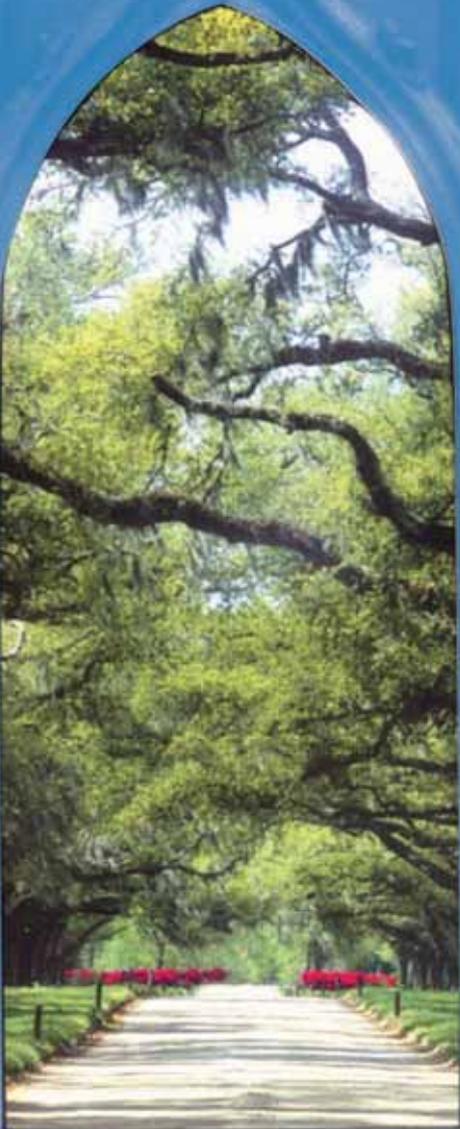




# Audit Committee Forum™

Position Paper 8

The evaluation of the  
external auditor's audit of  
the financial statements



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# The evaluation of the external auditor's audit of the financial statements



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## Introduction

The external audit report has traditionally provided management and the board with one source of assurance for identifying and controlling financial reporting risk – the risk that economic events will not be appropriately reflected in an entity's financial statements. The external auditor's independent attestation is also viewed as contributing to the effective functioning of the capital markets that value consistent and reliable financial reporting.

## What is a financial statement audit?

The purpose of an external audit of the financial statements is to obtain independent, objective and reasonable assurance on whether the financial statements, taken as a whole, comply with relevant accounting standards and present fairly the financial position and performance of the entity. This evaluation is communicated via the external auditor's report.

There is a statutory requirement for private and public companies to have their annual financial statements externally audited.

In forming an opinion on the financial statements:

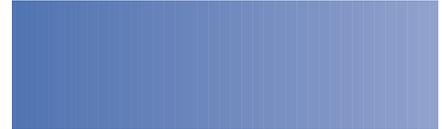
- an auditor's examination will be performed in accordance with International Standards on Auditing (ISA); and

- the auditor will perform sufficient procedures and tests to obtain reasonable assurance whether the information produced by the accounting and reporting systems is reliable and sufficient as the basis for preparation of the financial statements. Absolute assurance in auditing is not attainable as a result of such factors as the application of judgement, the use of testing, the inherent limitations of any accounting and internal control system and the fact that most of the evidence available to the external auditor is persuasive, rather than conclusive, in nature.

- the auditor, in examining and testing an entity's accounting and reporting systems, may detect weaknesses in controls or business processes that are then reported to management and the audit committee. However, given:

- the specific scope of an external audit (the financial report as a whole and not individual line items);
- that the audit involves testing on a sample basis, since an examination of all transactions is not practical; and
- the auditor may decide to follow a substantive approach in gathering audit evidence,

an external audit may not reveal all material control weaknesses that may exist within an entity, including those that may result in fraud or misappropriation.



It is therefore critical that audit committees do not inappropriately rely on the external audit to reveal all such matters, and that other reporting processes and review mechanisms, such as internal audit, are put in place as appropriate.

- the auditor will also consider whether there is adequate disclosure of relevant information in the financial report.

It should be noted that a financial statement audit **is not**:

- a detailed examination of all amounts in the financial statements;
- an opinion on an individual statement of financial position assertion (eg receivables). It is an opinion on the financial statements taken as a whole;
- a certification;
- a guarantee;
- an absolute assurance.

It is important to note that the directors, not the external auditors, are responsible for preparation of the financial report in accordance with the Statements of Generally Accepted Accounting Practice or International Financial Reporting Standards (where applicable) and must sign a directors' statement of responsibility before the audit report can be signed.

