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**Ensuring a High Quality Audit – Who is Responsible?**

**Five ideas for audit committees to maximize value from the external audit process**

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The world tends to repeat cycles, and the current attention to deficient audits is reminiscent of the years ushering in the Sarbanes-Oxley Act of 2002. However, this time it is different as regulators are proactively scrutinizing external auditors and imposing enforcement actions against audit committee chairs.

In a January 25, 2016 [speech](https://www.sec.gov/news/speech/directors-forum-keynote-ceresney.html)[[1]](#endnote-1), Andrew Ceresney, Director of the SEC’s Division of Enforcement, states: “audit committee members who fail to reasonably carry out their responsibilities, and auditors who unreasonably fail to comply with relevant auditing standards in their audit work, can expect to be in our focus.” Regulators are increasingly holding gatekeepers of the financial reporting process more accountable. According to Mr. Ceresney, the SEC has recently brought cases against three audit committee chairs who either approved public filings they knew were reckless or should have known to be false because of other information available to them. This is a very important sentence because it equates audit chair negligence of *knew were reckless* to *should have known to be false because of other information available to them*. No longer can audit committee members and chairs plead ignorance of not knowing a material disclosure is false if they should have known better due to available information. Here is a summary of the three audit committee chair cases:

1. The SEC charged a company and top executives with conducting a massive accounting fraud in which they repeatedly reported fake revenues from their China operations in order to meet financial targets and inflate their stock price. The audit committee chair learned facts from a high level employee who had visited China that the Chinese sales were suspected of being inflated. He then allegedly sought advice from a former director and company advisor, who recommended that the company conduct a full internal investigation. However, the audit committee chair ignored the recommendation and the red flags of fraud, and approved the public filing of the financial statements.
2. The SEC charged a company’s former audit committee chair for signing an annual report that she knew or should have known contained a false Sarbanes-Oxley certification with the digital signature of a declared acting CFO when, in fact the person selected for that role had rejected the offer to serve in the position.
3. The SEC found that a company’s former audit committee chair signed several filings that did not disclose the full extent of executive perks. He then learned through an internal review that certain perks had not been disclosed. The audit committee chair then relied on views of an independent consultant resulting in additional filings with incorrect disclosures.

Mr. Ceresney emphasized that “when an audit committee member learns of information suggesting that company filings are materially inaccurate, it is critical that he or she take concrete steps to learn all relevant facts and cease annual and quarterly filings until he or she is satisfied with the accuracy of future filings*.”* These are very important words to practice.

Mr. Ceresney also mentioned that the SEC settled high profile cases in recent months against two national audit firms, and individual audit partners from those firms, pertaining to false and misleading unqualified audit opinions. These are the first cases against national audit firms for audit failures since 2009.

While it is important to understand the regulators’ viewpoints and efforts, the levers for extracting value from the external audit process largely rests with the company. With the audit season concluded for companies with fiscal year-ends synced to the calendar year, now is an ideal time to assess the value of the external audit process. First, let’s visit some recent regulatory developments.

**Regulators – What Are The Issues?**

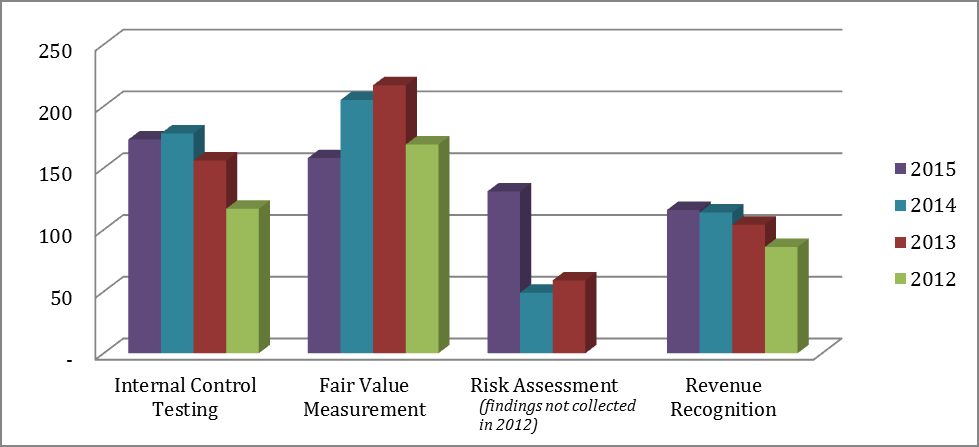
In addition to increased SEC enforcement actions, the Public Company Accounting Oversight Board (PCAOB) continues to find relatively high rates of audit deficiencies per their inspections. Earlier this month, the International Forum of Independent Audit Regulators (IFIAR) issued their [*Report on 2015 Survey of Inspection Findings*](http://www.irba.co.za/dmdocuments/IFIAR-2015-Survey-of-Inspection-Findings.pdf) on March 3, 2016 (Report[[2]](#endnote-2)) from audit regulators’ inspections of the six largest international audit firm networks. The IFIAR is composed of independent audit regulators from 50 jurisdictions, including the PCAOB. The Report concluded that 43% of inspected audits of listed public interest entities (PIEs) had at least one inspection finding. A PIE is an entity listed on a national securities exchange. This Report uses “finding” and “deficiency” interchangeably. Inspection findings are deficiencies in audit procedures indicating an audit firm did not obtain sufficient appropriate audit evidence to support its opinion. This does not necessarily imply that the audited financial statements were materially misstated.

