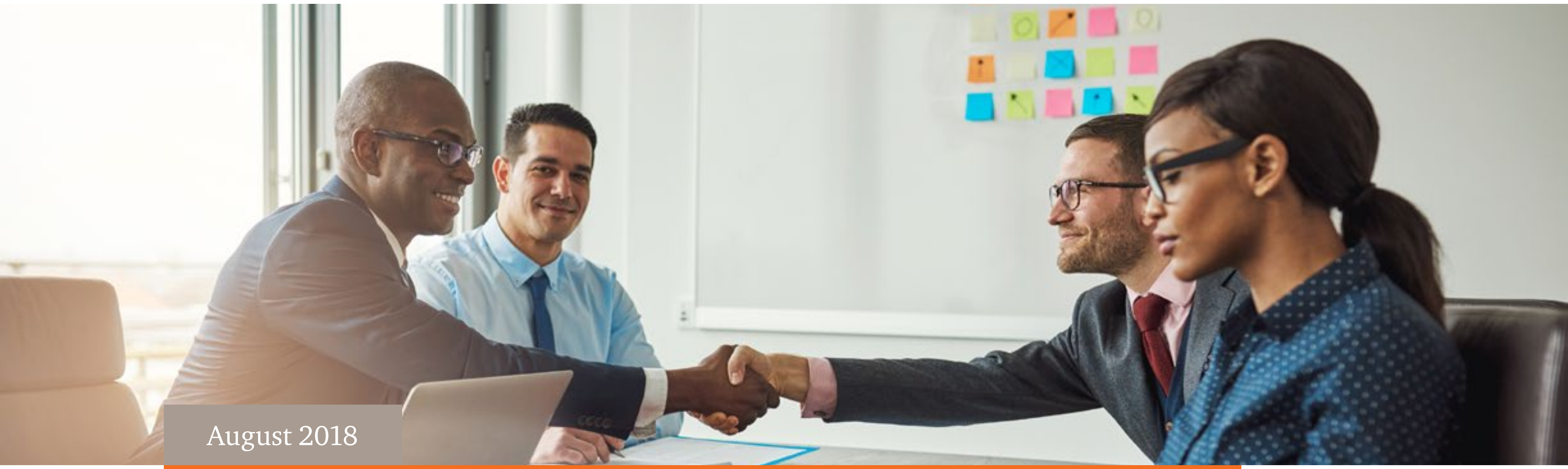
Governance Insights Center
ACES (Audit Committee Excellence Series)



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Overseeing the external auditors

How can the audit committee effectively oversee external auditors?

Increasing complexity, new and lengthy technical rules, and high expectations from shareholders, regulators, the public and other stakeholders make overseeing the integrity of a company's financial reporting a challenging area for audit committees. External auditors play a key role in helping audit committees address this responsibility. Audit committees will want to ensure they have a robust oversight process in place to get the most value from the external auditors.

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The fundamental responsibility of the audit committee is to oversee the integrity of the company's financial reporting. 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 and unique.

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 the committee's oversight role in proxy statement disclosures

> *Audit committees should not underestimate the importance of their role overseeing the external auditor.*
>
> *— Wes Bricker, Chief Accountant, SEC*

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, recent PCAOB rulemaking requires 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. 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.

Auditor independence is not 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. By working with management and the external auditors, 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.
- *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. The external auditor should be notified of any such changes before they occur. This gives the auditor and management time to evaluate the impact on independence and resolve any issues timely.

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 advisors

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 their respective websites.

Going beyond required auditor communications

Auditors are required to communicate certain matters to the audit committee. This includes discussions about the auditor's independence, specific items related to the planning and results of the audit and other items.

The list of required communications is extensive. But by taking the conversation beyond just what's required, audit committees can enhance their oversight. They can gain deeper insights 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 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 auditors' 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.

- *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.[1]

1 For additional information, refer to PwC's Audit Committee Excellence Series, Audit committee effectiveness: practical tips for the chair

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 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
  - ◊ Auditor quality control procedures
  - ◊ Other matters

For additional information on required communications, refer to: https://pcaobus.org/Standards/Auditing/Pages/AS1301.aspx

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.

