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Overseeing the external auditors

How the audit committee can effectively oversee external auditors during evolving times

As a key component of corporate governance, the audit committee serves as an independent and objective body responsible for overseeing the integrity of financial statements and ensuring compliance with relevant laws and regulations. Regulators view audit committees as vital gatekeepers who act as a check and balance mechanism to protect investors from potential financial misstatements and fraudulent activities. External auditors play a key role in helping the audit committee discharge this responsibility.

SEC rules require the audit committee to be directly responsible for appointing, compensating, retaining and overseeing the work of the external auditors. This makes the relationship between the audit committee and the external auditors important.

Audit committees should look to maximize the value from the external auditor as part of its oversight. In doing so, they should focus on:

-  **Building a strong working relationship with the external auditor**
-  **Helping protect auditor independence**
-  **Going beyond required auditor communications**
-  **Assessing the performance of the auditor**
-  **Communicating how the committee fulfills its oversight role in proxy statement disclosures**

"We remind audit committees of their role as critical gatekeepers for investor protection through oversight of a high-quality audit and the benefit of having an audit committee that is independent of management."

Source: Munter, Paul. "An Investor Protection Call for a Commitment to Professional Skepticism and Audit Quality." U.S. Securities and Exchange Commission. February 5, 2024.





Building a strong working relationship with the external auditor

A strong working relationship between the audit committee chair and the lead audit partner is vital. The strength of this relationship sets the tone for interactions between the committee and the external audit firm.

Creating the right relationship requires continuous communication, open and candid dialogue, and the ability to raise and address sensitive issues. Trust is the foundation. How do you build such a relationship? Here are some leading practices:

- Be active in selecting the lead audit partner**

Play a key role in the external auditor's assignment of the lead audit partner. Consider the individual's skills, experience, schedule capacity, cultural fit, communication style and other criteria. Being active in the selection process also helps begin the relationship with the lead audit partner right away.

- Set clear expectations**

Discuss the audit committee's expectations with the lead audit partner upfront. The discussion can be a valuable opportunity to set the tone, define cadence and the preferred format of communications, and reinforce the need to raise issues timely.

- Have regular meetings with the lead audit partner**

In between audit committee meetings and in preparation for upcoming meetings, the audit committee chair should have informal one-on-one meetings with the lead audit partner. This promotes candid and timely discussions of issues and concerns and helps develop a strong working relationship.

- Make the most out of private sessions**

Many audit committees have periodic private sessions with the external auditors, and some are required to do so. Use this unstructured time effectively to ask candid questions, inquire about sensitive topics and have confidential conversations.

- Ask open-ended questions**

Asking the external auditors open-ended questions can provide an understanding of their perspectives about sensitive and judgmental policies, accounts and transactions. It can also help prevent overly-scripted meetings.

- Go beyond the lead audit partner**

It is important to build a relationship with someone at the audit firm other than the lead audit partner, for example, the senior relationship partner or quality review partner. Having another relationship is particularly important when there are service issues or when assigning a new lead audit partner as part of a required rotation.



Auditor reporting of audit participants

To provide greater transparency into those involved in conducting audits, PCAOB rules require disclosure of the name of the engagement partner. They also require information about certain other accounting firms that took part in the audit (including other firms within the same network as the group auditor). The information is filed on PCAOB Form AP: *Auditor Reporting of Certain Audit Participants* and searchable on the [PCAOB's website](#).





Helping protect auditor independence

Auditor independence is key — both in fact and appearance. It is key because it fosters high quality audits, minimizing the possibility that external factors will influence the auditor's judgment, and it promotes investor confidence in public company financial statements. Various SEC and stock exchange listing rules define what auditor independence means.

Audit committees are responsible for appointing the external auditors. So, they play a major role in overseeing their independence.

"To maximize audit quality, the audit committee should also work to support the auditor's independence and facilitate the auditor's exercise of professional skepticism. This would require the audit committee to form a strong professional relationship with the auditor, independent of management, which can reduce the auditor's barrier to exercising professional skepticism and focusing on its responsibilities to investors."

Source: Munter, Paul. "An Investor Protection Call for a Commitment to Professional Skepticism and Audit Quality." U.S. Securities and Exchange Commission. February 5, 2024.

