

Independent Auditor Selection and Retention: The Role of the Audit Committee

By

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Skepticism may be at an all time high regarding the objectivity and competence of outside auditors in the wake of perceived weaknesses exposed by the Enron collapse. The SEC, accounting profession organizations and Enrons outside auditors have been quick to announce their intent to internally investigate and rectify any deficiencies in quality control processes. More stringent oversight, among other remedies has been proposed by virtually all of these parties. Though well meaning, such action is counterintuitive. History has demonstrated self-policing to be inconsistent in application and therefore not reliable. (Such thinking gave birth to the external audit industry; yet ironically, self-policing is supposed to be the cure for this industry's maladies.) While it is not believed that deficiencies in external audit practices and/or practioners character are pervasive, any lingering concerns of this nature can readily be allayed through the exercise of sound independent auditor selection and r/tention decision-making by the audit committee.

Step 1: Take Control

Though the final choice of outside auditors requires Board approval, much of the legwork tends to rest with senior management. The audit committee should spearhead this process (from the request for proposal through engagement letter approval, and beyond). The external audit planning process entails an evaluation of the control environment that includes senior management and the board. If the tone set by senior management dictates in part the external audit strategy, a more candid assessment should result if the external auditor recognizes his fate does not rest solely in the hands of those he is evaluating. Enact a policy that mandates responsibility for independent auditor selection which rests with the audit committee.

Step 2: Look Behind the Curtain

It is no secret, most accounting firms today have a marketing division and/or require the majority of their senior executives to actively sell firm services. Many have attained their positions primarily based on their sales capability. Accordingly, being captivated by a presentation should not be the driving force behind selecting one firm over another. Rather, once the show is over, conduct your own thorough audit of their written proposal including:

References: On the surface, not much may be expected from contacting references. Handpicked by the proposing firm, chances are positive feedback will be all but guaranteed. Go the next step. Ask the reference if you may speak with your counterpart on their audit committee. Inquire not only about the quality and timeliness of services rendered, but also their degree of direct communication with the audit committee members. If your company operates in a regulated industry, make inquiries of your regulators as to the reputation of prospective accounting firms as well.

Experience in the industry: Typically, the personnel overseeing your engagement will be specified in the proposal. These tend to be the most experienced individuals in the firm. Your

concern should be the degree of actual hands on participation they will have during the audit. Determine through direct inquiry of both the proposing firm representative and their client references, the experience level of the engagement team. If there are lingering doubts, convene meetings with outside audit team members as necessary to determine industry knowledge.

Peer Review Results: Some insight as to the quality control practices of the proposing firm may be gleaned from inspection of peer review documents. Available on the Internet at www.aicpa.org, peer review public file firm searches may be readily conducted. The nature of any quality control deficiencies identified, if any, should be pursued further with the proposing firm as necessary. Additionally, a sense as to the focus of their practice may be obtained via reference to the percentage of gross fees disclosure.

Litigation: Ironically, while you are sizing up the proposing firms, your outside auditors are required to document their rationale for accepting your organization as a potential client. One of the more critical elements in their investigation is your litigation experience. Likewise, it should be among the litmus tests employed to consider their worthiness to audit your organization. While terms of settlements may be required to be kept in confidence, the dollar volume and frequency of litigation and general disclosure as to their origin should be sufficient to draw some conclusions regarding the competence and integrity of the proposing firms.

Step 3: Penny Wise...

If your analysis of the proposing firms has been positive after the execution of the first two steps, reviewing the cost may narrow the field. Be leery of variations of the zero cost audit concept that has become prevalent in recent years. Few if any are the accounting firms with philanthropic mission statements. There is going to be a trade off and most likely it will be the depth of the service expected compared to the level of performance received. If quality performance is your goal, expect to pay for it. Having the candidates breakdown by position the anticipated hours and related costs is critical for comparison. Also pursue quantification of the hours to be expended ancillary to the audit. Often there are administrative features to audits that can readily be performed by your own staff from the typing of correspondence to the drafting and proofing of the financial statements. With the true audit cost isolated, ascertain through interviews what techniques are going to be applied to areas your organization considers higher risk. Communication of their general approach should give you a better sense of the scope of their procedures and the related cost.

Step 4: Order the Steak

While the cost of a quality audit may appear steep, determine what benefits your organization may reap from the process. In addition to free consultation access year round regarding audit related matters, ascertain the level of insight provided beyond traditional identification of control deficiencies. Do they share their experience with other clients in your industry, communicating cost saving measures or identifying potential profit opportunities observed elsewhere? It is not uncommon for some firms to use the audit process as a means for mining profit improvement ideas that are then sold to the client as consultation services. It is known as sharing the sizzle but not the steak. If you are paying a premium for the knowledge and experience of the external auditing firm, demand the steak.

Step 5: Lay the Cards on the Table

Upon due consideration of the results of your investigative efforts thus far, you should be in a position to make your recommendation for selection of an outside auditor at a mutually agreed upon fee. But your relationship with the external audit team should not then be restricted to annual industry mandated communications. Periodically request an audience (at no charge) with members of the audit team and consider the following:

Ensure full access to company records and representatives are being provided upon demand to the auditors. This will ensure efficiency in the execution of their procedures.

Encourage and facilitate unannounced onsite visits for various phases of their audit. This affords better insight as to whether controls are functioning as designed all the time, and not just as command performances.

Determine that the original draft of any correspondence regarding any potential control weaknesses is provided to the audit committee. Allowing drafts to be passed between the audit team and management to ensure factual accuracy sometimes also yields implementation of unnecessary editorial comments, and therefore should be discouraged. Management and the Board always have the opportunity to formally respond to any comments made by the external auditors. Allow that to be the forum to clarify any differences of opinion.

Ask that the working papers for the audit thus far be provided and ascertain the results of their efforts to date. Aside from ensuring the quality expected is being provided, this may also serve to identify early any weaknesses that should be addressed.

Step 6: Paranoia Strikes Deep

As part of the direct line of communication to be maintained between your outside auditor and the audit committee, do not hesitate to provide feedback to them if you grow displeased with a certain facet of their service. Equally as important, seek proposals on a periodic basis, regardless if the level of satisfaction with your current firm is high. Ask to inspect the working papers for the audit each time you meet as well, better ensuring the quality expected is being provided. At a minimum, all procedures highlighted under step 2 should be performed on at least an annual basis.

Diligence begets diligence. Objectivity and competence should be a given with your external auditing firm. By doing your homework at the outset, you will better ensure the requisite knowledge and experience will be provided. Maintenance of constructive communication lines and affording unbridled access to management and financial records should provide a forum for procedures to continue to be executed by the outside auditors in an independent manner, thereby ensuring the resulting opinion rendered on the integrity of the financial statements is reliable. So let the SEC, Enron auditors and the accounting profession organizations engage in their reindeer games and quibble over self-policing matters. Your organization should be immune to any rogue auditors that elude any quality control measures enacted by these governing bodies in the future, through diligent execution of the aforementioned six-step process.

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