Federation of European Accountants

Auditor selection

4 steps to a more effective process

SUMMARY OF A PAPER ISSUED IN 2013

HIGHLIGHTS

Companies are going to change their auditors more frequently than in the past. A good selection process is essential to enhance audit quality and ensure auditor's independence. Therefore, this paper provides a four step approach for a high-quality selection process. We previously identified these steps in our 2013 paper *Auditor selection: towards best practices*[1] which was based on a pan-European stakeholders' survey and the work of an expert task force.

This guidance will benefit 1) companies on managing the auditor selection process and 2) shareholders assessing a company's current selection process.

It can be of use to select auditors irrespective of the regulatory environment, country, market segment, or size of the company – e.g. public-interest entities (PIEs) and small- and medium-sized enterprises (SMEs). Due to the diverse legal frameworks and governance structures across Europe, the reader may also need to refer to local company law and corporate governance requirements.

HOW TO PREPARE FOR AN AUDITOR SELECTION PROCESS

Preparation is the key to success when it comes to choosing an auditor that fulfils the company's needs. There is value in investing in the project and mitigating the risks of selecting an auditor that is not fit for purpose. The following points could be taken into account in preparing the selection process:

- plan for the time required by the process
- develop a step-by-step procedure. The process should be robust and proportionate using project-management techniques
- communicate the primary objectives and the company's expectations to those invited to tender
- take an open-book approach so that the same information is available to all auditors who participate in the process
- for those invited to tender, consider the following questions:
  - should the incumbent auditor be invited to tender?
  - how many auditors are to be invited? Because of time constraints, we recommend that no more than six firms be invited to tender
  - for the short list, two would be an adequate number
- plan the transition of auditors in advance

4 STEPS TO SELECT AN AUDITOR

We recommend a step-by-step procedure to be put in place to prepare for selecting an auditor. We propose the following 4 steps in the selection process:

1. information-gathering
2. pre-screening of possible auditors
3. development of criteria to select the auditor
4. ranking of the chosen criteria

[1] *Auditor selection: towards best practices,* Federation of European Accountants, October 2013 http://www.fee.be/index.php?option=com_content&view=article&id=1365&Itemid=106&lang=en

Step 1: Information-gathering

Governance aspects of the appointment of the auditor

From a legal perspective, the auditor is formally appointed/elected by the shareholders of a company or by those charged with the entity's governance. The formal appointment is usually based on the recommendation of the board or the audit committee[2].

A different governance approach might be useful depending on the entity. For public-interest entities (PIEs) and other large entities, involving independent members of the board or the audit committee, if applicable, could be relevant for PIEs. For smaller unlisted companies it could be beneficial if directors and shareholders become more involved in the process.

Is there a role for the procurement department?

The relationship between an auditor and audited company is much more than a pure 'buyer-seller' one. The audit has historically been performed to serve shareholders. Now it is more and more about serving investors and, ultimately, the public at large.

Audit quality, as a shared commitment between all players in the financial reporting supply chain, should be in the centre of the discussion. Therefore, the decision to 'purchase' the audit service should be based on an overall assessment of all relevant criteria (see below) and not only the economic criteria. Certain corporate governance frameworks even prohibit the involvement of executives of the company in the auditor selection process.

Step 2: Pre-screening of possible auditors

Determining the needs of the company

The company's needs have to be properly defined before starting the auditor selection process. These needs can be linked to regulatory requirements, or to a need to assess the current audit approach and the service provided. The company may also reflect on whether it is the right moment for the company to initiate this process.

Independence of the auditor

A letter of representation has to be obtained. It is a letter from the potential auditor that includes information on whether the auditor is independent of the company and how the auditor monitors and maintains his/her independence. The company should review the audit-related services and non-audit services of the candidate-auditors over the past years and analyse compliance with any other independence requirements.