Auditor independence should not be just left to the external auditors. Instead, it is a shared responsibility among the audit committee, the auditors and management. A few key focus areas when overseeing auditor independence include:

- **Audit services**

Audit committees are required to pre-approve all audit services of the external auditor. For audit services, PCAOB rules require external auditors to affirm their independence in writing. They are also required to disclose to the audit committee all relationships between the audit firm (or any of its affiliates) and the company or persons in financial reporting oversight roles that may reasonably be thought to bear on independence. Together, the audit committee, the auditors and management should have vigorous discussions to determine whether any such relationships could affect the auditor's independence.

- **Non-audit services**

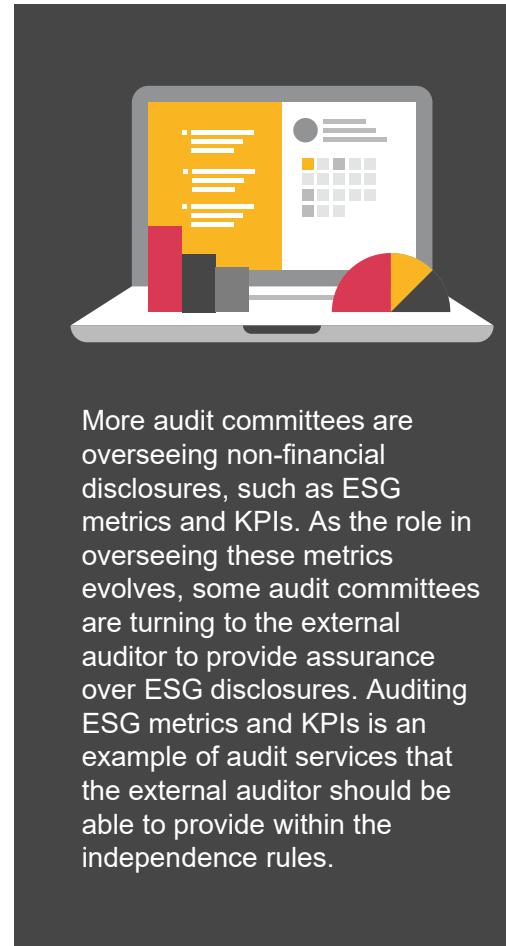
The audit committee must also pre-approve all permitted non-audit services provided by the external auditor. The audit committee should make sure that management and the external auditor have a process for this approval. It should be done prior to engaging the external auditor for the service. The scope of the non-audit services and any potential effects on auditor independence should be discussed with the external auditors and management before pre-approving these services. And, if the external auditor is asked to perform tax or other non-audit services related to internal control over financial reporting, the external auditor is required to provide information about the scope, fees and other details in writing to the audit committee.

- **Hiring of employees or former employees of the external auditor**

A cooling-off period is required before a company can hire certain individuals formerly employed by the external audit firm into a financial reporting oversight role. In addition, consideration should be given to whether any former audit professional from the external audit firm continues to have financial connections with the audit firm (e.g., a pension). By working with management and the external auditor, audit committees can make sure the right process is in place to identify whether any such hiring may impact the external audit firm's independence before hiring decisions are finalized.

- **Impact of significant events**

Sometimes, certain events at the company can impact external auditor independence. This could include acquisitions, mergers, new board members or executive management changes. A process should be in place to ensure the external auditor is notified of any such changes well in advance of their occurrence. In the case of a business combination, navigating the independence process could take time, so involving the external auditor early will allow them to evaluate the impact, if any, on auditor independence before the transaction closes. This gives the auditor and management time to evaluate the impact on independence and resolve any issues in a timely manner.





Knowing what's allowed: SEC permitted services

The audit committee has responsibility for pre-approving audit and non-audit services provided by the external auditor. But they are limited in what they can approve, since SEC rules prohibit certain services. Some services are “categorically” prohibited and can never be performed by the auditor. Others are “conditionally” prohibited services. These services are disallowed unless it is reasonable to conclude that the results of the particular service will not be subject to audit procedures during the audit of the company’s financial statements by the external auditor. That is, the auditor cannot be auditing its own work.

What non-audit services are prohibited by the SEC?

Categorically prohibited services:

- Management functions
- Human resources
- Broker-dealer, investment advisor, or investment banking services
- Legal services
- Expert services unrelated to the audit

Conditionally prohibited services:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services



Non-audit fees and proxy advisory firms

Companies are required, in their proxy statement, to disclose fees paid to their external auditor, including those relating to non-audit services. These disclosures can have a real impact on proxy voting. The two main proxy advisory firms, Institutional Shareholder Services and Glass Lewis, both examine this disclosure and use formulas to evaluate whether they consider non-audit fees to be excessive. If so, they may recommend that shareholders vote against ratification of the auditor. Sometimes they also recommend votes against members of the audit committee. These formulas are publicly available on proxy advisors’ websites. Furthermore, in efforts to enhance transparency, more companies are disclosing the reasons fees have significantly changed year to year.



