



## *Working with the external auditor*

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*The PwC Audit Committee Guide is designed to help members of the audit committee work through their maze of responsibilities in a practical manner.*



# Working with the external auditor

**Audit committees have an essential role to play in ensuring the integrity and transparency of corporate reporting.**

**The PwC Audit Committee Guide is designed to help members of the audit committee work through their maze of responsibilities in a practical manner.**

**The guide consists of:**

- Introduction
- Setting up the audit committee
- Financial reporting: Reviewing financial information
- Risk management & internal control
- Working with the external auditor
- Understanding internal audit
- Maintaining & measuring effectiveness
- Communicating & reporting
- Ethical, regulatory & compliance matters
- Compliance frameworks
- The audit committee's role in 'fit and proper' requirements for financial services entities
- Materiality in audits

We hope you will find this guide of value to your important role. If you would like to provide any feedback, or if you need more information, call your usual PwC contact.



## Working with the external auditor

*The audit committee has become the primary focus for the company's relationship with the external auditor.*



The role of the audit committee involves making recommendations to the board about the appointment of the auditor, agreeing audit fees, reviewing the scope of external audit work, and holding private meetings with the auditor to discuss its findings. It also includes reviewing, with the external auditor, the external auditor's independence.

The objective of an external audit of financial statements is to determine whether, in the auditor's opinion, the statements present fairly in all material respects – that is, they show a true and fair view in all material respects of the company's financial position, results of operations, and cash flows, in conformity with national or international generally accepted accounting principles (GAAP).

This covers a range of matters, many of which are a part of the audit committee's responsibilities. Hence, regular communication with the external auditor can be extremely valuable in assisting the audit committee's work.

Broadly, discussions with the external auditor can cover four key areas, which range from specifics about the auditor and its relationship with the company, to discussion about the industry, business and control environment of the company. These areas can be summarised as follows:

- service approach (the auditor's qualifications, including independence, to perform the work, and its approach to the audit)
- audit plan (the key risks identified by the auditor in relation to the financial statements and the company's controls, and the resulting audit plan and response to the risks)
- financial reporting (accounting policies, disclosures and observations about the overall quality of financial reporting)
- governance matters (matters noted by the auditor in the course of its work that it believes should be brought to the audit committee's attention).

These areas are discussed further in this section.

## Working with the external auditor

### Service approach

- Review last year’s external auditor’s performance – audit team, services and fees
- Discuss audit proposition – service approach/strategy, terms and fees
- Review auditor’s independence and experience of audit team, including understanding the auditor’s own performance evaluation processes



### Audit plan

- Understand the audit plan
- Understand from the auditor what to expect – services, timing and reporting requirements
- Review the experience of the audit team
- Consider how key risk areas will be addressed during the audit



### Governance matters

- Be aware of difficulties encountered in performing the audit – restrictions on access to information/management
- Be informed of deficiencies in internal control/fraud/illegal acts
- Be updated on matters affecting the auditor’s independence, including rotation plans for succession of the key audit partner



### Financial reporting

- Review the audited financial statements
- Discuss key audit findings – significant accounting policies/audit judgements/financial reporting quality
- Discuss any disagreements that occurred with management
- Meet separately with the external auditor



### Timing of communication

It is usual to hold regular discussions with the external auditor, not just when the annual audit is completed. Ideally, the audit committee will meet at least three times during the year, to coincide with the external reporting and audit cycles. Discussion with the auditor at each meeting, on different aspects of its work or the audit committee’s duties, can be helpful. In addition, most audit committees meet privately with the external auditor at least once a year to ensure free and open communication, and others also ensure they have a private conversation about the half-year report.

Auditing Standard ASA 260 includes specific requirements for communication between the external auditor and the audit committee. It flags matters that the external auditor should ordinarily report on or discuss with the audit committee. These requirements are incorporated in the guidance contained in this section, which emphasises the importance of regular communication.

