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How Audit Committees Can Assess Auditor Independence

By Catherine R. Allen

Audit committees have a tough job. As part of their duty to appoint and oversee the work of the company's auditor, they are charged with assessing auditor independence. With myriad relationships and rules to consider and judgments far into the gray zone, this is no easy task. For starters, audit committees may wish to incorporate certain practices into their activities to help them make better, more comprehensive independence assessments.

Practice # 1—Maximize Meeting Time. There are several things an audit committee can do to make the most of its time with the auditor. First, allot significant time to independence; what appears to be a relatively black-and-white issue can become a lengthy exchange. Assessing independence is a critical task. Whether it's a significant meeting to discuss several important matters or ten minutes for a brief update, allow time to discuss this important topic.

To make the most of everyone's time, ensure that the proper people will be able to participate—either in person or by telephone. Generally, this means the audit committee members and the audit team's lead audit partner and manager. However, there may be instances when other members of the audit firm should attend (as in the case of proposed non-audit services) or even the firm's leadership, if a contractual relationship will be discussed. In some cases, management should present its proposal that the audit firm is best suited to provide a particular service. A detailed agenda should be circulated to all attendees in advance of the meeting so that they may be fully prepared to contribute to the discussion.

Director Summary: Assessing auditor independence has recently become more critical and more difficult. Three practices—maximizing meeting time, compiling an inventory of independence issues, and going beyond the SOX list of prohibited services to ask more probing questions—will assist audit committees in their due diligence.

In addition to normal, recurring meetings, there may be occasions when an unexpected issue arises, which may affect the auditor's independence. Obviously, such a discussion should not be deferred to a regularly scheduled meeting; audit committees should be flexible enough to accommodate a comprehensive discussion of an emerging (or emergency) issue in a timely manner. If the matter turns out to be a bona fide independence issue requiring further action, not addressing it in a timely manner will cast a very poor light on the committee and its practices.

Practice # 2—Compile a Complete Inventory of Potential Independence Issues. It is impossible to assess or monitor independence if the audit committee is not aware of the range of potential issues that could impair the auditor's independence. Generally, the more complex the company in terms of affiliated entities and worldwide operations, and the greater the extent of the auditor's relationships with the company and its affiliates, the more potential issues will exist. While the list will vary somewhat, audit committees should be satisfied that the auditor is independent considering:

1. Audit team members or other firm personnel whose relatives are in management positions with the company or its affiliates.
2. Audit team members or other firm personnel who have financial interests or other relationships with the company or its affiliates.
3. Fee arrangements (commissions, contingent fees, overdue fees) between the audit firm or its affiliates and the company.
4. Non-audit services rendered by the audit firm to the company or its affiliates.
5. Audit partner rotation time frames (may involve numerous partners).
6. Company employees joining the audit firm, and vice versa, including auditor "cooling off" provisions.
7. Limitations of legal liability or indemnification agreements in audit engagement letters.
8. Litigation or the threat of litigation between

the audit firm and the company or its affiliates.

9. Business relationships, including vendor relationships, between the audit firm and the company or its affiliates.

The audit committee and the audit team should work together early in their relationship to develop a list of potential issues, which the committee can use to develop questions for the auditors and to monitor independence. Of course, the audit committee should also perform its own due diligence and determine whether other potential interests and relationships are relevant. In addition, the audit committee should, with the help of the auditor and also independently (working with legal counsel or an outside consultant) stay abreast of new rules developed by the Public Company Accounting Oversight Board (PCAOB).

Practice # 3—Look beyond the SOX List. While the Sarbanes-Oxley (SOX) list of prohibited non-audit services has become widely known in audit committee and other circles, it does not tell the whole story about services and activities that may impair independence. Accordingly, audit committees should consider additional factors when they pre-approve the audit firm's services.

First, the SOX list has grown—recent PCAOB rulemaking added personal tax services provided to persons in financial reporting oversight roles and certain services relating to aggressive or confidential tax transactions to the mix. Also, audit committees should carefully screen non-audit services for potential management functions or decision-making activities, which the rules strictly prohibit. In other words, audit committees must be convinced that the audit firm's proposed activities do not constitute management functions or put the audit firm's personnel in the place of company management. It should be clear that the company will assign competent management to oversee the audit firm's work, to ensure that the auditor does not make decisions that the company should be making.

Audit committees should ask probing questions about the proposed service and all independence-related matters. Discussing service proposals in broad generalities and allowing pre-approval to become a "rubber-stamp" activity will not suffice. Rather, audit committee members (or member, if a delegate will review the service on behalf of the committee) should ask the lead audit partner or non-audit service provider to explain the scope of the services to them. It is also critical that audit committees understand how the services will be performed (for example, where the lines of responsibility will be drawn, particularly when the service will involve or culminate in strategic decisions for the company).

All proposed activities should comply with the Securities and Exchange Commission's (SEC's) fundamental principles, which means that an auditor cannot: (1) function in the role of management, (2) audit his or her own work, (3) serve in an advocacy role for the client, or (4) have a mutual or conflicting interest with the client. Basing inquiries on these simple principles will help audit committees focus on what is truly at the heart of the SEC and PCAOB independence rules.

With myriad relationships and rules to consider and judgments far into the gray zone, this assessment is no easy task.

New Rules, New Practices

PCAOB rule 3524, *Audit Committee Pre-Approval of Certain Tax Services,* which received the SEC's blessing earlier this year, imposes additional requirements on auditors. The rule's intent is to enhance the quality of the information furnished to the audit committee and foster a thorough and meaningful discussion between the auditor and the audit committee about the potential effect of tax services and related arrangements on the audit firm's independence. New for the auditor is a requirement to provide a detailed written description to the audit committee about the scope and nature of proposed tax services, and related fee and other arrangements. Once the auditor has discussed these matters and their possible impact on independence with the audit committee, the auditor must document the substance of the discussion. The PCAOB plans to monitor implementation of this rule via their inspection process and may consider expanding the rule to other types of services. Audit committees can put themselves ahead of this curve by asking their auditors to apply the substance and/or spirit of the new PCAOB rule to *all* nonaudit services proposals.

Assessing independence is not an easy task. By implementing these practices and exercising appropriate due diligence, audit committees can enhance their abilities to assess auditor independence and arrive at solid, well-informed decisions. ■

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