Going beyond required auditor communications

Auditors are required to communicate certain matters to the audit committee. And the list of required communications is extensive. However, it is also important for the audit committee to provide the external auditor with its views on risks, fraud and other matters. These discussions could be mutually beneficial and promote audit quality.

By taking the conversation beyond just what's required, audit committees can enhance their oversight. They can gain deeper insight into the company on a variety of topics, including:

- **Quality of management and corporate culture**

The external auditor spends a lot of time at the company performing their audit work. They interact with employees and management at all levels. They can share feedback and provide another data point to the board and audit committee on the strength of the finance team, quality of management, tone at the top and corporate culture.

- **Perspectives on non-financial and financial statement disclosures**

Depending on where the disclosure is made, the external auditor has either limited or no responsibility over financial information disclosed outside of the audited financial statements. But the audit committee can ask for the external auditor's point of view on these items. This could include information such as non-GAAP measures in an earnings release or disclosures of critical accounting policies and estimates in MD&A in Form 10-K. Non-financial statement disclosures could include ESG metrics and qualitative data within the company's sustainability report, proxy statement or Form 10-K.

- **Business and industry risks**

Auditors often have a broad view on emerging trends in the industry. They can also share insights on business risks that the entity may be subject to, based on their work in the industry.

- **Audit committee leading practices**

The external auditors meet with many audit committees. They can share their views on [leading practices](#) other audit committees use to enhance their effectiveness and efficiency, such as agenda planning, pre-meeting preparation and meeting materials, among others.

Along with these broader discussions, audit committees can expand the dialogue around the external auditor's required communications to gain a better understanding of audit quality, audit efficiency and the strength of the company's financial reporting. Some topics include:

- Understanding how management plans to adopt new accounting standards or respond to new rules and their level of readiness;
- Reviewing the level of coordination between internal audit and the external auditor (e.g., sharing risk assessment information);
- Inquiring about special or new representations in management's representation letter that may highlight higher risk areas;
- Discussing plans for the external auditor to use new and emerging technologies in the audit;
- Evaluating the level of audit fees relative to the value and quality of work to be performed and opportunities for efficiency improvements; and
- Inquiring about findings from statutory audit work performed, including any "red flags" or themes (e.g., past due reports, qualified audit opinions).

What communications are required?

The external auditors are required to communicate with the audit committee certain things. These topics include:

- **Auditor independence**
- **Audit-related communications: planning**
 - Communications plan
 - Significant issues discussed with management prior to retention
 - Terms of the audit engagement
 - Obtaining information relevant to the audit
 - Summary audit strategy
 - Perspectives on fraud risks
- **Audit-related communications: results of the audit**
 - Fraud
 - Illegal acts
 - Accounting policies and practices, critical accounting estimates, and significant unusual transactions
 - Evaluation of the identification of, accounting for, and disclosure of relationships and transactions with related parties
 - Quality of the company's financial reporting
- Alternative accounting treatments
- Changes to the planned audit strategy
- Identified misstatements
- Material uncertainties related to events and conditions (specifically going concern)
- Control deficiencies
- Other information in documents containing audited financial statements
- Disagreements with management

- **Other matters**
 - Consultation with other accountants
 - Significant difficulties encountered in performing the audit
 - Other material written communications
 - Fees
 - Difficult or contentious matters
 - The auditor's report, including critical audit matters
 - Auditor quality control procedures
 - Other matters

For additional information on required communications, refer to the [PCAOB's website](#).



Critical audit matters (CAMs)

CAMs, which are included in a separate section of the auditor's report, are matters that are required to be communicated to the audit committee, relate to accounts or disclosures that are material to the financial statements, and involve especially challenging, subjective, or complex auditor judgment. Discussions with management and the external auditors are important to understand the types of matters that may be CAMs based on the company's facts and circumstances and the nature of the auditor's planned communications about such matters.



Assessing the performance of the auditor

Effective audit committees share their feedback, including issues and opportunities for improvement with the external auditors. They hold external auditors accountable for action items coming out of the assessment.