# 1. Appointment and remuneration

*Companies registered under the Corporations Act 2001 require an external audit to be undertaken by a registered company auditor. Given the value that a good working relationship can bring to the audit committee and the company, the appointment of the external auditor warrants careful consideration.*

Matters to consider in relation to the external auditor include the following.

## What to ask

### The audit firm and its people

Does the audit firm offer high-quality service in all of the key geographical areas in which we operate?

Does the audit firm employ dedicated industry specialists able to identify issues important to our business, thus providing a value-added service?

Does the audit firm have access to tax, corporate finance and systems specialists able to be channelled effectively to our company where required?

Are the personnel on the proposed audit team appropriately experienced, qualified and skilled?

Do the personnel on the proposed audit team exhibit high professional standards and personal integrity?

Does the audit firm exhibit styles and values compatible with those of our company?

### Audit approach

Will the audit approach be customised for the specific attributes of our company, incorporating the views and concerns of management and directors?

Will the audit firm advise the audit committee of the audit plan and scope at a mutually agreed time?

## What to look for in response

Does the firm operate in all our offshore and overseas locations? If not, how will it cover the audit of these countries?

What experience does the auditor have in our industry? What specialists will it use, and does this seem appropriate?

Will the audit firm be able to respond to the audit committee's needs and requirements in relation to understanding the central risk management environment?

Are the people being proposed for the audit team experienced in audit and/or the industry?

Do the audit team members give confidence that we will receive a quality audit?

Do the audit committee members feel they will be able to work productively with the audit team?

An audit is a judgement based on knowledge of the company and its operations. Does the audit approach reflect this?

What does the audit partner propose discussing with the audit committee? When are meetings proposed to be held?

## 1. Appointment and remuneration

### What to ask

Does the audit firm have effective means of reporting to and communicating with the audit committee and senior management on the identification and resolution of accounting and disclosure issues, recommendations on internal control, and other opportunities for improvement?

### Quality and service delivery

Will the audit firm be able to satisfy key service performance standards such as response times, deliverables, staff continuity and communication protocols?

Does the auditor have an internal process to measure client satisfaction?

Will the audit firm be able to provide clear and regular communication to appropriate staff members of our company?

Does the audit firm have appropriate resources at its disposal to be able to co-ordinate and deliver a range of other services within the mandate of the audit?

Is the audit firm able to provide comprehensive and timely guidance on technical developments and industry trends?

Does the proposed fee for the audit represent fair compensation for a comprehensive and high-quality audit?

Has the auditor shown evidence that it is prepared to make tough calls on audit matters, including potential disagreements with management?

### Other matters

Can the auditor demonstrate that the independence and objectivity of the audit firm will be maintained, considering the types of additional non-audit services that may be provided and the projected fees?

### What to look for in response

What are the audit team's proposals for informing the audit committee if a matter of serious concern, such as management fraud, is uncovered?

Has the auditor proposed specific measurable service standards? How will the audit committee be able to monitor this?

Who from our company is involved in this process?

Who is the auditor proposing to deal with at the company other than the CFO?

If the audit committee requires additional work in, for example, fraud analysis, will the audit team be able to assist?

To whom and when is the audit team proposing to provide updates?

Does the fee reflect the amount of work proposed and at a commercial rate?

Understand what additional work the auditor would perform if the fee was higher to evaluate whether that work seems appropriate to be left from the program.

Is the level of experience required to undertake the agreed audit plan reflected in the cost?

What stand has the auditor previously made in sensitive areas?

Can the auditor provide relevant information to confirm its independence, including plans for rotating the audit partner? (Also see the independence checklist in Appendix B.)

Audit committees lead the process of appointing an auditor to work with management, and, once a decision has been made, make a recommendation to the full board, which then appoints the auditor subject to shareholder approval.

If tendering for a change of external auditor, a number of formalities need to be undertaken. In addition to any commercial tender process, there are legal time limits for appointment, and there are matters a proposed new auditor must undertake before accepting an appointment. Therefore the timing and management of any change needs to be considered and discussed with the auditor.