## Evaluating the performance of the external auditor

The performance of the external auditor's audit of the financial statements should be regularly reviewed. In evaluating the effectiveness of the external auditor, the audit committee needs to assess the effectiveness of the financial statement audit against agreed performance criteria including:

- the overall comprehensiveness of the audit plan for the financial statement audit (Please refer to Appendix A for guidance on the elements which should be included in the audit plan);
- the timeliness and quality of communications promised under the plan; and
- the ability of external audit staff to achieve the scope as outlined in the plan.

In addition, the audit committee should obtain feedback from management and internal audit on the conduct of the external audit.

The following is an overview of possible steps in an evaluation approach:

- Discuss the evaluation process that will be adopted, decide who will coordinate the process, and create the evaluation form and compile the results.

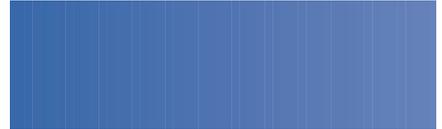
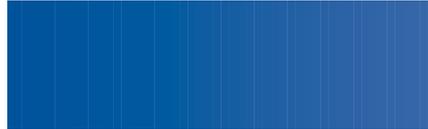
- Determine who will participate in providing initial input to the audit committee.
- Provide the evaluation form to all participants and have them return it to the coordinator for compilation.
- Use compiled reports that reflect each response and the overall response.

Refer to Appendix B for a range of questions the audit committee can use to evaluate the external auditor's performance of the financial statement audit.

## Conclusion

Should the external auditor's performance be evaluated as unsatisfactory, the audit committee should discuss the situation with the external auditor. The audit committee may request a change in the composition of the audit team and include more experienced team members. If considered necessary, the audit committee may request an increase in the scope of the audit to satisfy the audit committee that an appropriate external audit has been performed of the financial statements.

If the audit committee concludes that the financial statement audit should be awarded to a different auditor, the decision should be discussed with the board of directors and the appropriate tendering process followed.



## Appendix A

### The external audit plan

The audit plan is the external auditor's responsibility but it is important that the audit committee fully understands it. It is possible for the audit committee to ask for the scope of the audit to be expanded and to renegotiate the fee in accordance with changes in the scope of the audit.

During the planning phase, the audit committee's role is to:

- approve the terms of the audit, as detailed in the engagement letter. This will set out the responsibilities of management, the responsibilities of the external auditor and other logistical matters;
- approve the audit fee proposed; and
- read and critically assess the audit plan. The audit plan will typically set out the following:
  - Scope of the audit.
  - The materiality level to be applied by the external auditor.
  - Key areas of business risk leading to the audit risk for the entity.
  - Major accounting systems and systems of internal control to be reviewed.
  - Extent of reliance on controls.
  - Identification of significant transactions.
  - Areas of specific audit focus.
  - Nature of the audit procedures to be performed.

- Identification or anticipation of significant changes to the financial report as a result of new or revised accounting policies and/or regulatory requirements.
- Locations to be visited and audit procedures to be undertaken in respect of those locations not visited.
- Co-ordination with internal audit to avoid duplication of effort and to optimise audit efficiency.
- The extent to which the planned audit scope can be relied upon to detect errors or irregularities (e.g. fraud).
- The audit timetable.
- Frequency of meetings with the audit committee and any reports or other deliverables the audit committee and management require.
- Auditor independence including the number of years' service the engagement partner has been part of the external audit team (bearing in mind the various rotation requirements locally and internationally).
- Names of the external audit team members, their status and experience.



## Appendix B

*This questionnaire provides the audit committee with an holistic set of questions that could be used in evaluating the external auditor's performance. The questionnaire should be tailored by each audit committee to achieve the objective of the individual evaluation.*

Evaluation of the external auditor	Yes	No	Not sure	Comments
<i>Questions for audit committee members</i>				
<b>Engagement letter and audit approach</b>				
At the start of each annual audit cycle, was the external audit plan presented to the audit committee for their comment?				
Was there a correlation between the external audit plan and the scope and objectives outlined in the engagement letter?				
Did the audit approach take due account of previous work performed or any known issues relating to the entity's internal controls?				
Was the audit approach designed to take account of the role of internal audit and its findings? Were the results of relevant internal audit work used appropriately?				
Did the external audit plan indicate that the auditors understand the industry, the entity's businesses and the way the entity is run?				
Was there sufficient audit coverage across the entity to ensure that the external auditor was able to express an opinion on the financial statements?				
Did the auditor inform the audit committee of any risks, of which the committee was not previously aware?				
Was the audit work focused on major issues and did the work deal appropriately with those areas in terms of the external audit plan?				
Was the external audit plan relevant and up to date with new auditing standards (e.g. fraud) and did the plan adequately reflect changes in the entity?				
<b>Audit fieldwork</b>				
Did the auditor meet with the audit committee when requested?				
Did audit procedures used by the respective audit teams seem relevant, appropriate and reasonable?				
Did the audit partners and senior audit managers demonstrate that they have an up-to-date understanding of the industry, the entity's business and the way the entity is run?				
Where relevant, were appropriate management representations obtained?				



