

External audit

Audit Committee Handbook Chapter 6 – Part 2

This chapter is the second part of the chapter covered in the Audit Committee News – Edition 55.



Selecting, appointing and removing the auditor

Making recommendations to the board on the appointment, reappointment and removal of the auditor is an important audit committee responsibility. The audit committee's recommendation to the board should be based on its assessment of the qualifications, expertise and resources, and independence of the auditor and the effectiveness of the audit process. As described later in this chapter, the assessment should cover all aspects of the audit service provided by the audit firm and include obtaining a report on the audit firm's own internal quality control procedures and, where relevant, consideration of the audit firm's annual transparency report.

If the audit committee considers a formal audit tender is appropriate, it should oversee the selection process and in doing so ensure the process is conducted in a fair and unbiased manner. It is good practice to advise shareholders when the company intends to put the audit contract out to tender.

The audit committee should approve the terms of engagement and recommend the compensation to be paid to the auditor in respect of audit services provided. In doing so, it should satisfy itself that the level of fees in respect of the audit is appropriate and that an effective audit can be conducted for such a fee.

When considering the appointment (or reappointment) of the statutory auditor, consideration is normally given to a range of factors including:

- understanding of the organisation's risks and needs (including strategic management issues);
- geographical coverage;
- perceived value added;
- experience of sector and existing client list;
- staff experience and number of planned partner/senior staff hours; and
- proposed fee and value for money considerations.

It is important that in making its recommendation the audit committee also has regard to the effectiveness of the audit process (see below).

In the unlikely event that the board does not accept the audit committee's recommendation regarding the appointment/reappointment of the auditor, it is good practice to include in the annual report, and in any papers recommending the appointment or reappointment of the auditor, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different position.

Local codes and regulations may contain recommendations or have requirements (such as auditor rotation rules) that impact the audit committee's selection of statutory auditor. Contractual obligations may also act to restrict the audit committee's choice of statutory auditor.

If the auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

Assessment of audit effectiveness

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 being encouraged by regulators, but 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. Indeed, it is best practice for audit committees to evaluate the effectiveness of their audit arrangements every year.

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, subject to regulation.

Not only does such a review help optimise the performance of auditors; it also encourages good communication between the auditor and the audit committee.

"A good auditor is constructive, but critical. Reasoned, but concise explanation of judgements adds real value."

FTSE 100 Audit Committee Chair

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.

In determining the appropriateness of the external auditor, the audit committee should have full regard to the auditor's competence, the quality and efficiency of the audit, and whether the audit fee is appropriate in relation to size, complexity, and risk and control profile of the company. The committee might consider:

- ensuring the statutory auditor has met the agreed audit plan.
- understanding the reasons for any changes, including changes in perceived audit risks and the work undertaken by the auditor to address those risks;
- the robustness and perceptiveness of the auditor in handling the key accounting and audit judgements identified, responding to questions from the audit committee, and commenting where appropriate on the systems of internal control;
- obtaining feedback about the conduct of the audit from key stakeholders such as the CFO and head of internal audit;
- the views of shareholders;
- the timeliness and quality of communication between the statutory auditor and the audit committee – including, where appropriate, audit highlights memorandum, reports on control weaknesses, conduct during audit committee meetings and ad hoc communications between meetings. Good statutory auditors will identify issues early and brief the audit committee on the available options in a timely manner;

- the "value-added" by the audit process; and
- the degree to which the statutory auditor has been able to engage with the committee on broad business and strategic issues.

Such a review provides the audit committee with a disciplined approach to monitoring the auditor's performance.

Removal or resignation of auditors

Boards can generally pass a resolution to remove auditors before the end of their term of office if serious shortcomings are identified.

External auditors who have resigned or been removed from office for whatever reason are generally entitled to attend, and make representations to, the general meeting at which their term of office would have expired, or at which it is proposed to fill the vacancy caused by their resignation or removal. They are generally entitled to receive notices of, or other communications relating to, that meeting and to be heard on any part of the business which concerns them as former auditors of the organisation.

Where auditors cease to hold office for any reason, they would generally provide the organisation with a statement of the circumstances connected with their ceasing to hold office. In the case of a UK quoted company a statement of circumstances must be deposited at the companies registered office. The audit committee should investigate the issues giving rise to such resignation and consider whether any action is required.

Audit Quality Framework

The FRC's Audit Quality Framework (February 2008) promotes the key drivers of audit quality and is a useful tool in assisting audit committees in both evaluating audit proposals and undertaking annual assessments of the effectiveness of external audits.

Driver	Indicator
The culture within an audit firm	<p>The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm:</p> <ul style="list-style-type: none"> • Creates an environment where achieving high quality is valued, invested in and rewarded. • Emphasises the importance of "doing the right thing" in the public interest and the effect of doing so on the reputation of both the firm and individual auditors. • Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise. • Ensures financial considerations do not drive actions and decisions having a negative effect on audit quality. • Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgement. • Ensures robust systems for client acceptance and continuation. • Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing. • Ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.
The skills and personal qualities of audit partners and staff	<p>The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Partners and staff understand their clients' business and adhere to the principles underlying auditing and ethical standards. • Partners and staff exhibit professional scepticism in their work and are robust in dealing with issues identified during the audit. • Staff performing detailed "on-site" audit work have sufficient experience and are appropriately supervised by partners and managers. • Partners and managers provide junior staff with appropriate "mentoring" and "on the job" training. • Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.

Driver	Indicator
The effectiveness of the audit process	<p>An audit process is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • The audit methodology and tools applied to the audit are well structured and: <ul style="list-style-type: none"> – Encourage partners and managers to be actively involved in audit planning. – Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently. – Require appropriate audit documentation. – Provide for compliance with auditing standards without inhibiting the exercise of judgement. – Ensure there is effective review of audit work. – Audit quality control procedures are effective, understood and applied. • High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with. • The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor. • The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.
The reliability and usefulness of audit reporting	<p>Audit reporting is likely to provide a positive contribution to audit quality where:</p> <ul style="list-style-type: none"> • Audit reports are written in a manner that conveys clearly and unambiguously the auditor's opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations. • Auditors properly conclude as to the truth and fairness of the financial statements. • Communications with the audit committee include discussions about: <ul style="list-style-type: none"> – The scope of the audit. – The threats to auditor objectivity. – The key risks identified and judgements made in reaching the audit opinion. • The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting.
Factors outside the control of auditors	<p>Factors outside the control of auditors which are likely to make a positive contribution to audit quality include:</p> <ul style="list-style-type: none"> • An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process. • Audit committees that are active, professional and robust in dealing with issues identified during the audit. • Shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements. • Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period. • Appropriate, agreed arrangements for any limitation of liability. • An audit regulatory environment that focuses on the drivers of audit quality.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received, or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation. The scope of any potential collaboration with audit clients is defined by regulatory requirements governing auditor independence.

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