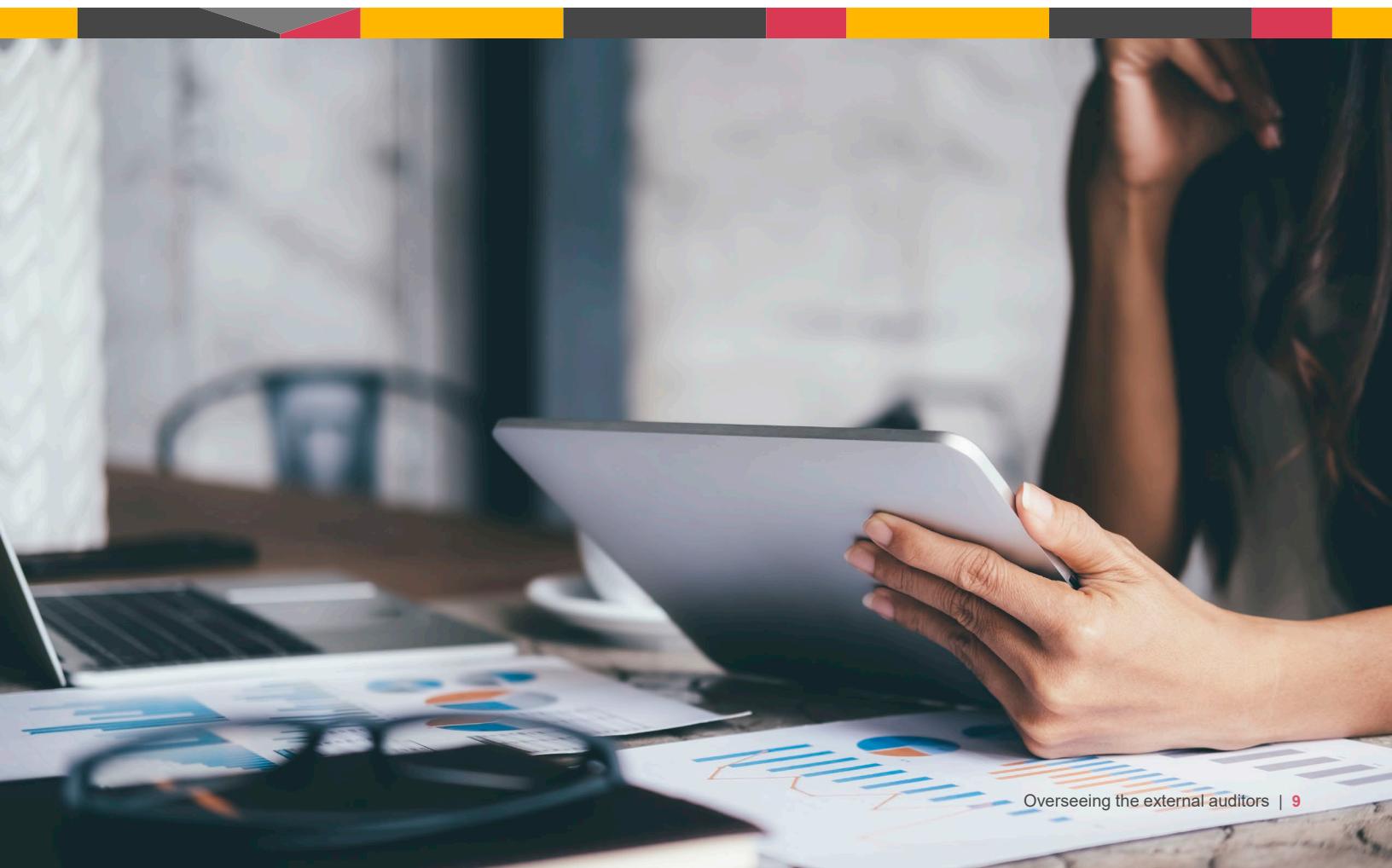
Assessing external audit quality is an area audit committees should continuously focus on. Commitment to audit quality begins with an independent audit committee selecting and overseeing the independent auditor, prioritizing quality to encourage auditors to compete based on their ability to perform high-quality audits. The audit committee should regularly assess the auditor's performance to ensure quality. For more on how regulators view the audit committee's role in audit quality, see the [SEC's website](#).

What should be assessed?

