Audit Committee Excellence Series

Achieving excellence: Overseeing external auditors

September 2014

PwC's Audit Committee Excellence Series (ACES) provides practical and actionable insights, perspectives, and ideas to help audit committees maximize their performance. This edition is about effective oversight of external auditors.

This ACES module discusses overseeing the external auditors, including:

1. Why the external auditor relationship is so important
2. Communications with the external auditor
    - Private sessions
    - The chair's working relationship with the lead audit partner
3. Auditor independence, preapprovals and multi-location audits
4. External auditor relationship with internal audit
5. Other parties whose influence the committee should be aware of
    - Public Company Accounting Oversight Board (PCAOB)
    - Center for Audit Quality (CAQ)
    - Proxy advisory firms
6. Evaluation of the external auditor

1. Why the external auditor relationship is so important

A fundamental responsibility of the audit committee is to oversee the integrity of the financial statements of the company. The audit committee undertakes this task in an environment of elevated expectations from various groups including investors, regulators and proxy advisors. Audit committees, management and the external auditor need to work together with a common goal of furthering the public interest in the Company issuing reliable financial statements.

2. Communications with the external auditor

Auditing standards *require* external auditors to communicate certain information to the audit committee. The question for audit committees is whether the robustness of that communication could be enhanced.

Some audit committees have developed practices to enhance their communications with the external auditor, including:

- Receiving all required communications in writing well before the meeting and reviewing them in advance
- Focusing the discussion with the external auditor on the more sensitive and judgmental areas instead of listening to a recitation of the prepared materials
- Probing deeper and engaging in a discussion of specific examples, audit areas, and facts and circumstances that underlie important areas

Communication with the external auditor can also be more effective when meetings aren't scripted. On the one hand, this approach generally keeps unexpected items from coming up and some believe leads to more time efficient meetings. However, scripts can have a dampening effect on robust, open conversations. Asking open-ended questions and seeking individual opinions on various topics can be an effective approach to moving past scripted dialogue.

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Private sessions

The importance of private sessions between the audit committee and the external auditor, without the CEO, CFO or other members of management in attendance, cannot be overstated. There may be times when the dialogue about the company's culture, financial reporting issues, operations, or other matters may be more candid without management present. Private sessions should occur at each in-person audit committee meeting. The established routine can reduce awkwardness if an issue arises that necessitates private discussions between the external auditor and the audit committee.

Usually private sessions are left until the end of the audit committee meeting. If there are time constraints that limit an effective discussion, the opportunity for meaningful interaction and sharing of perspectives may be lost. Audit committees should ensure sufficient time and energy is allotted for private sessions.

The chair's working relationship with the lead audit partner

The strength of the working relationship between the audit committee chair and lead audit partner sets the tone for the interaction between the committee and the engagement team and the firm as a whole. The most effective ones foster candid discussions and contribute to audit committee excellence. The lead audit partner should meet face-to-face with the audit committee chair periodically (e.g., quarterly, semi-annually or annually). A meeting of this sort may not require a formal agenda. Starting with the current status of the interim review or annual audit and related topics will often stimulate discussion. The meeting will help both participants understand any concerns the other may have and give each a view into the perspectives of the other.

Another important aspect of the audit committee's relationship with the external auditor is his or her involvement in the selection and evaluation of the lead engagement partner. The chair should assess his or her ability to effectively communicate with the partner. And the performance of the lead partner is an essential aspect when it comes to evaluating the external auditor.

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Audit committee considerations:

- Evaluate whether the committee is having a sufficiently robust dialogue during its meetings.
- Have regular private sessions with the external auditor.
- Ask the external auditor open-ended questions to get an understanding of its perspectives.
- Ensure an in-depth discussion and adequate understanding of the external auditor's perspective any time they express concerns about a particular accounting, internal control, or disclosure issue.
- Evaluate the frequency of, or the need for, one-on-one meetings between the chair and the lead engagement partner.
- Consider the level of audit committee involvement in the selection and evaluation of the firm and the lead engagement partner.

3. Auditor independence, preapprovals and multi-location audits

Independence in fact and appearance is a shared responsibility that is core to the auditor's relationship with the company. The SEC has rules on auditor independence which boil down to whether the auditor is capable of exercising objective and impartial judgment in completing the audit.