Step 3: Development of criteria to select the auditor

Depending on the needs and objectives defined in the previous step, the evaluation criteria may include the following:

- **approach to business and operations in general**
    - business model and governance of the audit firm

[2] For more information, see *Briefing paper - The impact of the audit reform on audit committees in Europe*, Federation of European Accountants, November 2015
http://www.fee.be/images/publications/company_law/160115_Impact_of_audit_reform_on_audit_committee.pdf

- internal processes to ensure independence and other relevant rules are correctly applied

- **audit approach**
  - description of the methodology to be used by the auditor
  - areas that will receive primary emphasis and the audit approach in such areas
  - comprehensive work plan to ensure an adequate coverage
  - business understanding
  - industry-specific experience, if applicable
  - use of its tools
  - use of associated or affiliated member firm personnel and third-party experts, if necessary
- **communication strategy**
  - additional internal status report, i.e. to outline weaknesses in internal controls
  - means put in place to ensure the timeliness of the information
  - policy regarding the availability of partners and managers for miscellaneous inquiries and short meetings throughout the year
- **reputation:** auditors need to demonstrate a good and ethical reputation. Requesting references may help in this evaluation
- **evidence of audit quality:** need to understand the auditor's system of internal quality assurance based on the auditor presentation and available documentation
- **assessment of the individual auditor/audit engagement partner:** the individual auditor/audit engagement partner(s) put forward to be in charge of the audit should be met in person. It is a good opportunity to assess whether they meet the professional expectations about the firm as anticipated in the tender documents
- **people management**
  - **qualification**
    - audit qualifications of the team members
    - involvement of experts on specific subject matters, such as tax issues, actuarial services, etc. (such involvement will enhance audit quality depending on sector specificities)
  - **training**
    - continuing professional development (CPD)
  - **experience**
    - expertise and knowledge of audit engagement partner
    - appropriate level of seniority of team members and effective contribution at the relevant level
    - informed audit team with international outreach, where necessary
    - relevant industry experience and expertise of the audit firm and/or the audit team
  - **availability**
    - availability of the engagement partner
    - staff continuity, i.e. staff turnover records from previous years
- **geographical coverage:** important for audits of multinational entities

- **insurance coverage:** the auditor should comply with what is required by local legislation or justified by the needs of the business, the sector, and the circumstances
- **pricing:** the audit contract should be awarded on the basis of the most economically advantageous offer, not the lowest price. This to ensure that the quality of the audit is not compromised

To identify the most economically advantageous offer, audit fees should be assessed against the:

  - availability of the key members of the team and the resources of the audit firm as a whole
  - personnel resources, their expertise and qualifications
  - allocation of personnel, i.e. hours to be spent allocated to each type and level of qualified resource
  - risk approach and the audit methodology – these can have a significant effect on pricing for both sides (e.g. gain in efficiency, use of experts, site visits, etc.)

- **relationship management and interpersonal skills:**
  - the auditor applying should be able to demonstrate capacity in building objective, independent, and transparent working relationships with the management team and task forces, as well as with those charged with governance
  - a good relationship and positive attitude are not indicative of a lack of independence or conflict of interest on the part of the auditor. The right balance has to be struck between professional scepticism and cooperation
- **capacity for innovation:** the auditor should be able to demonstrate his/her ability to improve the audit processes, for instance through the use of technology

Step 4: Ranking of the chosen criteria

Different criteria have to be taken into account when performing the evaluation. Some may be easy to measure (e.g. factual criteria), while others may be more subjective (e.g. soft-skill criteria).

Not all evaluation criteria are strategic for all entities. Their importance varies depending on the company, the criteria relevant to the audited entity need to be properly weighted.

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Federation of European Accountants

WHO WE ARE

The Federation of European Accountants represents 50 professional institutes of accountants and auditors from 37 European countries, with a combined membership of almost 1 million professional accountants working in different capacities. As the voice of the European profession, the Federation recognises the public interest.

The Federation is in the EU Transparency Register (No 4713568401-18).