

Audit Committee Institute



Evaluation of external auditors

The current spate of restated financial statements, missed earnings projections, and high profile corporate failures has sent a brisk current of change sweeping through UK board rooms aimed at strengthening the independence and effectiveness of audit committees.

In response, audit committee members have been more focused than ever on enhancing both the effectiveness and efficiency of their audit committees, including improving the interaction of the audit committee with management, internal audit, and the external auditors. Indeed, the relationship with the external auditors is a key element of reform both in the UK and the US - audit committees seem set to take on greater responsibilities, including an enhancement of the responsibilities associated with recommending the appointment of external auditors and approving significant non-audit services.

The audit committee plays a key role in keeping under review the scope and results of the external audit, its cost effectiveness and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money.

In the current environment, many audit committees are considering how they should discharge their responsibilities in relation to the effectiveness and efficiency of the external audit arrangements. Tendering the audit is by no means the only available option under this responsibility - audit committees are capable of evaluating the performance of their independent auditors and holding them accountable for the performance of their professional duties.

A review of the audit process, the effectiveness and performance of the audit team, and the output, quality and cost effectiveness of the audit, is a valid alternative to the tender approach. Not only would such a review help optimise the performance of auditors, it would also encourage good communication between the auditor and the audit committee.

Such a review should evaluate the relationship between the auditor and executive management and ensure that an appropriate balance exists. The relationship should not be so close as to put at risk the auditors' independence and objectivity yet, at the same time, should be such that management and auditors can work together in an environment of constructive challenge.

This paper suggests a checklist framework for an audit committee to carry out a formal review of the effectiveness and efficiency of their external auditors, without an audit tender. Such a review provides the audit committee with a disciplined approach to keeping the auditors' performance under review. It will also help to ensure that the auditors remain alert to the company's needs and to maintaining an appropriate relationship with the executive management, the audit committee and the board as a whole.



Checklist - Evaluating the external auditor

Calibre of external audit firm

What is the reputation of the external audit firm? Are there recent or current litigation cases against the firm?

What is the reputation and presence of the external audit firm in this industry?

Does the external audit firm have the size, resources and geographical coverage required to audit this company?



Quality processes

What are the quality control processes in the external audit firm?

Factors to be considered include the level and nature of review procedures, the approach to audit judgements and issues, independent quality control reviews and the external audit firms approach to risk.

How are key audit individuals at the external audit firm compensated and evaluated, and do these compensation and evaluation schemes run the risk of impairing the external auditor's independence?

What is the external audit firm's process for internal review of accounting judgements, including an understanding of the key issues?

What relevant specialists does the external audit firm employ and how are these linked to the audit process?

Audit team

Do the individuals assigned to the external audit team have the requisite expertise, including industry knowledge, to effectively audit this company?

Are sufficient resources allocated to the audit?

What is the scope of the engagement partner's/other senior personnel's involvement in the audit process and is it sufficient?

Does the external audit firm have adequate key team member succession plans in place which meet the relevant audit partner rotation requirements and facilitate the maintenance of objectivity?

Audit scope

Is the external audit scope adequate to address all of the financial reporting risks facing the company?

Factors to be considered include the geographical coverage, the allocated resources, the level of audit testing and the nature of the audit reports issued at each location.

Does the external audit firm agree the audit scope and plan with the audit committee?

Is specialist input to the audit in areas such as taxation, pensions, regulatory and environment at an appropriate level?

Are all key operations covered by the external audit?

How are overseas audits controlled and is audit effectiveness regarded as consistent internationally?

Are the reporting processes for subsidiary audit teams effective?

What is the external audit firm's approach to seeking and assessing management representations?

Does the external auditor have an effective working relationship with internal audit?



Audit fee

Is the external audit fee reasonable given the scope of the external audit, and how does the audit fee compare with other similarly-sized companies in this industry (a fee that is either too high or too low can be of concern)?

How are differences between actual and estimated fees handled?

Is an assessment made of the amounts and relationship of audit and non audit fees and services?

Audit communications

Does the external audit firm advise the audit committee about significant issues and new developments regarding risk management, corporate governance, financial accounting and related risks and controls on a timely basis?

Does the external auditor discuss the critical accounting policies and whether the accounting treatment is conservative or aggressive?

Does the external audit firm meet freely, regularly, and on a confidential basis with the audit committee?

Does the external audit firm resolve accounting issues in a timely manner?

Does the external audit firm seek feedback on the quality and effectiveness of the service they are providing?

Audit governance and independence

Is the relationship with the external auditor controlled by the audit committee or does management control the relationship?

Does the external audit firm have open lines of communication and reporting with the audit committee?

Are unadjusted audit differences and significant weaknesses in internal controls appropriately communicated?

Do the individuals assigned to the audit demonstrate a high degree of integrity in their dealings with the audit committee?

Does the external audit firm discuss their internal process for ensuring independence with the audit committee?

Do management respect the external auditors as providers of an objective and challenging audit process?

Is the level and nature of entertainment between the external audit firm and management appropriate?

Does the nature of non audit services provide any potential to impair audit independence?



If you would like further information on any of the matters discussed in this publication, please talk to your usual contact at KPMG UK or contact:

Timothy Copnell on 020 7694 8082
tim.copnell@kpmg.co.uk

Further material is available on the Audit Committee Institute website at www.kpmg.com/aci/uk/home.html