The audit committee needs to monitor the audit firm's independence and consider all relationships between the auditor and the company, company management, and the directors in assessing independence. And remember, the external auditor reports directly to the audit committee and the committee approves all services and fees.

Preapproving auditor services

For U.S. public companies, SEC regulations require that audit committees preapprove audit and non-audit services. The company should have internal procedures in place that require employees to get audit committee preapproval for services to be provided by the external audit firm. There should also be controls designed to prevent the provision of certain services that are prohibited by SEC rules. The audit committee should understand the company's preapproval protocols and assess their efficacy. Compliance with these protocols is often particularly challenging for company personnel at international locations and should be an area of focus.

Most audit firms have a reporting system in place to obtain approval before any work is performed, but this is not a substitute for a company having its own controls.

Here are some key points in this area:

- It is important to make sure that all parties (audit committee, external auditor and management) have an understanding of the limitations on services and fees when requesting approval for audit and non-audit services.
- Many times an audit committee will preapprove permitted services up to certain dollar thresholds. If needed, management, in consultation with the audit firm, will request approval for incremental fees in advance of incurring the work if preapproval limits are exceeded. The audit committee should satisfy itself that this protocol is understood by the company and the auditor.
- For companies with international operations, fee tracking can get difficult when you add in the complexity of currency translation on foreign fees.
- The same procedures and controls established for preapproval typically generate the fee information to be summarized in the proxy statement.

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Multi-location audits

When companies have operations in multiple locations and countries, the corporate audit team often uses the work of other auditors that may or may not be part of their global network of firms. In either case, the audit firm participating in the audit receives instructions from the corporate audit team regarding the level of services requested. The instructions may call for a full scope audit – basically an opinion on the local entity's financial statements based upon a materiality level determined by the corporate audit team. In other situations, procedures may be requested on only certain accounts, referred to as specified procedures. Upon completion of the work, the participating auditor generally issues a report and correspondence to the corporate audit team with the results of their procedures before the consolidated audit opinion is issued.

Audit committees should understand the extent of involvement of other auditors participating in the consolidated company audit as well as the timing of the completion of the work. The capabilities and credentials of the individual partners signing off on the most significant operations, as well as significant findings may be of interest to the committee.

Statutory audits

Although most of a company's international subsidiaries may be required to file statutory audits on the separate local entity accounts to meet local requirements, the timing of completion may not allow a corporate engagement team to leverage the work performed. It is common for statutory audits to be finalized well after the consolidated audit is completed and the financial statements issued. If not completed at the date the external audit opinion is issued, this work cannot be considered to provide direct audit evidence for the consolidated audit of the current period.

Audit committee considerations:

- Evaluate whether adequate controls exist to ensure appropriate preapproval and capture of all fees, audit and non-audit.
- Consider whether controls are sufficient to evaluate if requested services are permitted or prohibited.
- Consider the role and capabilities of other offices performing significant work on the consolidated audit.

4. External auditor relationship with internal audit

For an external auditor to use the work of internal audit, the external auditor is required to evaluate the competency and objectivity of internal auditors, and evaluate and test their work. This can take considerable time and effort. Also, the focus of many internal audit functions has become increasingly separated from financial statement and internal control over financial reporting audits. This can create challenges for the external auditor. Internal auditors may need training on the particular approach and documentation requirements of the external auditor before they can participate in an audit.

Audit committees should assess the most effective ways to maximize the value proposition of both the internal and external audit functions. Periodically asking the right questions about the external audit coordination with internal audit may further contribute to audit committee excellence.

5. Other parties whose influence the committee should be aware of

Effective audit committees should have an understanding of the forces that influence the external auditor as well as other parties that could potentially impact the audit committee. These forces are sometimes regulatory (PCAOB, SEC) and sometimes involve other influencers like proxy advisory firms. Some of the outside forces committees should be aware of include:

Public Company Accounting Oversight Board (PCAOB)

The PCAOB is the external audit firms' regulator for audits of public companies. Among its responsibilities, the PCAOB inspects registered public accounting firms to assess compliance with the relevant standards.