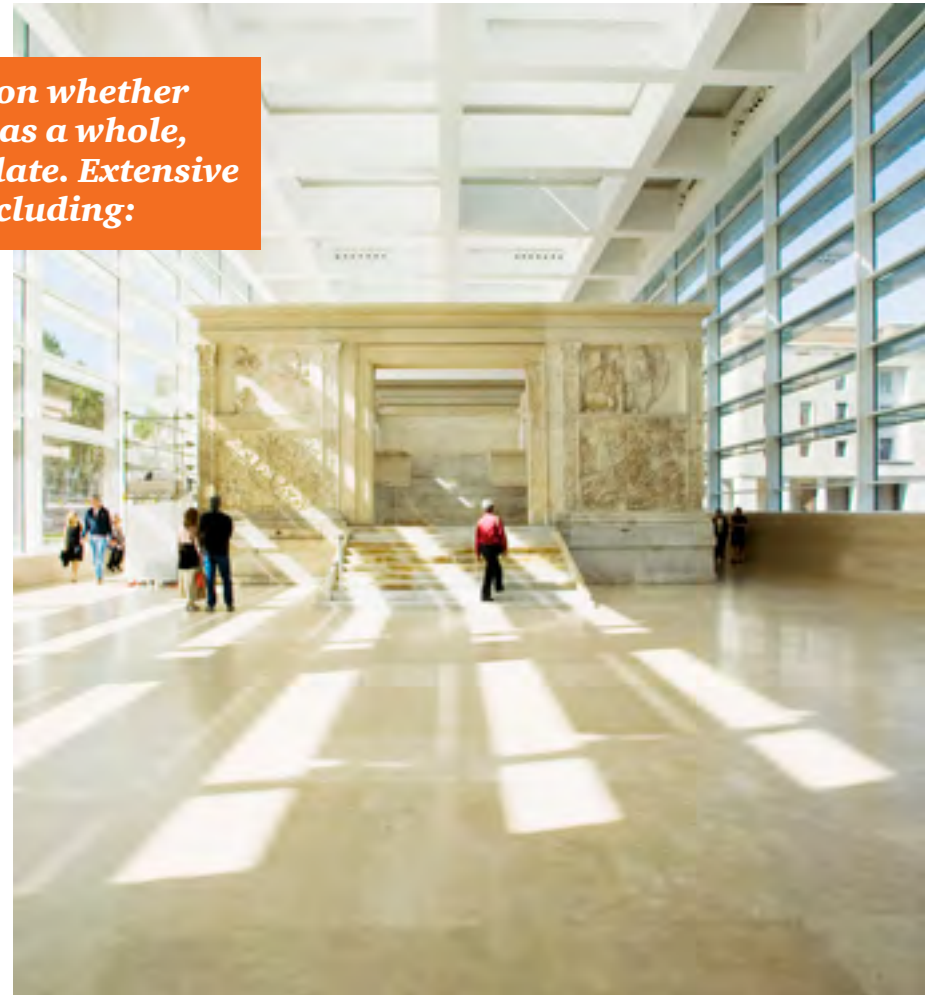
## 2. Scope of audit work

*The purpose of the statutory audit is to form an opinion on whether the information presented in the financial report, taken as a whole, reflects the financial position of the company at a given date. Extensive background work is required to produce this opinion, including:*

- understanding the company's activities
- considering any significant economic and industry issues that might have affected the business during the period
- identifying and assessing risks associated with the major items reported in the financial report
- understanding how management has managed the risks identified and how the reported results were prepared.

The audit committee should ask the auditor to provide its views on matters relevant to the conduct of the audit, for example, the effectiveness of the company's systems, management of fraud risks, or the quality of the reporting process. Audit committees may request additional comfort in areas over and above the scope of the statutory audit. If this is the case, the scope of this work is discussed and agreed with the external auditor at the beginning of the audit process.

