



Who watches the watchers?

Observers on audit committees

The Audit Committee Institute

Part of the KPMG Board Leadership Centre



The Final Report of the Competition and Market Authority's (CMA's) Statutory audit services market study includes the recommendation that the new audit regulator, the Audit, Reporting and Governance Authority (ARGA), should have the power to, if they consider it necessary, place an observer on the audit committee to monitor compliance with minimum standards for both the appointment and oversight of auditors. Furthermore, the CMA recommend that regulator should take remedial action where necessary, by for example issuing public reprimands, or making direct statements to shareholders in circumstances where it is unsatisfied with Audit Committees.

Could there be unintended consequences? What challenges might such a recommendation bring if put into practice, and how might audit committee members adapt to an observer on the audit committee?

Audit committee agenda

Many audit committees find it "increasingly difficult" to oversee the major risks on the audit committee's agenda in addition to their core oversight responsibilities over financial reporting and controls, and internal and external auditors¹. Would the attendance of an observer – someone less familiar with the company and its issues than the audit committee members – throw the agenda and timings out further? Might the committee feel the need to spend more time on 'context' to ensure the observer has a full understanding of the issues being covered, the decisions made and the background to those decisions?

Perhaps the conscious provision of a short amount of additional time for the first couple of observed meetings (or more comprehensive audit committee papers - which many argue are already too long), might alleviate the situation and help ensure that the usual business of the committee can be dealt with effectively until the arrangement beds in.

Audit committee papers

If the audit committee papers are shared with the observer in advance of the audit committee meeting (and that is not clear) then the background information contained therein may provide the observer with sufficient context so as not to adversely impact the length, conduct and flow of the meeting – but equally greater thought and attention might be required when drafting papers that will be meaningful to an observer as well as the audit committee members themselves.

¹ ACI Global Audit Committee Survey, KPMG, 2019

Focus and scope creep

Today's audit committees generally have a broad remit. Even the core oversight responsibilities span financial reporting, internal control and risk management, and internal audit – as well as the sole focus of the CMA recommendation, the appointment and oversight of external auditors. Will the regulator's narrow focus reshape the audit committee's work programme and redefine the time they devote to different areas of their role? It would be unfortunate that if in pursuit of better oversight of external audit, audit committees neglected other important elements of their remit. In practice it is difficult to see how the observer would be able to limit their remit to the appointment and oversight of auditors – so scope creep is also a possibility.

Pre-meetings

Will having an observer in attendance at the audit committee meeting drive the audit committee into either making decisions outside the audit committee room (poor governance) or more likely rehearsing the meeting in advance to help ensure a 'clean bill of health'? On the one hand a well prepared audit committee is a good thing – but equally it could both add to the committee's workload and present an observer with arguably an artificial view of the committee's normal practices.

Grandstanding

Will an observer encourage 'grandstanding' whereby one or more individuals dominate the meeting in a (perhaps unconscious) bid to demonstrate their strengths, skills or experience? Taking a long time to make a point and excessive use of 'war stories' can be lead to both inefficiencies and discord. Strong chairmanship is essential to ensure that all committee members have an opportunity to contribute and a chance to convey opinions and views in a manner that is not detrimental to others or the conduct of the meeting.

Challenging for challenge's sake

Will audit committee members, consciously or otherwise, be tempted into challenging issues that might normally go unchallenged – in effect challenging for challenge's sake because they believe it is what the observer expects to see? While appropriate challenge is questioning is a good thing, it would be unfortunate if immaterial matters were to disrupt the proper functioning of the meeting. Again, strong chairmanship is key here, alongside techniques such as taking points of detail off-line away from the committee meeting where appropriate.

Relationships

Any audit committee changing its modus operandi and the degree and style of its 'challenge' risks impacting its relationship with the executives and audit professionals it comes into contact with. This could have both positive and negative consequences. Done properly, executives and auditors will have clarity over the audit committee's expectations and be motivated to provide the high-quality information the audit committee needs to provide effective oversight. However, there is a danger that a committee falling into the trap of 'challenge for challenge's sake' risks destroying the very relationships it needs to do its job. The ideal place to be is a balanced relationship where those working with the audit committee look to the committee as a useful partner or sounding board rather than a necessary corporate governance burden. The exchange of information flourishes in such circumstances and that leads to better oversight.

Less debate/challenge

Alternatively, an observer could potentially stifle the audit committee debate with individual members being inclined to collegiality - particularly if it is a 'mature' audit committee that believes itself to be highly effective. Not wanting to undermine colleagues or prevent a disunited front in the presence of a third party could result in lack of challenge, and ultimately the ability of the chair to encourage the probing questions, bring individuals in to the fold, and spark a healthy productive debate.

Planning ahead

The audit committee chair has an essential part to play in ensuring an observer contributes positively to the effectiveness of the committee rather than undermine it. Strong chairmanship, great questioning and the ability to manage different personalities on the committee will provide a great foundation. Other areas audit committees might want to consider might include the audit committee chair seeking advance feedback from the audit committee members on their thoughts about observed meetings and how they might work best for everyone. Also, seek to avoid confusion and speculation by working with the observer to establish their modus operandi, any ground rules, and the expectations of audit committee members.

- What are their concerns? What do they think the committee might not be on top of?
- How frequently will the observer attend meetings?
- Is it the same observer each time?
- Their approach at the meeting – e.g. totally passive?
- Papers they will want to see in advance
- Any follow-up /reporting that the committee can expect

Actual face-time across the audit committee table is really precious. Audit committee meetings should be well thought-out and structured in a way that allows the committee to make the most of its time together and it's vital that anything introduced as a result of the CMA's recommendations does not undermine an important aspect of board operations. We have many useful resources on our BLC website to help audit committees be effective including:

[150 Audit committee best practices](#)

[Effective conversations](#)

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