The Center for Audit Quality released a tool to help audit committees with evaluations. The [External Auditor Assessment Tool](#) provides a general framework and contains sample questions. The sample questions cover:

- Quality of services and sufficiency of resources provided by the external auditor;
- Communication and interaction with the auditor; and
- Auditor's independence, objectivity and professional skepticism.

Another area on which the auditors should be assessed is their continued focus on audit quality. Auditors are turning to technology in order to improve quality and provide audit efficiencies.



How often should the auditor be assessed and what are possible methods?

Leading practice is to evaluate the external auditor's performance at least annually. Methods for evaluating external auditors vary. Some audit committees use surveys to understand management's views. Others use informal discussions. We recommend that audit committees get management involved. The perspectives of the chief financial officer and chief audit executive can be especially useful. But the key is to focus on what is most important to the audit committee. Audit committee members who serve on other audit committees can also share their experiences working with other external auditors.

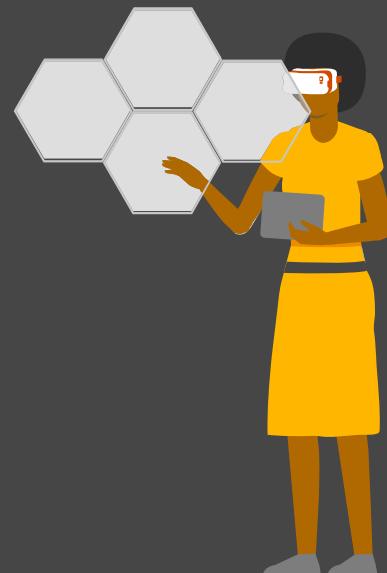
Understanding how technology could improve audit quality

Auditors are making significant investments in their people and technology to transform the audit experience. Gone are the days of vouching a sample of invoices and tracking the results in an Excel spreadsheet. You should expect your auditors to have the ability to use bots to perform mundane repetitive activities, extraction technology to pull data and move away from sampling to viewing complete data sets.

As a result, new technology enables them to automate the extraction and analysis of data from a company's information systems, eliminating the manual processes of data gathering — a burden on both the finance and audit teams.

Also, new technologies should allow the auditor to focus on deeper analysis of complete data sets using data auditing and visualization tools instead of evaluating smaller samples. Having the complete picture of the business lets the auditor spot emerging business risks, create more precise audit plans, potentially detect fraudulent activity and identify accounting anomalies requiring follow up. This access to data should allow the auditor to get better evidence to support the audit report and provide deeper insights about the broader business to management and the audit committee. The audit committee may want to consider asking the auditor the following questions:

- What potential risks have the external auditor identified in the company's financial reporting processes, controls or systems that could be impacted by company-implemented artificial intelligence (AI)?
- How is our external auditor using technologies like data analytics, cloud services and AI to improve our company's audit?
- How integrated is the technology our auditor uses?
- How is our auditor helping reduce the time and effort our own people spend on audit-related work?
- What digital skills do our auditor's teams have, and how do they use them to improve our audit?
- What kind of data visualizations and insights does our auditor offer to add value?



The PCAOB's influence

The role of the PCAOB

The PCAOB regulates how external audit firms audit public companies. They set auditing and related professional practice standards that must be followed by registered public company accounting firms as they prepare and issue audit reports. The PCAOB also inspects these firms to make sure they are complying with those standards.

The audit committee should know:

- How any new or emerging PCAOB auditing standards could impact the company's audit;
- How the PCAOB's annual inspection process of registered public accounting firms could impact the company's audit;
- If the company is selected for a PCAOB inspection, what are the protocols for timely notification to the audit committee, the potential impact on any planned public filings, and the results of the review and any necessary responsive actions; and
- The audit firm's processes to address prior year PCAOB inspection reports. In addition, the audit committee may want to review other audit firms' inspection reports, to see if there are any lessons learned or similar issues.

Audit committees could also review the audit firm's annual quality report as a measure to evaluate the audit firm. Some audit firms release a quality report which includes similar data points to those discussed above, and could provide additional insights.