Based on its knowledge of the company and risks related to the financial statements, the external auditor prepares a detailed audit plan. The audit committee's review of the proposed plan and approach enables it to understand what it can expect from the external audit.



## 2. Scope of audit work

Questions the audit committee might ask the external auditor about the plan include:

- What are the objectives of your audit?
- What are our company's financial reporting requirements (including the time within which the company is to report)?
- Which risk areas do you plan to emphasise in your audit? Why?
- To what extent will you assess our company's system of internal controls?
- How will any recent actions by our company – such as mergers and acquisitions, restructurings, changes of business strategy and changes in financing arrangements – affect your audit?
- To what extent do you plan to rely on the work of the internal auditors?
- Which company locations will you visit this year? How do you determine which locations to visit and when?
- Which subsidiaries will you audit? What steps do you take regarding those not audited?
- If other auditing firms are involved, how will you satisfy yourself that their work is acceptable and that they are independent? Do you intend to refer to them in your report?
- Is the audit fee sufficient to undertake the level of work proposed?

### Governance

The auditor may have views about the company's governance structure and processes. Many audit committees invite the external auditor to comment on:

- the way in which the audit committee has operated and responded to significant issues
- the composition and range of audit committee and board member experience
- company and board responsiveness to recommendations and requests
- the effectiveness of governance processes from the auditor's perspective
- the role and working of the internal audit function.

#### Tip:

**Audit committees commonly ask the external auditor to inform them of major resolved and unresolved issues encountered during the audit and of any restrictions senior management imposes on the scope of the audit.**



### 3. Independence requirements

**External auditors must act with objectivity. This is a fundamental principle of the audit profession, which requires its members to observe ethical rules designed to safeguard auditors' independence. The International Federation of Accountants (IFAC)<sup>16</sup> has issued a code of ethics that sets out potential threats to independence and safeguards to mitigate those threats.**

Although the audit committee's primary focus is the effectiveness of the audit, it is also important to consider the effect on objectivity of any relationships or other services the external auditor has with, or provides to, the company or its management. The audit committee will need to determine to its own satisfaction that the auditor's independence has not been compromised.

The rules in some countries require the audit committee to review and make recommendations on company policy about engaging the auditor to perform other services. For SEC registrants, there is also a requirement that audit committees must pre-approve all services – both audit and non-audit – performed by the external auditor.

In Australia, requirements for the audit committee's consideration of auditor independence are set out in the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations and in the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*. A summary of the requirements is set out on the following page.



16. The International Federation of Accountants (IFAC) is the worldwide organisation for the accounting profession. Its mission is to serve the public interest, strengthen the worldwide accounting profession, and contribute to the development of strong international economies by establishing, and promoting adherence to, high-quality professional standards.

### 3. Independence requirements

Information to be publicly available:

- Procedures for the selection and appointment of external auditors (ASX CGC, Principle 4)
- Procedures for the rotation of external audit engagement partners (ASX CGC, Principle 4).

Information to be reported to the board:

- Procedures for selection and appointment of external auditors and rotation of engagement partners (ASX CGC, Principle 4)
- Recommendations for the appointment or removal of an auditor (ASX CGC, Principle 4)
- Assessment of the performance and independence of the external auditor and whether the audit committee is satisfied about independence having regard to the provision of non-audit services (ASX CGC, Principle 4).

Information to be included in the directors' report in the annual report:

- A copy of the external auditor's independence declaration (CA298(1c))<sup>17</sup>
- The name of each person who:
  - is an officer of the company at any time during the year AND
  - was a partner in an audit firm ... that is an auditor of the company for the year AND
  - was such a partner ... at the time when the audit firm ... undertook an audit of the company (CA300(ca)).
- For listed companies only: if the audit engagement partner has been auditing the company for more than five successive financial years (CA300(11A)).
- For listed companies only: amounts paid for non-audit services, including a statement that the directors are satisfied that the provision of these services is compatible with the auditor's independence and reasons why (CA300(11B)).<sup>18</sup>

17. The auditor must provide a written declaration that to the best of its knowledge and belief there have been no contraventions of the auditor independence requirements of the Act or professional codes of conduct.