The Report found the highest number of financial statement audit inspection deficiencies for PIEs in the areas of:

* Internal control testing (23% frequency of findings)
* Fair value measurement (18% frequency of findings)
* Revenue recognition (15% frequency of findings)
* Risk assessment (14% frequency of findings)

Refer to Figure 1 for Table 3 from the Report provides a four-year summary of the four inspection themes with the highest number of findings reported in the 2015 survey.

***Listed PIE Audits: Number of Inspection Findings, 2015-2012 Selected Summary***



(Source: Table 3 from the *Report on 2015 Survey of Inspection Findings*, published by the International Forum of Independent Audit Regulators on March 3, 2016)

The IFIAR first began collecting information on risk assessment findings in their 2013 survey. While the one year spike for 2015 is not conclusive of a trend, it does indicate a sharp annual increase in risk assessment finding, which includes the failure of the auditor to respond appropriately to risks identified, whether during audit planning or as new information arises during the course of an audit. This is also an important matter for audit committees in keeping their antennas up for new risks pertaining to the financial statements, regulatory disclosures, and underlying controls. Conversations with management, internal auditors, external auditors, and other sources are important in ensuring that important risks are appropriated vetted.

The Report also found the highest number of firm-wide quality control deficiencies in the areas of:

* Engagement performance (59% frequency of findings)
* Independence and ethical requirements (40% frequency of findings)
* Human resources (36% frequency of findings)
* Monitoring (33% frequency of findings)

On the same day the Report was issued, March 3, 2016, the IFIAR issued a press release entitled [*International Audit Regulators Say Pace of Audit Quality Improvement Too Slow; Call for Measurable Improvement By 2019*](https://www.ifiar.org/IFIAR/media/Documents/General/About%20Us/Inspection-Findings-Survey-Report_Press-Release.pdf)[[3]](#endnote-3). This press release states: “IFIAR and the six largest network firms have agreed on a new initiative to improve audit quality globally. The goal is to reduce the number of deficient audits reported by our members in the survey. To provide a means to measure progress, for the first time IFIAR’s working group that engages regularly with the largest global audit firms has set a measurable target for the reduction of audits with findings: a reduction of at least 25 percent in the next four years in audits with at least one finding as reported by the members of this working group.”

Accomplishing this goal will likely not settle the audit quality concern, but at least it is a start. The IFIAR plans to support this objective by encouraging root cause analysis, as well as increased monitoring and dialogue with the six largest international audit firm networks.

A powerful PCAOB staff perspective entitled, “[*The State of Audit Quality*](http://pcaobus.org/News/Speech/Pages/Munter-AICPA-2015-inspections-update.aspx)[[4]](#endnote-4),” was given at the American Institute of Certified Public Accountants (AICPA) Conference on Current SEC and PCAOB Developments last December, 2015, by Helen A. Munter, PCAOB Director, Division of Registration and Inspections. Ms. Munter emphasizes that the *goal of inspections is not to simply identify deficiencies, but rather “to help auditors improve the quality of their audits and the value that they bring to their clients and to investors.”*

While clearly the auditor owns the responsibility of complying with applicable auditing standards, companies have a lot of power towards ensuring that value is derived from the external audit process. Both the audit committee and the CFO have important roles, with the audit committee taking the lead with hiring, evaluating, and retaining the external auditor. The CFO also has an important role in filtering up valuable insights on the day-to-day working relationship with the auditor. Incorporating regulatory hot-buttons into the conversations with the external auditors can pay dividends by reinforcing that the company is paying attention to the auditor’s world and holding them accountable.

