Appointing, Assessing, and Compensating the Independent Auditor

The Role of the Audit Committee

Under the Sarbanes-Oxley Act of 2002, the audit committee is directly responsible for overseeing the work of the independent auditor. Section 301 of the legislation declares that the audit committee is "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer". This document provides some considerations, based on regulatory requirements and leading practices, that may help audit committees in executing these tasks.

Paul Beswick, SEC Chief Accountant, discussed these and other audit committee related topics during the 2014 SEC Speaks conference.

Appointing the independent auditor

Selecting an independent auditor that meets a company's expectations and needs is paramount to effective corporate governance. Although the chief financial officer, chief accounting officer, or controller typically manages the request for proposal process, the audit committee plays a critical role and ultimately owns the selection process. The following outlines a number of matters (not all inclusive) for audit committees to consider as they participate in the independent auditor selection process.

Firm's profile and qualifications

- Industry and firm qualifications
- Independence considerations
- The firm's approach to quality control and consultations
- Results of recent regulatory inspections or investigations

Engagement team's qualifications

- Experience of the partners who will serve the company, along with a description of the roles and responsibilities of other key team members
- Roles and responsibilities of specialists who will participate in the audit
- References for core team members
- Key features of the audit approach and how it will be tailored to the company
- The firm's views on the highest risk areas and how it will approach them
- Use of national office resources and the technical consultation and issue resolution process
- The approach to the internal controls audit in accordance with Sarbanes-Oxley Section 404
- The role that the company's internal audit department and IT professionals will play in the audit process
- A detailed transition plan that will be tailored to meet your needs and objectives

Fee structure and approach

- An understanding of the firm's fee structure relative to the services requested
- The firm's estimates for professional hours and the average billing rates on which fee estimates are based
- The services that are included in the fee estimate and whether those services include providing training on industry matters, current accounting developments, and similar topics to the company's management and audit committee
- A description of the firm's approach to engagement-related expenses
- An understanding of what services are and are not included in the base fee and the process for determining when services should be billed separately
- The billing rates to be used for services not covered under the base fee estimate

Industry and firm qualifications

- Distinguish between audit and nonaudit clients served
- Differentiate overall national and global qualifications from regional and local qualifications
- Understand the experience and capabilities of the key serving offices including international participating offices
- Understand the firm's views on the biggest challenges facing the company and industry and how they could affect the audit

Independence considerations

- The firm's protocols to comply with the SEC independence rules addressing the following issues[1]:
- Relationships between the auditor and the client arising from financial interests, employment, and business dealings other than the audit and nonaudit services
- Nonaudit services provided by auditor
- Contingent fees and commissions
- Partner rotation
- The audit committee's administration of the audit engagement
- Under the SEC's rule, an auditor is not independent if, at any point during the audit and professional engagement period, any audit partner other than a specialty partner receives compensation from selling engagements to provide the audit client with any services other than audit, review, or attest services

Figure 1: In conjunction with the process outlined above, the following is a framework addressing potential decision-making criteria for audit committees to consider:

Possible evaluation and decision-making criteria			
Team: • Seniority • Right depth of experience • Ability to work well together • Enthusiasm	**Depth of knowledge and qualifications:** • Understanding of the business • Understanding of the industry • Experience with regulatory environments	**Commitment:** • Sufficient time available • Focused investment of time • Importance of your company as a client	**Quality:** • Litigation record • Brand eminence • Media perception
Transition plan: • Detailed and well-prepared audit plan • Integrated audit approach that includes dealing with internal audit and other advisers • Previous successful transitions	**Reach:** • Decision-making (central or dispersed) • Local quality and relationship depth • Central control of fees	**Approach:** • Effectiveness of the audit methodology • Ease of issue resolution/consultation • Ability and authority of the team to make decisions • Ability of the team to deliver required services	**Communication:** • "No-surprises" approach • Early feedback on issues • Transparency
Fees: • Reasonableness and competitiveness • Long-term competitiveness and sustainability	**Added value:** • Corporate governance and training options • Support provided to company personnel (e.g., training, workshops, etc.) • Board effectiveness evaluation • Fresh approach • Quality of deliverables	**Empathy:** • Understanding of corporate and personal issues and priorities • Fit with your company's culture • Collaborative nature	**Managing conflicts:** • Clarity of approach • Risk from competitors

Evaluating and retaining the independent auditor

For the audit committee to make an informed recommendation as to whether to retain an existing auditor, the audit committee should evaluate the independent auditor's performance each year. Common criteria for evaluating the audit engagement team, individually and as a whole, includes technical competence, industry knowledge and experience, communication, cohesiveness as a team, independence and professional skepticism, and support provided to the audit committee.[1]

Additionally, NYSE listing standards require the audit committee to review a report by the independent auditor describing quality control, results of investigations, and independence. Accompanying commentary[3] states that after reviewing the report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance, and independence.

A group of leading governance organizations[2] released *Audit Committee Essentials: The Annual Auditor Assessment* to help audit committees evaluate the independent auditors as part of the annual reappointment process.

Compensating the independent auditor

The SEC's rules on the audit committee's oversight responsibilities state, "The audit committee must have ultimate authority to approve all audit engagement fees and terms."[4] This task cannot be delegated to management. In assessing and determining whether the audit fees are reasonable, the following are among the common criteria that may be considered:

- Size, complexity, and risks of the company
- Centralized versus decentralized operations
- Domestic versus international operations
- The number of registrants and reports issued
- Additional reporting requirements including statutory reports, agreed-upon procedures reports, comfort letters, and employee benefit plan audits
- The impact of regulatory and accounting changes
- Changes in the company's risk profile
- Acquisition or divestiture activity
- The company's investment in technology and the sophistication of its systems
- The auditor's use and leverage of company resources (e.g., internal audit) to conduct the audit
- Competency of the company's finance function that supports the audit
- Changes in the scope of the audit
- Inefficiencies on the part of the auditor or management

Conclusion

The process of appointing, assessing, and compensating the independent auditor is an important activity for audit committees. It is subjective and varies from company to company. In general, these processes support the audit committee's responsibility to oversee the work of the independent auditor and also contribute to an effective audit. It is the independent auditor's responsibility to perform a high-quality audit; however, as part of their annual activities, audit committees should carefully consider and review the auditor's work and take any steps that are appropriate in supporting audit quality and effectiveness.

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[1] Audit Committee Resource Guide, Deloitte Development LLC, 2013

[2] The following organizations contributed to the tool: Association of Audit Committee Members, Center for Audit Quality, Corporate Board Member, Independent Directors Council, Mutual Fund Directors Forum, National Association of Corporate Directors, and Tapestry Networks.

[3] NYSE Section 303A.07 (b) (iii) (A) - http://nysemanual.nyse.com/lcm/

[4] http://www.sec.gov/rules/final/33-8220.htm#P238_65596