIs. Several members responded that it would indeed be helpful for regulators to lead in this fashion. One member issued a *“plea”* for it, while another said, *“It would be useful to have guidelines that the regulator looks at.”* The member went on to explain that guidance on AQIs shouldn’t only be too detailed. *“Having something granular would be too much. General guidelines would help.”*

Some members hoped for greater communication between regulators and audit committees regarding inspections. *“As audit chairs we’re responsible for coming to our own conclusions on quality. But we need official information from the audit inspection, which currently is not the case. The regulator should ask the auditor firm to inform us on an inspection,”* a member said. Another member agreed: *“We are, in a way, partners. So, yes, you should release these reports.”*

Members also described some of the methods they currently use to assess audit quality:

- **Audit firms’ quality reviews.** Members said that the audit firms’ engagement-level self-assessments are useful. *“Every audit firm has internal review standards,”* one member said. *“They know somebody else looks into it. I get documented reviews of their quality on my desk.”*
- **Reviews from stakeholders.** One member said, *“Annually, we question stakeholders on the quality of the auditors’ work. Then we have quality assurance with internal and external reviews. Having done two tender processes, I know it’s a good way to compare auditors across the globe where it’s relevant. Transparency is important.”*

- **Management surveys.** Surveys of the members of management who interact with the audit firm can be useful, a member said, but they can be more useful when they are conducted frequently and in conjunction with other resources. A member said, *“We have a yearly survey, but one shot is insufficient.”*

## Audit technology: the benefits and challenges of a redefined audit

The *Audit Committee Realities* report examines how audit committees perceive the use of technology as a distinguishing factor in the audit tender process. Members and guests emphasized that technology is critical to audits and will continue to evolve and improve audit quality. *“I’m optimistic about technology,”* a member said. *“It brings so much to the audit and the operations of our companies. I think it will provide opportunities like we haven’t had before.”* Mr. Bose concurred, saying, *“I’m delighted about what technology can do.”* But he cautioned, *“We as regulators have to be realistic.”*

### Data analytics provides new insights and value

Data analytics can improve audit coverage and precision—and thereby improve audit quality—by drawing conclusions about massive amounts of information. Mr. Bose said, *“Of course, when you look at audit technology, you’re looking at audit quality in the first place. But it’s also about added value from audit results audit chairs could be interested in. Insofar as added value is ‘only’ a byproduct.”* For example, audit firms can use data analytics to achieve a better understanding of risk, which enables them to develop more effective audit plans.

Mr. Bose explained that the key task for auditors is to use the right data in a thoughtful way in conjunction with internal controls. *“From a regulator’s standpoint, the point is audit quality and the old question, Is it garbage in and garbage out?”* he noted. The data used to have to be complete, correct and consistent. *“If you’re using an analytics tool, then you have to make sure the control environment to capture each business transaction and its related data is efficient and working.”* A member raised the same concern: *“We need controls around the input. With technology, it’s in concept the same as the job we’re doing, but a little more sophisticated.”* The member went on to explain that technology will continue to transform the control environment, the audit, and the audit committee’s role in these functions—but with a fresh set of uncertainties: *“We’ll probably have much more data mining. These data will theoretically enable us to address the right issues. I hope that, in the end, we do.”*

Mr. Bose identified additional things to be mindful of when using data analytics:

- **Deliver data in a usable format.** *“The most important area is the purposeful use of these tools. There are different ways to deliver data. You cannot just deliver data. In many cases you have to structure and to adjust them, then deliver them in a certain format required by the auditor. This could take time, cost money, and use resources.”*
- **Maintain data security.** It’s important to know the answer to these questions when it comes to data processing, he said: *“Where are the data—in the cloud of a service provider, the*

*firm's own IT system, or just an auditor's PC. Is it held domestically or abroad? Who has access to the data? Etc."*

- **Balance quality with efficiency.** *"In the past there were a limited number of samples to be audited. Now we analyze millions of transactions, but possibly with several thousands of outliers," he said. "These have to be grouped and analyzed and the auditor has to come to a conclusion basically for all of them. There is more quality, maybe, but not necessarily more efficiency."*

### Technology helps automate and manage the audit

Audit software is improving audit planning and execution. Mr. Bose explained that such software *"guides the auditor through the audit process"* according to auditing standards and firm's audit methodology. It supports the documentation and the supervision and review processes of an audit. Mr. Bose's overall assessment of auditors' increased reliance on technology across the audit process was positive: *"Specifically in audits with effective supervision and review, we've seen fewer inspection findings than in others where this wasn't the case."*

Mr. Bose also discussed project management tools, which essentially help to monitor the audit process or a portfolio of different audits. Managing an audit as a project gives the opportunity to see whether the audit is on time and certain milestones have been reached at a predefined point in time. Together with sharing platforms the clients and auditors in multiple locations can better be involved in the audit. Documents can be provided to each other and outstanding deliverables of both sides can be monitored and managed. This technology helps to detect inefficiencies and quality issues during the audit rather than after the fact when the audit opinion has been issued.