**Company Considerations to Extract Audit Value**

Here are some ideas towards ensuring a healthy external audit process to maximize value:

1. **Obtain a high-level understanding of the external audit world**: Acquiring a basic knowledge of audit standards and the regulatory audit environment is helpful in understanding the audit perspective. New auditing standards generally draw more attention from regulators in assuring that the new audit procedures are properly applied. For example, PCAOB’s auditing standard number 18 ([AS-18](http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2014_002_Related_Parties.pdf)) requires more robust audit considerations in three critical areas, including related party relationships and transactions. The increased expectations triggered by AS-18, combined with the PCAOB’s tendency to focus on recently issued standards in their inspections, has audit firms laser-focused on related party transactions. This indirectly can have a significant impact on their audit clients. Preparing for sensitive audit areas well before the auditors arrive for fieldwork can greatly reduce stress levels. In addition to acquiring a general knowledge of regulatory interests, ask your auditors to identify the hot buttons they anticipate for the upcoming audit.

This suggestion should not be interpreted as a time-consuming and detailed educational ordeal, but rather quick management briefs to the audit committee or members subscribing to summary updates that are widely available from numerous sources, including large audit firms. Audit committees should also consider utilizing their internal audit function, whether staffed internally, outsourced, or co-sourced, to periodically inform them of regulatory hot-buttons. For more significant regulatory and accounting developments, such as COSO’s 2013 *Internal Control-Integrated Framework*, or new revenue recognition or lease accounting standards, audit committees should consider brief training sessions on these topics to become more comfortable.

1. **Ask lots of questions**: Audit committees need to be comfortable with the auditor’s understanding of risk of material misstatement (RMM) and their audit plan. It is prudent for them to ask plenty of questions to their auditors at audit committee meetings. A red-flag should go up if the external auditor simply rolls through their required communications without any discussion. As communicated in PCAOB’s “[Audit Committee Dialogue](http://pcaobus.org/sites/digitalpublications/Documents/AuditCommitteeDialogue.pdf)” issued in May 2015, questions to consider include:
   1. What are the points within the company’s critical systems processes where material misstatements could occur?
   2. How has the audit plan addressed the RMM at those points?
   3. What new risks have been identified?
   4. How have the areas of significant RMM changed since the prior year?
   5. What is the approach for evaluating the company’s controls over financial reporting for significant unusual transactions or events, such as the acquisition of assets and assumption of liabilities in business combinations, divestitures, and major litigation claims?
   6. What is done to obtain a thorough understanding of the assumptions and methods the company used to develop critical estimates, including fair value measurements?
   7. Has the engagement team lost key auditors or specialists to other lines of business?
   8. How are you ensuring that the quality of the audit team will remain high over time?

Audit committees may also want to discuss with their auditors the types of audit deficiencies identified in their PCAOB inspections, as well as how they are addressing them in the their audits. The Sarbanes-Oxley Act authorizes the PCAOB to inspect audit firms registered with the PCAOB for the purpose of assessing compliance with certain laws, rules, and professional standards in connection with a firm's audit work for public company and broker-dealer clients. All audit firms who conduct attestation work for public company and broker-dealer clients must be registered with the PCAOB. Registered CPA firms range in size from sole proprietorships to large firms that are members of extensive global networks, made up of separately registered firms in multiple jurisdictions.

Regardless of the size of the registered CPA firm, those who issue audit reports opining on the financial statements of public company and broker-dealer clients are periodically inspected. The Sarbanes-Oxley Act requires the PCAOB to issue a written report on each inspection. The public report portion of the inspection can be retrieved at [PCAOB’s website](http://pcaobus.org/Inspections/Reports/Pages/FirmsFailedToAddressQCSatisfactorily.aspx). There is also potentially a nonpublic report portion if defects in the quality control systems of the audit firm are identified through the inspection. In these circumstances the audit firm has 12 months after the date of the inspection report to remediate the deficiencies, in which case this nonpublic report section is not made public. For audit firms that fail to address quality control criticisms satisfactorily with the PCAOB, this part of the inspection report is made public on the [PCAOB’s website](http://pcaobus.org/Inspections/Reports/Pages/FirmsFailedToAddressQCSatisfactorily.aspx). Audit committee members should check these website pages on an annual basis to keep abreast of PCAOB findings relative to their external audit firm. The findings can also serve as a point of discussion with the auditors.

1. **Understand how your internal audit function will be leveraged**: Overseeing the external audit relationship from contract award to termination is one of the most fundamental responsibilities of audit committees. Unfortunately, some audit committees go about this duty with little or no consideration of their internal audit function. This can be a wasted opportunity to help reduce potential audit fees by having discussions with the external auditor on their stance for leveraging internal audit’s work. Indeed PCAOB Auditing Standard (AS) No. [2201.17](http://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx) states that; “the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting.” The auditing standard goes on to also caution the external auditor from using the work of others who have a low degree of objectivity, regardless of their level of competence. Once again this points to the importance of independence and objectivity of the audit function, including any portions leveraged from the internal audit function.