18. The audit committee must provide the board with written advice to this effect.

#### Factors to consider

There are several factors to consider when assessing the external auditor's independence.

Most important is to discuss independence issues. The auditor will be able to inform the audit committee of the broad range of safeguards it uses to protect its independence, such as the regular rotation of the engagement partner, use of review partners, and internal quality inspection programs. These discussions can also cover a range of questions that the audit committee members and other directors will need to be comfortable about before making an annual report statement. For example:

- the level of fees and other services compared to comparable companies or situations
- safeguards of the auditor and of the client in relation to independence matters
- an assurance over systems to ensure compliance with legal requirements.

#### Other services

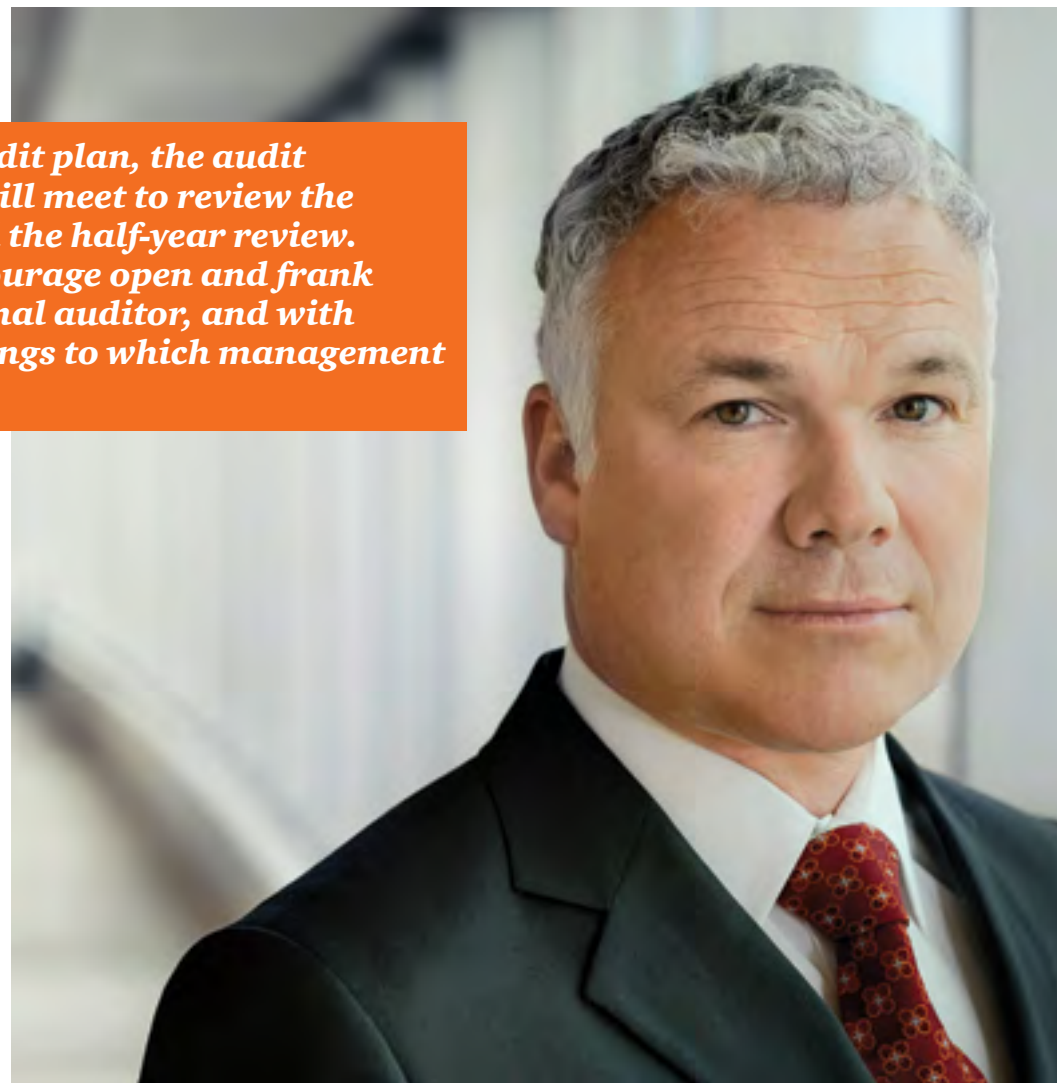
The company may engage the audit firm for a variety of special services if these services do not pose an unacceptable threat to independence, or breach independence restrictions. Using people who know the company and its culture, and who can apply this knowledge in providing other services, can have significant advantages. And the increased knowledge the auditor gains from performing these services can in turn contribute to the quality of the audit. However, audit committee members still need to act in the best interests of the company and ensure that the services supplied represent value for shareholders.

