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OCTOBER 2012

Audit Committee Essentials: The Annual Auditor Assessment

INTRODUCTION

Audit committees of public companies and registered investment companies have direct responsibility to oversee the integrity of a company's financial statements and to hire, compensate and oversee the external auditor. Public focus on how audit committees discharge their responsibilities, including their oversight of the external auditor, has increased significantly.

Each year, audit committees should evaluate the external auditor in fulfilling their duty to make an informed recommendation to the Board whether to retain the auditor. The evaluation should encompass an assessment of the qualifications and performance of the auditor; the quality and candor of the auditor's communications with the audit committee and the company; and the auditor's independence, objectivity and professional skepticism.

To this end, this assessment questionnaire can be used by audit committees to inform their evaluation of the auditor (i.e., the audit firm, as well as the lead audit engagement partner, audit team, and engagement quality reviewer). **The sample questions highlight some of the more important areas for consideration and are not intended to cover all areas that might be relevant to a particular audit committee's evaluation of its auditor or suggest a "one size fits all" approach.** Moreover, this assessment tool is not meant to provide a summary of legal or regulatory requirements for audit committees or auditors. Sources of additional information on hiring and evaluating the auditor and an overview of portions of the relevant standards on required auditor communications with the audit committee are included at the end of this assessment.

ASSESSMENT PROCESS

The annual auditor assessment should draw upon the audit committee's experience with the auditor during the current engagement (presentations; reports; dialogue during formal, ad hoc and executive sessions), informed by prior year evaluations. It is appropriate to obtain observations on the auditor from others within the company, including management and internal audit, accompanied by discussions with key managers. A suggested survey for obtaining observations from others within the company follows the assessment questionnaire. In assessing information obtained from management, the audit committee should be sensitive to the need for the auditor to be objective and skeptical while still maintaining an effective and open relationship. Accordingly, audit committees should be alert to both a strong preference for and a strong opposition to the auditor by management and follow up as appropriate.

It makes good sense for audit committee members to continuously evaluate the auditor's performance throughout the audit process, for example, noting the auditor's skepticism in evaluating unusual transactions or responsiveness to issues. These contemporaneous assessments provide important input into the annual assessment. Audit committees may wish to consider those contemporaneous observations during a more formal assessment process, perhaps by using a questionnaire or guide that considers all relevant factors year-over-year. To ensure that all views are considered, audit committees may wish to finalize their assessment during group discussions (as opposed to collecting audit committee member comments separately) during formal committee meetings or conference calls.

Finally, audit committees should consider advising shareholders that they perform an annual evaluation of the auditor and explain their process and scope of the assessment.

QUALITY OF SERVICES AND SUFFICIENCY OF RESOURCES PROVIDED BY THE AUDITOR

The audit committee's evaluation of the auditor begins with an examination of the quality of the services provided by the engagement team during the audit and throughout the financial reporting year. Because audit quality largely depends on the individuals who conduct the audit, the audit committee should assess whether the primary members of the audit engagement team demonstrated the skills and experience necessary to address the company's areas of greatest financial reporting risk and had access to appropriate specialists and/or national office resources during the audit. The engagement team should have provided a sound risk assessment at the outset of the audit, including an assessment of fraud risk. During the engagement, the auditor should have demonstrated a good understanding of the company's business, industry, and the impact of the economic environment on the company. Moreover, the auditor should have identified and responded to any auditing and accounting issues that arose from changes in the company or its industry, or changes in applicable accounting and auditing requirements. Another consideration for the audit committee is the quality of the engagement teams that perform portions of the audit in various domestic locations, or abroad by the firm's global network or other audit firms.