While there are no requirements for the external auditor to utilize internal audit efforts, standards do require them to consider it (refer to [PCAOB AS 2605](http://pcaobus.org/Standards/Auditing/Pages/AS2605.aspx)). The external auditor’s assessment of the competence and objectivity of the internal audit function is central to their decision. Regarding competency, PCAOB AS 2605.09 states that “the auditor should obtain or update information from prior years about such factors as:

* Educational level and professional experience of internal auditors.
* Professional certification and continuing education.
* Audit policies, programs, and procedures.
* Practices regarding assignment of internal auditors.
* Supervision and review of internal auditors' activities.
* Quality of working-paper documentation, reports, and recommendations.
* Evaluation of internal auditors' performance”

As a result, it is in the audit committee’s best interest to ensure that these competency factors are being met. In addition, audit committees should have a significant role in ensuring the objectivity of their internal auditors. PCAOB AS 2605.10 states that “the auditor should obtain or update information from prior years about such factors as:

* The organizational status of the internal auditor responsible for the internal audit function, including:
  + Whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors.
  + Whether the internal auditor has direct access and reports regularly to the board of directors, the audit committee, or the owner-manager.
  + Whether the board of directors, the audit committee, or the owner-manager oversees employment decisions related to the internal auditor.
* Policies to maintain internal auditors' objectivity about the areas audited, including:
  + Policies prohibiting internal auditors from auditing areas where relatives are employed in important or audit-sensitive positions.
  + Policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function.”

The company, through their audit committee and CFO management team, should be comfortable that internal audit efforts will be considered by the external auditor with a strong appetite to potentially use some of these efforts in support of their opinions. Of course, use of this effort assumes that the external auditor is comfortable with the internal audit function in accordance with external auditing standards. The external auditor’s responsibility to report on the financial statements rests solely with them since they own their opinions.

1. **Do not treat the audit opinion as a commodity purchase:** Not all audit firms and audit teams are the same. Quite the contrary, as good and bad audit teams exists within all larger and mid-sized firms. Likewise, the size of the audit firm is not always indicative of value. Audit committees need to carefully select and retain firms they feel can best provide value through a robust opinion. In many cases, these audit firms will not be the low price bidder. The audit firm must be independent and the audit team must demonstrate plenty of objectivity and professional skepticism.
2. **Develop an audit improvement plan:** Consider what went well and what did not during the recent audit cycle. Draft an internal improvement plan, with key conclusions eventually shared with your auditor. The plan should contain audit committee and management objectives, and an assessment if they were met. Specific recommendations for improvement should be discussed between the company and the auditor, including actions to mitigate stress points and opportunities to glean more value from the external audit process. A good resource for identifying key elements of a quality audit can be retrieved from the Center for Audit Quality’s, [*CAQ Approach to Audit Quality Indicators*](http://www.thecaq.org/docs/reports-and-publications/caq-approach-to-audit-quality-indicators-april-2014.pdf?sfvrsn=2)[[5]](#endnote-5), published in April, 2014.

While the above list is not meant to be exhaustive, it should help trigger ideas to extract more value from the external audit process. Maximizing value rests largely on the audit committee’s shoulders, not the regulators. Don’t let another audit-year go by without aligning the external audit process objectives to an action plan to maximize value.

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1. The Securities and Exchange Commission, Speech, Directors Forum 2016 Keynote Address, Andrew Ceresney, Director of Division of Enforcement, San Diego, California, January 25, 2016, <https://www.sec.gov/news/speech/directors-forum-keynote-ceresney.html> [↑](#endnote-ref-1)
2. International Forum of Independent Audit Regulators’ Report on 2015 Survey of Inspection Findings, March 3, 2016. [↑](#endnote-ref-2)
3. International Forum for Independent Audit Regulators’ press release, International Audit Regulators Say Pace of Audit Quality Improvement Too Slow; Call for Measurable Improvement By 2019, Amsterdam, the Netherlands, March 3, 2016. [↑](#endnote-ref-3)
4. Public Company Accounting Oversight Board’s Speeches & Statements, The State of Audit Quality, December 11, 2015, <http://pcaobus.org/News/Speech/Pages/Munter-AICPA-2015-inspections-update.aspx> [↑](#endnote-ref-4)
5. The Center for Audit Quality’s CAQ Approach to Audit Quality Indicators, April, 2014. [↑](#endnote-ref-5)