If the audit committee can be satisfied in these respects, the company should be free to engage the firm it considers best equipped to perform a particular task.

## 4. Significant audit findings and recommendations

*Throughout the audit, and as agreed to in the audit plan, the audit committee, management and external auditor will meet to review the financial statements and results of the audit and the half-year review. The intention of these regular meetings is to encourage open and frank dialogue between the audit committee and external auditor, and with management, although there may be some meetings to which management is not invited.*

As well as meeting the audit committee for discussions, the auditor will normally also prepare reports relating to the annual audit of financial statements (and sometimes the half-year review). These may be delivered at different times of the year, as work progresses. The reports may take different forms – a written report covering all relevant matters, a series of papers to be discussed in a meeting, a presentation, or an oral report. Their content will vary depending on circumstances. The content may include the items listed on the following page.



## 4. Significant audit findings and recommendations

<i>What to discuss</i>	<i>Who to ask</i>	<i>What to look for in response/How to follow up</i>
The general approach and scope of the audit, including any expected limitations or additional requirements.	External auditor	Link to agreed audit plan and deliverables. Check that management is not hindering progress.
The selection of, or changes in, significant accounting policies and practices that have or could have a material effect on the financial statements.	External auditor/ management	Does the selection make sense in light of the company's expectations and strategies?
The auditor's judgements about the quality, not just acceptability, of the company's financial accounting principles.	External auditor	This could include issues such as the transparency of the company's financial disclosures and degree of aggressiveness or conservatism of its accounting policies and underlying estimates, areas of greatest judgement and most sensitive accounting policies and underlying estimates.
The auditor's insight into those areas of greatest importance in coming to a view as to the truth and fairness of the financial report as a whole.		
The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that must be disclosed in financial statements.	External auditor/ management	Is this properly disclosed?
Audit adjustments, whether or not recorded by the entity, that have or could have a significant effect on the financial statements.	External auditor	Amount and significance of impact. What does this say about management's ability and/or integrity?
Material uncertainties about events and conditions that may cast doubt on the entity's ability to continue as a going concern.	External auditor/ management	How is this being disclosed, and what impact does it have on market perceptions?
Disagreements with management about matters that individually or in aggregate could be significant to the financial statements or the auditors' report.	External auditor	These communications include consideration of whether the matter has been resolved and the significance of the matter.
Expected modifications to the auditor's report.	External auditor	Understand why these modifications are necessary and why they arose.
Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management.	External auditor	
Any other matters agreed in the terms of the audit engagement.	External auditor	For example, review of preliminary results, fraud investigation.
Other information in the annual report.	External auditor	Understand the auditor's limited responsibility in this area and what was done.

For more detail about financial reporting discussions and questions, refer to the Financial reporting: Reviewing financial statements section.

## 5. Reviewing the performance of the external auditor

*Most audit committee charters suggest a regular (generally annual) review of the performance of the external auditor.*

Matters to consider when assessing the performance of the external auditor are broadly:

- the audit firm’s professional capabilities, resources and personnel assigned to the audit
- the audit approach
- the audit team’s knowledge of the company’s industry
- the geographic coverage of the audit
- the audit firm’s availability and its communications with the audit committee
- the audit firm’s commitment and ability to stand firm on tough decisions.