SAMPLE QUESTIONS

Q1	Did the lead engagement partner and audit team have the necessary knowledge and skills (company-specific, industry, accounting, auditing) to meet the company's audit requirements? Were the right resources dedicated to the audit? Did the auditor seek feedback on the quality of the services provided? How did the auditor respond to feedback? Was the lead engagement partner accessible to the audit committee and company management? Did he/she devote sufficient attention and leadership to the audit?
Q2	Did the lead engagement partner discuss the audit plan and how it addressed company/industry-specific areas of accounting and audit risk (including fraud risk) with the audit committee? Did the lead engagement partner identify the appropriate risks in planning the audit? Did the lead engagement partner discuss any risks of fraud in the financial statement that were factored into the audit plan?
Q3	If portions of the audit were performed by other teams in various domestic locations, or abroad by the firm's global network or other audit firms, did the lead engagement partner provide information about the technical skills, experience and professional objectivity of those auditors? Did the lead engagement partner explain how he/she exercises quality control over those auditors?
Q4	During the audit, did the auditor meet the agreed upon performance criteria, such as the engagement letter and audit scope? Did the auditor adjust the audit plan to respond to changing risks and circumstances? Did the audit committee understand the changes and agree that they were appropriate?
Q5	Did the lead engagement partner advise the audit committee of the results of consultations with the firm's national professional practice office or other technical resources on accounting or auditing matters? Were such consultations executed in a timely and transparent manner?

QUALITY OF SERVICES AND SUFFICIENCY OF RESOURCES PROVIDED BY THE AUDITOR *continued*

A broader but important consideration is whether the audit firm has the relevant industry expertise, as well as the geographical reach necessary to continue to serve the company, and whether the engagement team effectively utilizes those resources. Other firm-wide questions include the results of the audit firm's most recent inspection report by the Public Company Accounting Oversight Board (PCAOB), including whether the company's audit had been inspected and, if so, whether the PCAOB made comments on the quality or results of the audit. The audit committee also may want to know how the firm plans to respond to PCAOB comments contained in the inspection report, more generally, and to any internal findings regarding its quality control program.

SAMPLE QUESTIONS

Q6	If the company's audit was subject to inspection by the PCAOB or other regulators, did the auditor advise the audit committee of the selection of the audit, findings, and the impact, if any, on the audit results in a timely manner? Did the auditor communicate the results of the firm's inspection more generally, such as findings regarding companies in similar industries with similar accounting/audit issues that may be pertinent to the company? Did the auditor explain how the firm planned to respond to the inspection findings and to internal findings regarding its quality control program?
Q7	Was the cost of the audit reasonable and sufficient for the size, complexity and risks of the company? Were the reasons for any changes to cost (e.g., change in scope of work) communicated to the audit committee? Did the audit committee agree with the reasons?
Q8	Does the audit firm have the necessary industry experience, specialized expertise in the company's critical accounting policies, and geographical reach required to continue to serve the company?
Q9	Did the audit engagement team have sufficient access to specialized expertise during the audit? Were additional resources dedicated to the audit as necessary to complete work in a timely manner?

COMMUNICATION AND INTERACTION WITH THE AUDITOR

Frequent and open communication between the audit committee and the auditor is essential for the audit committee to obtain the information it needs to fulfill its responsibilities to oversee the company's financial reporting processes. The quality of communications also provides opportunities to assess the auditor's performance. While the auditor should communicate with the audit committee as significant issues arise, the auditor ordinarily should meet with the audit committee on a frequent enough basis to ensure the audit committee has a complete understanding of the stages of the audit cycle (e.g., planning, completion of final procedures, and, if applicable, completion of interim procedures). Such communications should focus on the key accounting or auditing issues that, in the auditor's judgment, give rise to a greater risk of material misstatement of the financial statements, as well as any questions or concerns of the audit committee.

PCAOB standards, SEC rules, and exchange listing requirements identify a number of matters the auditor must discuss with the audit committee. Audit committees should be familiar with those requirements and consider not only whether the auditor made all of the required communications, but, importantly, the level of openness and quality of these communications, whether held with management present or in executive session.

SAMPLE QUESTIONS

Q10	Did the audit engagement partner maintain a professional and open dialogue with the audit committee and audit committee chair? Were discussions frank and complete? Was the audit engagement partner able to explain accounting and auditing issues in an understandable manner?
Q11	Did the auditor adequately discuss the quality of the company's financial reporting, including the reasonableness of accounting estimates and judgments? Did the auditor discuss how the company's accounting policies compare with industry trends and leading practices?
Q12	In executive sessions, did the auditor discuss sensitive issues candidly and professionally (e.g., his/her views on, including any concerns about, management's reporting processes; internal control over financial reporting (e.g., internal whistle blower policy); the quality of the company's financial management team)? Did the audit engagement partner promptly alert the audit committee if he/she did not receive sufficient cooperation?
Q13	Did the auditor ensure that the audit committee was informed of current developments in accounting principles and auditing standards relevant to the company's financial statements and the potential impact on the audit?