When it comes to the PCAOB, the audit committee needs to know:

- How any new or emerging auditing standards could impact the company's audit;
- How the annual inspection process of registered public accounting firms could impact the company's audit; and
- If the company is selected for a PCAOB inspection, 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.

Getting a jump start on Critical Audit Matters (CAMs)

A new PCAOB rule requires the reporting of CAMs in the external auditor's report. While the "pass/fail" structure of an audit opinion stays intact, the rule will bring significant change.

Audit committees will want to understand the impact of the new rule at their company. And, leading practice is to participate in a dry run of CAM reporting well in advance of the effective date of the rule. Discussions with management and the external auditors will be important to understand the types of matters that may be CAMs based on their company's facts and circumstances and the nature of the auditor's planned communications about such matters.

The PCAOB rule defines CAMs as matters that meet all three of the following criteria:

- Matters that arise from the audit that have been communicated to the audit committee
- Relate to accounts or disclosures that are material to the financial statements
- Involved especially challenging, subjective or complex auditor judgment

Early discussions are extremely valuable as they could lead companies to consider whether to revisit financial statement disclosures or make other changes in advance of potential CAM reporting.

Assessing the auditor

Leading practice is to evaluate the external auditor's performance at least annually. A formal evaluation process can also help with shareholder relations. Investors and other stakeholders have heightened interest regarding the audit committee's involvement in this area.

Methods for evaluating external auditors vary. Some audit committees use surveys. Others use informal discussions. We recommend that audit committees get management involved. The perspective of the 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.

The Center for Audit Quality, in partnership with the Audit Committee Collaboration, 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 auditor
- Quality of communication and interaction with the auditor
- Auditor's independence, objectivity and professional skepticism

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

Communicating the committee's oversight role in proxy statement disclosure

Shareholders and proxy advisory firms continue to want to know more about how audit committees oversee 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.

Given the heightened interest, audit committees are taking a closer look at their report in the company's proxy statement. By providing greater transparency around their oversight role, audit committees can take credit for their hard work. And they can voluntarily provide stakeholders with a greater understanding of what they do.

> *I encourage audit committee members of listed companies to continue to consider reviewing their audit committee disclosures and consider whether providing additional insight into how the audit committee executes its responsibilities would make the disclosures more effective in communicating with investors.*
>
> *— Wes Bricker, Chief Accountant, SEC*

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.

> *Audit committees play important roles in enhancing audit quality and representing investor interests, so it is encouraging to observe how public companies continue to shed more light on audit committee practices.*
>
> *— Cindy Fornelli, Executive Director, Center for Audit Quality*

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

Audit firm partner selection:

49% / **13%** — State that the audit committee is involved in audit partner selection

Audit firm evaluation/supervision:

38% / **8%** — Discuss criteria considered when evaluating the audit firm

Audit firm selection/ratification:

37% / **13%** — Disclose the audit committee's considerations in recommending the audit firm's appointment

63% / **47%** — State the length of audit firm engagement

Audit firm compensation:

20% / **8%** — State the audit committee is responsible for fee negotiations

31% / **28%** — Provide an explanation of a change in fees paid to the audit firm

2017 / **2014**

Source: Center for Audit Quality/Audit Analytics, *2017 Audit Committee Transparency Barometer,* November 2017.

Looking forward: what audit committees should be thinking about

Quality financial reporting is critical to the efficiency of the capital markets and protecting investors' interests. Audit committees' role in overseeing the external audit and the company's financial reporting process is a key part of this. But it is not simple. Financial reporting is often complex and changes with different regulatory agendas. Added to this are the heightened expectations from shareholders, regulators, the public and other stakeholders to get it right.

Audit committees with a robust oversight process can maximize the value of the external auditors.

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 Governance Insights Center.

Paula Loop
Leader, Governance Insights Center
(646) 471 1881
paula.loop@pwc.com

Sharad Jain
Partner, Governance Insights Center
(313) 401 9005
sharad.p.jain@pwc.com

Barbara Berlin
Director, Governance Insights Center
(973) 236 5349
barbara.berlin@pwc.com

www.pwc.com/us/GovernanceInsightsCenter