Audit committees should understand the potential impact of a PCAOB review of the external audit. If a PCAOB review identifies audit deficiencies that require remediation, it can affect the auditor's ability to reissue its audit opinion until the remediation is resolved, which could delay a company's public offering of its securities or debt. Audit committees focused on excellence should obtain timely information about the results of a PCAOB review of their company's audit as well as the timing and nature of any required remediation of audit deficiencies.

The PCAOB also establishes auditing and related professional practice standards for registered public accounting firms to follow in the preparation and issuance of audit reports. Current PCAOB projects and areas of focus that audit committees should be aware of include:

- *Identifying critical audit matters (CAMs) in the auditor's report*. The PCAOB believes auditors have relevant insight that should be communicated to users of the financial statements in the auditor's report. Among other items, they have proposed disclosure of the most difficult, subjective, or complex auditor judgments.
- *Disclosing the audit partner and other participants in the audit*. The PCAOB has proposed amendments requiring the audit firm to disclose the name of the engagement partner on the most recent period's audit and the names, locations, and extent of participation of other public accounting firms (including network firms) that took part in the audit.
- *Review of participating auditors' work*. In cases where network firms, or other firms, in foreign countries are conducting audit procedures for certain operations, the PCAOB wants the opportunity to inspect those audits.

Center for Audit Quality (CAQ)

The CAQ is an autonomous, nonpartisan, not-for-profit group whose vision is to enhance investor confidence and public trust in the global capital markets.

In 2013, the CAQ called for audit committees to voluntarily expand the disclosures included in the audit committee report in the proxy statement[1]. They suggested that additional disclosures would help investors and others better understand and inspire confidence in the audit committee. PwC's BoardroomDirect Special Edition: Audit Committee Disclosure dated November 20, 2013, discusses this release.

Audit committees striving for excellence should consider whether some or all aspects of this proposal make sense for their own audit committee report. Some items suggested for enhanced disclosure include:

- The audit committee's duties
- The audit committee's composition
- Relevant factors when selecting or reappointing an audit firm
- The committee's involvement in the selection of the lead audit engagement partner
- Factors the committee considers when determining auditor compensation
- Information about how the committee oversees the external auditor
- Information about the process for evaluating the external auditor

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Proxy advisory firms

Proxy advisory firms make proxy voting recommendations to their subscribers. Institutional Shareholder Services and Glass Lewis are the largest organizations in this industry. Their policies relative to developing their voting recommendations can influence the practices of listed companies related to their audit firms. For example, if the ratio of nonaudit to audit fees is considered excessive, the proxy advisor may recommend a vote against the ratification of the external auditors.

6. Evaluation of the external auditor

A thorough evaluation of the external auditor's performance is critical in achieving excellence. The evaluation should consider whether the performance of the auditor and the quality of the auditor's communications with the committee meets the audit committee's expectations. As part of the assessment, the committee should also consider the auditor's independence, objectivity and professional skepticism. Audit committees can reference the October 2012 CAQ

[1] http://www.thecaq.org/reports-and-publications/enhancing-the-audit-committee-report-a-call-to-action

publication about evaluating the auditor, which included sample questions to consider[2].

Audit committees should also consider the perspectives of management and internal auditors in the evaluation of the external auditors.

Audit committee considerations:

- *Understand the allocation of external audit hours between the internal auditor and the external auditor*. Consider whether it maximizes the value contribution of both parties.
- *Discuss the status of proposed regulations that could impact the external auditor*. Address how, if adopted, they would impact the company or the audit committee's relationship with the external auditor.
- *Consider proposals that could impact the committee and discuss the committee's position on these matters*. Consider constituent pressure to expand the audit committee report in the proxy statement as well as the proposals to expand the content of the external auditors' report.
- *Monitor the policies of the proxy advisory firms related to audit fees*.
- *Perform an effective annual evaluation of the external auditor's performance*. Consider the perspectives of management and internal audit in the assessment of the external auditors.

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[2] http://www.thecaq.org/reports-and-publications/audit-committee-annual-evaluation-of-the-external-auditor

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Center for Board Governance.

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Other topics

Other "Audit Committee Excellence Series" topics include:

- Assessing the company's forward-looking guidance practices and the potential risks of consensus estimates (March 2014)
- Financial reporting oversight (May 2014)
- Overseeing internal audit (July 2014)

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