Communicating how the committee fulfills its oversight role in proxy statement disclosures

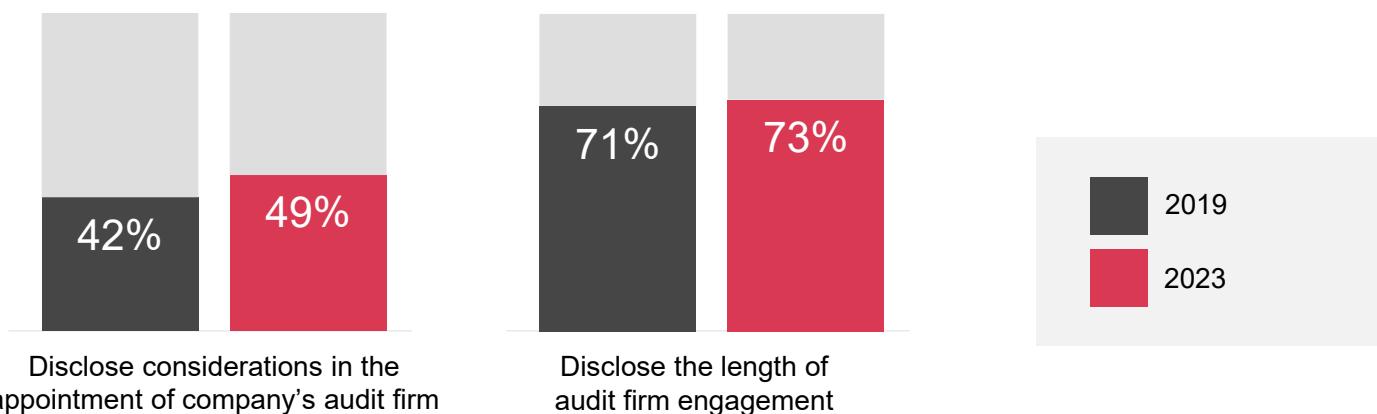
Shareholders and proxy advisory firms continue to want to know more about how the audit committee discharges its responsibilities, including its oversight of the external auditors. They consider such information in voting on whether to ratify the appointment of the external auditors as the company's independent registered public accounting firm. And additional disclosure in the proxy statement can help them make that decision.

As a start, audit committees can ask management to benchmark their disclosure. By comparing how their description of oversight of the external auditors compares with that of peer and competitor companies, they might see areas for improvement. The committee can also ask management to draft a sample enhanced disclosure, to consider what they might include.

Transparent disclosure describing the criteria used by the audit committee in their external auditor evaluation process is becoming more and more common and expected by investors.

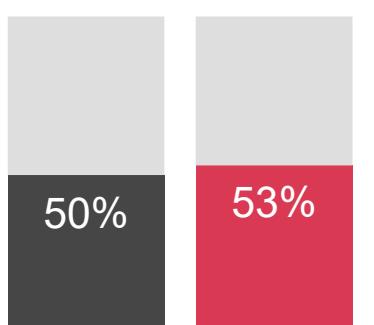
Increase in S&P 500 companies' disclosure around external auditor oversight

Audit firm selection/ratification



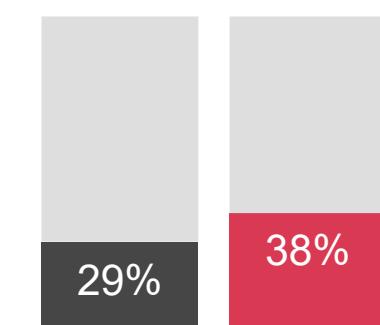
While there is a requirement for external auditors to include their firm's tenure in the audit report, there has been an upward trend in the number of companies voluntarily disclosing their perspectives regarding their audit firm's tenure.

Audit partner selection



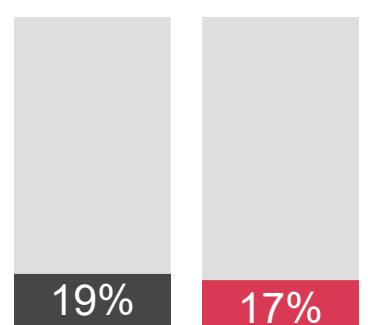
State that the audit committee is involved in audit partner selection

Audit firm evaluation/supervision



State that evaluation of the external auditor is at least an annual event

Audit firm compensation



Disclose the audit committee is responsible for fee negotiations



Robust oversight leads to maximized value

Quality financial reporting is critical to the efficiency of the capital markets and protecting investors' interests. The audit committee's role in overseeing the external auditor and the company's financial reporting process is a key part of this. Building a strong relationship with your external auditors while keeping an eye on independence and holding them accountable through an annual assessment process will help the audit committee deliver on their oversight role. Transparent disclosure of their efforts will address the heightened expectations from shareholders, regulators and other stakeholders. This robust oversight process will ensure that the audit committee gets the most value from their external audits.

For more information

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

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