## Appendix B (cont)

Evaluation of the external auditor	Yes	No	Not sure	Comments
<i>Questions for audit committee members (cont.)</i>				
Where other external audit firms were involved, was there appropriate coordination and a good working relationship established with these firms, particularly with regard to joint audit situations?				
Was there reasonable and appropriate use of experts and/or technology in the performance of the audit?				
<b>Management letter and audit reporting</b>				
Did the external auditor raise with the audit committee issues that arose during the course of the audit; review key accounting and audit judgements; and review levels of errors identified during the audit; providing their opinion as to the materiality of unadjusted errors?				
Did the auditor adequately discuss issues of the quality of financial reporting, including the applicability of new and significant accounting principles?				
Were issues raised at the right time, with the appropriate level of audit staff, to the appropriate level of management within the entity?				
Were useful recommendations made to improve internal controls, risk management and any other issues/areas that the external auditor noted?				
Did the management letters indicate that the external auditors have a good understanding of the entity, its business model, risk management practices and the control environment?				
Were the issues and recommendations raised in previous management letters followed-up by the external auditor to establish whether appropriate action was taken to resolve these issues and whether there would be any impact on the current audit?				
<b>Quality control</b>				
Was the agreed external audit plan met, and where there were any deviations from this plan, were reasons provided for these deviations?				
<b>Independence and objectivity of the external auditor</b>				
Did the auditor communicate issues freely with the audit committee, or did the auditor seem protective of management?				
Did it appear that management exercised undue influence on the external auditor?				

## Appendix B (cont)

Evaluation of the external auditor	Yes	No	Not sure	Comments
<i>Questions for audit committee members (cont.)</i>				
Did it appear that the external auditor was reluctant or hesitant to raise issues that would reflect negatively on management?				
Did the audit committee review all audit-related and non-audit services conducted by the external auditor in the prior year. Were you satisfied that the external auditor remained independent and objective both in fact and appearance?				
Do you understand the size of the firm and its total revenues firm-wide, for the office(s) providing a substantial amount of services to the entity? Was the firm, the office or the partner dependent on the entity for a material percentage of its fee income?				
<b>Expertise, leadership and resources</b>				
Are the key members of the audit team appropriately qualified to perform and manage the audit and do they have relevant industry expertise and experience?				
Did the lead partner provide appropriate leadership and direction e.g. through ensuring that there was effective delivery against the agreed audit approach for the entity?				
Did the audit partner(s) and senior audit managers have the personal authority, knowledge and integrity to interact effectively with and robustly challenge management?				
Did the external auditor provide information, where relevant, relating to succession plans and management of rotation of the lead partner and key audit partners?				
Did the lead partner spend sufficient time on the audit, bearing in mind any major issues that arose during the audit? Similarly, did the key partners spend sufficient time on work related to the respective subsidiaries/divisions/locations?				
<i>Following are some questions the audit committee should ask different individuals in the entity to assist in evaluating the performance of the independent auditors.</i>				
<b>Head of Internal Audit</b>				
From your perspective in working with the external auditor, were you satisfied with the scope, nature, extent, and timing of testing performed by the external auditor?				



## Appendix B (cont)

Evaluation of the external auditor	Yes	No	Not sure	Comments
<i>Following are some questions the audit committee should ask different individuals in the entity to assist in evaluating the performance of the independent auditors (cont.).</i>				
Did the external auditor work with you to ensure the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources?				
Were you satisfied with the knowledge, skills, and abilities of the staff assigned to do the audit work?				
Were you satisfied with the engagement leadership assigned, including the partner(s), manager(s) and supervisors?				
Were you satisfied that the external auditor remained independent of the company in spite of any audit-related, or non-audit services the auditor provided to the entity?				
Are you aware of any other information that might impair the independence of the external audit firm?				
Are you aware of any individuals on the audit team who might not be independent with respect to the entity for whatever reason?				
If the choice were yours, would you hire the firm to conduct the next audit?				
If yes, what changes would you make?				
<b>Chief Financial Officer</b>				
From your perspective in working with the external auditor, were you satisfied with the scope, nature, extent, and timing of testing performed by the external auditor?				
Were you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work?				
Were you satisfied with the engagement leadership assigned, including the partner(s), manager(s), and supervisors?				
If the choice were yours, would you hire the firm to conduct the next audit?				
If yes, what changes would you make?				
<b>Other comments, further questions</b>				

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