An assessment of the auditor’s performance will be most effective if there is openness between the committee and the auditor. For that reason, expectations and performance criteria will need to be understood by both parties. A checklist that can help the audit committee with this assessment is provided in Appendix A.

The audit committee’s charter will usually require the committee to be involved in any decision to remove the external auditor. Matters to consider in such a case are whether the proposed removal is based on substantial grounds and not, for example, merely because the external auditor took positions on accounting issues contrary to management’s preferences.

If the audit committee has concerns about the quality of service, the first step is to discuss those concerns with the partner in charge of the external audit. Open and candid discussions between the parties can lead to a constructive resolution of matters of concern.



# Appendix A: Evaluating the performance of the external auditor

<i>Good practice</i>	<i>Is good practice being followed? Yes/No/NA</i>	<i>Follow-up steps necessary</i>
<i>Firm qualities</i>		
The audit firm exhibits strength and depth in all key geographies and industries in which the company operates.		
The audit firm has a transparent and rigorous process for dealing with difficult accounting and auditing issues.		
The audit firm has a well-considered process for establishing independence and this is communicated fully, appropriately and promptly to the audit committee.		
<i>Team member qualities</i>		
Members of the audit team are dedicated industry specialists able to identify important issues in the business and provide a value-added service.		
Team continuity and succession planning are actively managed and discussed with the company.		
Members of the audit team exhibit style and values compatible with working with company personnel.		
Members of the audit team are appropriately experienced, qualified and skilled.		
Members of the audit team demonstrate strength of character in carrying out their audit work.		
Members of the audit team exhibit high professional standards and personal integrity.		
<i>Team technical skills and knowledge transfer</i>		
Lead partners and key personnel are visible at the company and deliver practical advice to senior management, the audit committee and the board.		

## Appendix A: Evaluating the performance of the external auditor

<i>Good practice</i>	<i>Is good practice being followed?</i>	<i>Follow-up steps necessary</i>
<i>Yes/No/NA</i>		
<p>The advice provided by the auditor on regulatory/industry developments and implications is timely, technically robust and commercially sound.</p>		
<i>Audit approach and deliverables</i>		
<p>The audit approach is customised to incorporate the risks of the company and the views and concerns of management, the audit committee and the board.</p>		
<p>The audit timetable is efficient and well planned.</p>		
<p>Reporting and communication with the audit committee, board and management provides identification and resolution of accounting and disclosure issues, recommendations on internal control, commentary on the organisation’s financial reporting, and other opportunities for improvement with an appropriate level of benchmarking against best practice.</p>		
<p>The audit approach adds value by explaining the impact of audit findings and results of the auditor’s risk assessments.</p>		
<p>Audit requests are responded to and resolved in a timely manner, with agreed-on deadlines met.</p>		
<p>Key service performance standards are satisfied, including response times, deliverables, staff continuity, communication protocols.</p>		
<p>The audit firm is able to co-ordinate and deliver a range of other services as circumstances require.</p>		
<p>Feedback on service quality is actively sought at all levels, and issues swiftly rectified where required.</p>		

## Appendix A: Evaluating the performance of the external auditor

<i>Good practice</i>	<i>Is good practice being followed? Yes/No/NA</i>	<i>Follow-up steps necessary</i>
Access to tax, corporate finance and systems specialists is channelled effectively by the lead partner where required.		
Clear and regular communication is provided by the auditor to the audit committee and staff members of the company where appropriate.		
The audit committee and board are satisfied that the audit firm has met expectations, delivered results and provided overall value relative to fees. Reference is made to management and key staff opinions and reasons.		
<i>Fees</i>		
A clear analysis of fees is delivered annually.		
The fee for the audit represents fair compensation for a comprehensive and high-quality audit.		



