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Audit Committee Expectations for Performance of the External Independent Auditor

**A veteran director provides concrete help for
communication with your outside auditor.**

About NACD

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.

The inadequate performance on specific audits by various external auditors recently documented in the press may stem from a variety of factors. Undue pressure on partners for revenue growth, the lack of adequate auditing firm policies and procedures for quality control, insufficient training, and the inability to see accounting and reporting practices from a strategic corporate viewpoint are four commonly mentioned factors influencing the professionalism of the audit.

A fifth key factor should be considered: *the lack of a clearly stated set of audit committee expectations for the performance of the external independent auditor.* Contractors deliver to requirements, and the external auditor is a contractor to the audit committee. By charter and in accordance with accounting standards and industry practice, the audit committee is charged with selecting the external independent auditor, evaluating the external auditor's work, and, when necessary, replacing the external auditor, with the approval of the full board of directors. Providing the external auditor with an unambiguous list of requirements should enhance the professionalism of the audit.

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Creating an Expectation Statement for Performance of the External Independent Auditor

This statement is intended to help the audit committee communicate their expectations of performance to the external auditor, and to serve as a checklist for an annual evaluation of the work of the external auditor. Three principal areas of performance should be addressed: reporting relationships and communications; professional knowledge; and planning for, and performance of, the audit.

This statement does not purport to be all-encompassing; however, directors need some mechanism to judge how their external audit firm is complying with increased regulation as well as understanding key issues of the company's business. In any case, the external auditor remains responsible for meeting all standards set by the accounting profession, law, or auditing firm policy.

As a caveat, any communication by any audit committee of a statement of expectations for performance, such as this, in no way supersedes or takes precedence over any law, regulation, or standard as set by federal or state government or by the American Institute of Certified Public Accountants (AICPA) Auditing Standards Board and embodied in the 10 generally accepted auditing standards (GAAS) and Statements on Auditing Standards (SAS), as currently stated or amended hereafter.

External Auditor Performance Criteria/Expectations of the Audit Committee

The criteria listed in this article arose from the author's extensive research as an audit committee member, and especially from the desire of the board of USAA, a \$65 billion insurance group for active and retired military personnel, to implement both the letter and the spirit of the recommendations of the Securities and Exchange Commission (SEC) Blue Ribbon Committee and the NACD Blue Ribbon Commission.

The underlying principle of these recommendations is that the external auditor must apply the highest standards of professional conduct and work, *along with common sense*, to provide the audit committee with an effective and complete audit.

Reporting Relationships and Communications

In communications with the audit committee, the external auditor:

- Presents a complete and appropriate engagement letter, which, at a minimum, describes the services to be performed, identifies management's responsibilities, and defines any limitations to or qualifications on the auditor's work and representations.
- Recognizes the board of directors and the audit committee ("committee") as the client.

The external auditor must apply the highest standards of professional conduct and work, along with common sense.

- Understands the responsibilities and operation of the committee as defined by the committee charter.
- Understands the expectations of the committee and its chairperson and responds on a timely basis.
- Maintains candid and open dialogue with the committee. Communicates in a timely, forthright manner with clarity and a frequency sufficient to keep the committee fully informed at all times. Meets the letter and spirit of communications requirements of published standards.
- Clearly articulates an understanding of external auditor independence and openly and frankly discusses this matter with the committee.
- Provides a formal statement of all relationships between the external auditor and related entities, including those with similar names, which may be independent. Identifies all services offered by all entities in adequate specificity to be meaningful. Addresses any possible or perceived conflicts of interest.
- Maintains an open and effective dialogue with management so that the external auditor may know the enterprise and the industry sufficiently well to conduct a high quality audit. The external auditor gives management a careful hearing and offers a complete explanation of the auditor's findings and basis for its conclusions.
- Provides the committee with a copy of the latest peer review of the external auditor and highlights its important elements for the committee.

Professional Knowledge

In awareness of ever-evolving reporting and independence standards, the external auditor:

Director Summary: In recognition of changing reporting and independence standards, it is increasingly important to articulate the audit committee's expectations for the company's external independent auditor. After exhaustive research, the author presents a checklist of expectations audit committees may use as a guide for their own interactions with the outside auditor.

The external auditor provides “value added” by proactive suggestions that go beyond the bread and butter of “things are OK.”

- Develops and sustains a comprehensive knowledge of the enterprise and its industry. This knowledge is shared with the committee on a regular basis.
- Identifies to management and the committee specific external auditor interpretations of accounting and reporting standards so that management and the committee may discuss and conform as appropriate. Reviews the propriety of accounting policies and any changes therein, and communicates the results of these reviews to the company.
- Utilizes staff with the appropriate professional certifications and level of experience for each of the various tasks in the audit. Provides the committee with a summary listing of staff, experience level, and the professional qualifications that each person holds.
- Ensures that the external audit partner and staff maintain a current knowledge of proposed and changed accounting and auditing standards. In addition, the external auditor communicates to the committee new developments regarding financial accounting, related risks, controls, and auditing.
- Demonstrates a comprehensive understanding of computer, accounting, and reporting systems.
- Gains a thorough understanding of the enterprise internal controls so that the external auditor may assess the degree to which to use the work of the internal auditor.
- Explicitly defines “materiality” for the committee and explains its implementation in the audit.
- Shares with the committee the external audit firm’s quality control standards and processes, including its independence policies and procedures (e.g., personnel rotation, avoiding conflicts of interest).
- Emphasizes a quality audit and ensures quality reporting by the enterprise.
- Provides an overview of the external audit organization and staffing. The staffing overview should include leadership, areas of expertise, and estimates of time commitment. Also, audit discipline and quality control features of the audit should be outlined.
- Maintains audit work according to schedule, but is flexible with regard to pursuing areas of concern on an as-needed basis. When necessary, adds staff so that the entire audit is completed in a timely manner.
- Coordinates the external audit with the internal audit.
- Maintains independence, integrity, and objectivity combined with an attitude of professional skepticism. Makes the “tough calls.”
- Conducts sample tests for fraud (forensic accounting) or as otherwise deemed necessary.
- Reviews a “sample” audit methodology with the committee: i.e., a vertical slice of a specific substantive audit test. In this manner, the committee may gain confidence in the rigor and thoroughness of the external audit firm’s approach.
- Provides “value added” by proactive suggestions that go beyond the bread and butter of “things are OK.”
- Develops and communicates a “big picture” view of the enterprise. This perspective would include an understanding of strategy, organization, financing, financial control, financial reporting, subsidiary operations, accounting, the regulatory and legal environment, and the interaction of subsidiary accounts as they are consolidated at an enterprise level. ■

Planning for and Performance of the Audit

In preparing and performing the audit itself, the external auditor:

- Provides evidence of external audit firm professional leadership, i.e., “the tone at the top,” which may be expected to support the performance of quality audits.
- Conducts an extensive assessment of risk (including inherent risk, control risk, and detection risk) in accordance with SAS No. 47 and good risk management techniques. The resulting relevant, organized, and focused annual audit plan is reviewed in reasonable detail with the committee prior to finalization of the plan.
- Shares with the committee the external audit firm’s goals/objectives and personnel performance measures, so that the committee may assess the likelihood of unwarranted pressures for client retention, cost cutting, and so forth.

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Ed. Note: The author used an extensive bibliography to formulate the foregoing external independent audit guidelines, which is not reproduced here. For a complete list, contact the editor at dj davidson@nacdonline.org.