AUDITOR INDEPENDENCE, OBJECTIVITY AND PROFESSIONAL SKEPTICISM

The auditor must be independent of the issuer and — in the case of mutual funds, independent of the investment company complex. Audit committees should be familiar with the statutory and regulatory independence requirements for auditors, including requirements that the auditor advise the audit committee of any services or relationships that reasonably can be thought to bear on the firm's independence.

The technical competence of the auditor alone is not sufficient to ensure a high-quality audit. The auditor also must exercise a high level of objectivity and professional skepticism. The audit committee's interactions with the auditor during the audit provide a number of opportunities to evaluate whether the auditor demonstrated integrity, objectivity and professional skepticism. For example, the use of estimates and judgments in the financial statements and related disclosures (e.g., fair value, impairment) continues to be an important component of financial reporting. The auditor must be able to evaluate the methods and assumptions used and challenge, where necessary, management's assumptions and application of accounting policies, including the completeness and transparency of the related disclosures.

An important part of evaluating the auditor's objectivity and professional skepticism is for the audit committee to gauge the frankness and informative nature of responses to open-ended questions put to the lead audit engagement partner (and members of the audit engagement team as appropriate). Examples of appropriate topics include: the financial reporting challenges posed by the company's business model; the quality of the financial management team; the robustness of the internal control environment; changes in accounting methods or key assumptions underlying critical estimates; and the range of accounting issues discussed with management during the audit (including alternative accounting treatments and the treatment preferred by the auditor). The auditor also should be able to clearly articulate the processes followed and summarize the evidence used to evaluate the significant estimates and judgments, and to form an opinion whether the financial statements, taken as a whole, were fairly presented in accordance with Generally Accepted Accounting Principles.

SAMPLE QUESTIONS

Q14	Did the audit firm report to the audit committee all matters that might reasonably be thought to bear on the firm's independence, including exceptions to its compliance with independence requirements? Did the audit firm discuss safeguards in place to detect independence issues?
Q15	Were there any significant differences in views between management and the auditor? If so, did the auditor present a clear point of view on accounting issues where management's initial perspective differed? Was the process of reconciling views achieved in a timely and professional manner?
Q16	If the auditor is placing reliance on management and internal audit testing, did the audit committee agree with the extent of such reliance? Were there any significant differences in views between the internal auditors and the auditor? If so, were they resolved in a professional manner?
Q17	In obtaining pre-approval from the audit committee for all non-audit services, did the lead engagement partner discuss safeguards in place to protect the independence, objectivity and professional skepticism of the auditor?

EXAMPLE FORM
OBTAINING INPUT ON THE EXTERNAL AUDITOR FROM COMPANY PERSONNEL

Because you have substantial contact with the external auditors throughout the year, the Audit Committee is interested in your views on the quality of service provided, and the independence, objectivity, and professional skepticism demonstrated throughout the engagement by the external audit team and firm.

Please rate the auditor's performance on each of the following attributes using a five-point scale, where 5 = Very High/ Completely Satisfied and 1 = Very Low/Completely Dissatisfied.

	QUALITY OF SERVICES PROVIDED BY THE EXTERNAL AUDITOR	RATING
1	**Meets commitments** e.g., by meeting agreed upon performance delivery dates, being available and accessible to management and the audit committee.	
2	**Is responsive and communicative** e.g., by soliciting input relative to business risks or issues that might impact the audit plan, identifying and resolving issues in a timely fashion, and adapting to changing risks quickly.	
3	**Proactively identifies opportunities and risks** e.g., by anticipating and providing insights and approaches for potential business issues, bringing appropriate expertise to bear, and by identifying meaningful alternatives and discussing their impacts.	
4	**Delivers value for money** e.g., by charging fees that fairly reflect the cost of the services provided, and being thoughtful about ways to achieve a cost-effective quality audit.	