### Conclusion

Three years into the implementation of the ARD, Europe's audit market remains in the middle of a major transition. Stakeholders continue to debate the effects audit-firm economics and nonaudit services have on auditor independence and audit quality. Audit chairs and regulators, as informal partners in monitoring audit quality, have opportunities to enhance their collaboration on this front, by sharing information and developing AQIs. Technology is transforming the way audits are delivered, and audit chairs and regulators—not typically experts in these technologies—are working to stay abreast of technology's benefits and unanticipated pitfalls. At the same time, investors' expectations about corporate reporting are changing and they seek more structured disclosures of nonfinancial and intangible information along with financial data. This demand could lead to a marked evolution in corporate reporting in the future.

## About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisors as they endeavor to fulfil their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, management, and advisors who become systematically engaged in this dialogue, the more value will be created for all.

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## Appendix 1: Guest biographies

- **Ralf Bose** started his career with KPMG in Frankfurt in 1991 in the financial services department. During his time at KPMG, he passed the exam for the qualification as a German qualified auditor and was promoted to a partner in 2001. As a partner, he was responsible for the audit of many different internationally operating credit institutions with both investment and retail banking backgrounds. He served listed and nonlisted clients in corporate banking and transaction banking sectors and in private equity/venture capital businesses. In his recent years at KPMG, he was a managing partner (co-head) of the audit financial services department of KPMG in Germany, responsible for finance, organization, quality, and human resources functions. In 2012, he joined the German Auditor Oversight Body as head of the unit responsible for the inspection of auditors of public-interest entities. With the establishment of the new competent authority for auditor oversight in Germany in June 2016, Mr. Bose took over as its chief executive director. In July 2016, he was elected as the first chairman of the newly established Committee of European Auditing Oversight Bodies. In April 2017, he was nominated as board member of the International Forum of Independent Audit Regulators.
- **Alain Deckers** has over 20 years of experience in public service at the European Commission. He has been responsible for policy reviews and policy development in areas including trade in goods, environmental policy, public procurement, and financial services regulation. He currently heads a team responsible for corporate reporting—including both financial and nonfinancial reporting, audit, and credit rating agencies—as part of the Directorate-General for Financial Stability, Financial Services and Capital Markets Union. He is also the vice chairman of the European Corporate Reporting Lab @ EFRAG Steering Group. Mr. Deckers holds a B.Sc. in physics and a master's degree in the economics of technical change, both from the University of Manchester, UK.

## Appendix 2: Participants

The following EACLN members participated in all or part of the meeting:

- Carolyn Dittmeier, Assicurazioni Generali
- Renato Fassbind, Nestlé and Swiss Re
- Byron Grote, Tesco, AkzoNobel, and Anglo American
- Catherine Guillouard, Airbus
- Sian Herbert-Jones, Air Liquide
- Dagmar Kollmann, Deutsche Telekom
- Nasser Munjee, Alumnus
- Helman le Pas de Sécheval, Bouygues
- Pierre Rodocanachi, Alumnus
- Guylaine Saucier, Wendel
- Erhard Schipporeit, RWE
- François Thomazeau, Bolloré

EY was represented in all or part of the meeting by the following:

- Jean-Yves Jégourel, EY EMEIA Assurance Leader
- Alain Perroux, EY Managing Partner, Western Europe & Maghreb Region
- Julie Teigland, EY EMEIA Area Managing Partner

### Appendix 3: Discussion questions for audit committees

- ? Are audit firms and audit partners underpaid? Overpaid? Does the current market for audit services adequately compensate auditors and attract the right talent?
- ? What is the relationship between audit quality, independence, and audit-firm profitability? How can these be realigned?
- ? How, if at all, do audit firms' advisory services arms affect the quality and independence of their audit work?
- ? How do you measure audit quality? Should there be a universal set of audit quality indicators?
- ? How is audit technology affecting audit planning and management?
- ? How are data analytics changing the audit?
- ? Where is audit technology likely to go? How will it change the audit?
- ? How does audit technology affect audit quality and your choice of auditor?

## Endnotes

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<sup>1</sup> Regulation (EU) No 537/2014 of The European Parliament and of The Council of 16 April 2014 on Specific Requirements Regarding Statutory Audit of Public-Interest Entities and Repealing Commission Decision 2005/909/EC, *Official Journal of the European Union*, Volume 57 (May 27, 2014), L158/77.

<sup>2</sup> Regulation (EU) No 537/2014 of The European Parliament and of The Council of 16 April 2014 on Specific Requirements Regarding Statutory Audit of Public-Interest Entities and Repealing Commission Decision 2005/909/EC, L158/77.

<sup>3</sup> Regulation (EU) No 537/2014 of The European Parliament and of The Council of 16 April 2014 on Specific Requirements Regarding Statutory Audit of Public-Interest Entities and Repealing Commission Decision 2005/909/EC, L158/77.