## Appendix B: Assessing the independence of the external auditor

*These questions, and discussions arising from them, are designed to help (or 'assist audit committees to form') audit committees form a view about the independence of the external auditor.*

### Questions to consider

### Has the issue been satisfactorily addressed?

Have you received from, and discussed with, your auditor a declaration of independence covering professional and regulatory matters? If not, ask the auditor for such a declaration, and discuss. Y / N

*This declaration should cover the audit firm and audit team's financial independence (eg shares or loans), business relationships and other Professional Statement F1 matters.*

### Management liaison

Has the audit committee met with the auditor on a regular basis without management present? If not, set up a process to allow regular meetings without management present. Y / N

Are you satisfied that management has not placed undue pressure on the auditor? If not, discuss with the auditor and ensure there are direct communication channels for the auditor and audit committee. Y / N

*'Undue pressure' is real or implied pressure on the auditor to act as management wishes rather than in an objective manner.*

Have any disagreements between the auditor and management been discussed and resolved? If you are unsure, ask management and the auditor separately to explain the nature and extent of all disagreements. Y / N

*There may be real or implied pressure on the auditor, particularly if management has 'shopped around', to accept management's application of an accounting principle or reduce the level of audit work.*

## Appendix B: Assessing the independence of the external auditor

### Questions to consider

### Has the issue been satisfactorily addressed?

Are you satisfied that if there is any actual or threatened litigation between the auditor and the company, it will not affect independence? If not, consider the nature and source of the litigation. Y / N

*Litigation may impact objectivity, for example if it arises from previous audit work.*

### Relationships

Are the tenures of the audit signing partner and the review/concurring partner in line with rotation requirements? If not, discuss with the audit signing partner options for a change. Y / N

Are you satisfied that none of the employment or family relationships of the company's directors and officers, or of the auditors, affect audit independence? If not, ask management for a list of relationships (including former audit firm staff employed in senior company positions), and ask the company directors and the auditor for confirmation that all such relationships are disclosed. Y / N

Have you received confirmation that significant gifts or hospitality have not been provided to or from the auditor? If not, identify the nature and extent of the items and consider the implications in light of other company and auditor safeguards. Y / N

Services Ask management to provide you with an analysis of services and fees, covering all group companies.

Are additional services provided by the auditor in accordance with board policy and negotiated at arm's length in a transparent process? If not, consider the analysis and the particular circumstances, including the company's internal approval processes and auditor safeguards, and discuss with the auditor. Y / N

*'Other services' may give the impression of additional financial benefit being linked to the audit (also consider contingent fees).*

Is the nature of other services consistent with the auditor's independence? If you are unsure, consider the analysis and the particular circumstances, including the company's internal approval processes and auditor safeguards, and discuss with the auditor and management. Y / N

*Certain services that place the auditor in the position of acting in a management capacity, being responsible for material in the financial statements, or having a mutual or conflicting interest are not considered permissible.*

## Appendix B: Assessing the independence of the external auditor

### Questions to consider

### Has the issue been satisfactorily addressed?

Is the ratio of total fees for other services to total audit fee appropriate to the company's circumstances for the period?	If you are unsure, consider the analysis and the particular circumstances, including the company's internal approval processes and auditor safeguards, and discuss with the auditor and management.	Y / N
<i>A high ratio may give an impression that audit independence is being compromised.</i>		
<b>Audit scope and fee</b>		
Is the audit committee responsible for, and does it have significant involvement in, determining the audit scope and plan and audit fee?	If not, discuss with the auditor at a private meeting and ensure future audit committee involvement.	Y / N
Is the audit fee commensurate with the scope of the audit?	If not, discuss with the auditor at a private meeting and obtain a full understanding of the circumstances and implications.	Y / N
<i>An unreasonable budget may restrict or reduce necessary audit work. This is particularly relevant when there is a change of auditor.</i>		
Are all audit fees paid as due?	If not, ask management to explain the delay, then help to resolve it.	Y / N