	SUFFICIENCY OF AUDIT FIRM RESOURCES	RATING
5	**Is technically competent and able to translate knowledge into practice** e.g., by delivering quality services within the scope of the engagement, using technical knowledge and independent judgment to provide realistic analysis of issues, and providing appropriate levels of competence across the team.	
6	**Understands our business and our industry** e.g., by demonstrating an understanding of our specific business risks, processes, systems and operations, by sharing relevant industry experience, and by providing access to firm experts on industry and technical matters.	
7	**Assigned sufficient resources to complete work in a timely manner** e.g., by providing access to specialized expertise during the audit and assigning additional resources to the audit as necessary to complete work in a timely manner.	

COMMUNICATION AND INTERACTION		RATING
8	**Communicates effectively** e.g., by maintaining appropriate levels of contact/dialogue throughout the year, effectively communicating verbally and in writing, being constructive and respectful in all interactions, and providing timely and informative communications about accounting and other relevant developments.	
9	**Communicates about matters affecting the firm or its reputation** e.g., by advising us on significant matters pertaining to the firm while respecting the confidentiality of other clients' information, and complying with professional standards and legal requirements, including informing us when the company's audit is subject to inspection by the PCAOB or other regulatory review and sharing the results of the review that are pertinent to the company's accounting or auditing issues.	

INDEPENDENCE, OBJECTIVITY AND PROFESSIONAL SKEPTICISM		RATING
10	**Demonstrates integrity and objectivity** e.g., by maintaining a respectful but questioning approach throughout the audit, proactively raising important issues to appropriate levels of the organization until resolution is reached, and articulating a point of view on issues.	
11	**Demonstrates independence** e.g., by proactively discussing independence matters and reporting exceptions to its compliance with independence requirements.	
12	**Is forthright in dealing with difficult situations** e.g., by proactively identifying, communicating and resolving technical issues, raising important issues to appropriate levels in the organization, and by handling sensitive issues constructively.	

RECOMMENDATIONS	
13	**Are there actions the external auditor should take to improve its delivery of a quality audit?**

Please sign, date and return the form to _____ by _____.

Questions may be directed to _____. Thank you.

Signed _____ Title_____

Date _____

RELEVANT REQUIREMENTS AND STANDARDS

PROHIBITED NON-AUDIT SERVICES

There are nine statutory categories of non-audit services that may not be provided to companies by the external auditors (Section 10A (g) to the Securities Exchange Act of 1934). For investment companies, these non-audit services may not be provided to any company in the investment company complex (as defined in 210.2-01(f)(14)):

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other service that the PCAOB determines, by regulation, is impermissible.

Audit committees must pre-approve the provision of all other non-audit services by the auditor.

OVERVIEW OF AUDITOR COMMUNICATIONS WITH AUDIT COMMITTEES

SEC Rule 2-07 requires the auditor to communicate the following to the audit committee prior to the filing of the company's Form 10-K. For investment companies that file Form N-CSR, these communications must take place annually, except that if the annual communication takes place more than 90 days prior to the filing, the auditor must provide an update describing any changes to the previously reported information.

- Critical accounting policies and practices used by the issuer;
- Alternative accounting treatments within U.S. GAAP for accounting policies and practices related to material items that have been discussed with management during the current audit period, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the independent auditor;
- Material written communications between the independent auditor and management of the issuer; and
- If the audit client is an investment company, all non-audit services provided to any entity in an investment company complex that were not pre-approved by the investment company's audit committee pursuant to 210.2-01(c)(7).

PCAOB Auditing Standard No. 16 (AS 16), Communications with Audit Committees, replaces AU 380 for audits of issuers for fiscal years beginning on or after December 15, 2012.[1] The standard requires the following communication with the audit committee:

- The independent auditor's responsibilities in relation to the audit under the standards of the PCAOB; as part of establishing an understanding with the audit committee on the terms of the engagement; preferably through a written communication (i.e., engagement letter). Also requires communication of major issues discussed with management prior to the initial selection or retention as auditors;
- Whether the audit committee is aware of any matters relevant to the audit, particularly any violations of laws or regulations. Also requires the auditor to communicate the overall audit strategy, timing of the audit and significant risks; including the participation of others in the audit (i.e., specialists, firms beside the principal auditor, etc.); and

[1] AS 16 will not go into effect until the SEC formally approves it. Auditors of emerging growth companies and broker dealers are subject to AU 380 until the SEC determines to extend AS 16 to the former and adopts amendments to SEC Rule 17a-5 for the latter.

- The following with respect to the entity's accounting policies and practices, estimates and significant unusual transactions; and the auditor's evaluation of the quality of a company's financial reporting:
  - Significant accounting policies and practices – Management's initial selection of, or changes in the current period; the effect on financial statements or disclosures for policies that are considered controversial, there is a lack of guidance, or diversity in practice; and the auditor's qualitative assessment of such policies and practices. Specifically, the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting and disclosures, including situations in which the auditor identified bias in management's judgments and the auditor's evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements which are individually reasonable, that indicate a possible bias on the part of company management;
  - Critical accounting policies and practices – The reasons such policies and practices are considered critical; how current and anticipated events could affect this determination; and the auditor's assessment of related management disclosures;
  - Critical accounting estimates – A description of the process used to develop such estimates; management's significant assumptions in the estimates that have a high degree of subjectivity; any significant changes in management's process to develop an estimate; and the auditor's conclusion as to the reasonableness of such estimates;
  - Significant unusual transactions – Significant transactions outside the normal course of business, or that are unusual due to timing, size or nature; and the auditor's understanding for the business rationale of such transactions;
  - Financial statement presentation – The evaluation of whether the financial statements and related disclosures are presented fairly in accordance with the applicable financial reporting framework;
  - New accounting pronouncements – Any concern identified by the auditor related to management's application of pronouncements that have been issued but are not yet effective in relation to future periods; and
  - Alternative accounting treatments – All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.
- Other communications from the auditor include:
  - Other information – The auditor's responsibility with respect to and results of audit procedures performed on other information accompanying the audited financial statements;
  - Difficult or contentious matters for which the auditor consulted;
  - Management consultation with other accountants;
  - Going concern – Whether the auditor believes there is: i) substantial doubt including related events or conditions; ii) substantial doubt has been alleviated due to management's plan; iii) substantial doubt remains despite management's plans; and iv) related effect on the financial statements;
  - Corrected and uncorrected misstatements and omitted disclosures – Requires the auditor to provide the audit committee with a written schedule of uncorrected misstatements that was provided to management. Also requires communication for the basis of whether: i) uncorrected misstatements were immaterial, including qualitative assessment; ii) uncorrected misstatements or underlying matters could potentially cause future-period financial statements to be materially misstated; and iii) corrected misstatements other than those deemed trivial, that might not have been detected other than through the audit procedures;
  - Disagreements with management, whether or not satisfactorily resolved that individually or in the aggregate could be significant to the entity's financial statements or the audit report; and
  - Significant difficulties encountered with management in performing the audit.

PCAOB standards require the independent auditor to communicate all material weaknesses and significant deficiencies identified during the audit to the audit committee. If the independent auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, the auditor is required to inform the board of directors.

PCAOB rules also require at least an annual written statement delineating all relationships between the independent auditor and the company, including individuals in financial reporting oversight roles at the company that reasonably can be thought to bear on independence.

New York Stock Exchange Rule 303A.07(b), from its Listed Company Manual, requires audit committees to have a written charter that sets forth the committee's purpose, including, at a minimum, certain provisions of SEC rule 10A-3(b)(2), (3), (4), and (5), as well as other specific duties and responsibilities, to assist board oversight of the integrity of the company's financial statements, and the independent auditor's qualifications, independence and performance. Pertinent to auditor oversight, the rule includes the following audit committee requirements:

- Obtain and review at least annually a report by the independent auditor which describes the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company;
- Meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the listed company's i) specific disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations"; and ii) policies with respect to risk assessment and risk management, the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;
- Meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;
- Review with the independent auditor any audit problems or difficulties and management's response;
- Set clear hiring policies for employees or former employees of the independent auditors; and
- Report regularly to the board of directors.

Commentary to the rule pertinent to the assessment of the independent auditor further provides that after reviewing the auditor's quality control report and the auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence (including a review and evaluation of the lead partner) taking into account the opinions of management and the company's internal auditors. The commentary further provides that, in addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. Finally, audit committees are instructed to present their conclusions to the full board of directors.

RECENT SOURCES AND SUGGESTED READINGS

New York Stock Exchange. *New York Stock Exchange Listed Company Manual.* 2012.

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MUTUAL FUND DIRECTORS FORUM
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Association of Audit Committee Members, Inc.

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